

# **U.S. FRANCHISE REGULATION AS A PARADIGM FOR THE EUROPEAN UNION**

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## **ABSTRACT**

*The protection afforded to franchisees differs widely across the world. Nations with economically strong franchise sectors typically regulate the contract's bargaining phase and post-formation. Responding to the European Parliament's call for a review of regulations governing Europe's underperforming retail franchise sector,<sup>1</sup> we propose reforms to counter the structural and economic inequality between franchise parties. Drawing on lessons from comparatively successful federal frameworks, we present a regulatory trifecta of mandatory disclosures to prospective franchisees, required express or implied contractual obligations and rights for both franchisors and franchisees, and compulsory adherence to certain protections of franchisees throughout the franchise relationship.*

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<sup>1</sup> Report on the Functioning of Franchising in the Retail Sector, at ¶ C, INI (2016) 2244 (May 17, 2017) (explaining that while franchising represents 5.95 percent of GDP in the United States, and 10.83 percent of GDP in Australia, it represents a mere 1.89 percent of the EU's GDP).

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## INTRODUCTION

Franchising, as a concept, dates back to the thirteenth century or earlier, over four hundred years before it was first adopted as a business model.<sup>2</sup> Moreover, since the 1800s, franchising has helped to foster the entrepreneurial spirit.<sup>3</sup> Notwithstanding its longevity, regulation of the franchise business model is a fairly recent phenomenon. Many jurisdictions—including the EU and a number of its Member States—have no dedicated body of regulation to govern the rights and obligations of the parties, either in the period leading up to the signing of the franchise agreement or at any point during the life cycle of the contractual relationship.<sup>4</sup> For several reasons, the regulatory gap in EU law leaves room for potential abuse and opportunistic behavior by enterprising franchisors. This gap encourages some franchisors to engage in regulatory arbitrage by seeking out jurisdictions that offer an attractive regulatory structure in a bid to monopolize jurisdictions in the EU that offer relatively little to no

<sup>2</sup> In the United Kingdom, the Magna Carta of 1215 “enfranchised” Barons to collect taxes. See *Magna Carta, 1215*, in SOURCES OF OUR LIBERTY: DOCUMENTARY ORIGINS OF INDIVIDUAL LIBERTIES IN THE UNITED STATES CONSTITUTION AND BILL OF RIGHTS 14 (Richard L. Perry & John C. Cooper eds., rev. ed. 1978) (reprinting and contextualizing two provisions of the Magna Carta that did not allow for the ‘taxation of scutage or aid’, except by approval of the barons through the common council of the kingdom) (citing Magna Charta, 9 Hen. III, chs. 12, 14 (1225), 1 Stat. at Large (1769), confirmed 23 Edw. I, ch. I (1297)); Robert W. Emerson & John W. Hardwicke, *The Use and Disuse of the Magna Carta: Due Process, Juries, and Punishment*, 46 N.C.J. INT'L L. 571, 599 & 599 n.156 (2021) (discussing how the Magna Carta came to England’s American colonies as part of the common law; “[m]any colonial charters in the early 1600s promised the ‘liberties, franchises, and immunities’ of an Englishman”). Similarly, the “Tied House” system, an early form of franchising, developed in the United Kingdom in the 1700’s, to ensure the distribution of beers by brewers. MARK ABELL, THE LAW AND REGULATION OF FRANCHISING IN THE EU 12 (2013).

From the 1600s onwards, the *Norenkai* system of restaurant chains were in use in Japan. Under the Japanese-based *Norenkai* system, an employer would permit an employee to create a restaurant in a different location using the same name and same menu as their employer. *Id.* at 14 n.2.

<sup>3</sup> *Franchising 101: How Franchising Began*, POINT FRANCHISE (Apr. 17, 2020, 5:05 PM), <https://www.pointfranchise.co.uk/articles/the-history-of-franchising-3061/>. But see William L. Killion, *The History of Franchising*, in FRANCHISING: CASES, MATERIALS, & PROBLEMS 1, 24 (Alexander M. Meiklejohn ed., 2013) (noting that it was not until the 1970s that franchising “became a highly regulated method of doing business”).

<sup>4</sup> In the 1970s, the U.S. legislature first introduced federal regulation in an attempt to govern franchise relationships. FED. TRADE COMM’N, *FTC’s Beales Testifies on the Commission’s Enforcement of the Franchise Rule* (June 25, 2002), <https://www.ftc.gov/news-events/press-releases/2002/06/ftcs-beales-testifies-commissions-enforcement-franchise-rule>; see 16 C.F.R. § 436.2 (2007) (requiring franchisors to make certain disclosures to a franchisee, in Franchise Disclosure Documents, prior to the sale of a franchise); accord Mark Siebert, *The Rules and Regulations of Being a Franchisor*, ENTREPRENEUR (Dec. 2, 2015), <https://www.entrepreneur.com/article/252590> (discussing how some of the disclosures included in the Franchise Disclosure Documents serve as a form of regulation of both the franchise agreements and the franchise relationship); 16 C.F.R. § 436.5 (2020) (detailing the disclosure items).

regulation.<sup>5</sup>

First, the dynamic of the franchisee's dependence on the franchisor creates a power imbalance which requires the prospective franchisee to rely on the franchisor for full disclosure of pertinent information during the bargaining phase.<sup>6</sup> This relationship is borne out of the franchisor's commercial expertise and its direct, hands-on, ongoing, and incremental operational experience of the franchise in the marketplace. The franchisee's dependence on the franchisor extends throughout the contract's lifespan, as the franchisee relies on the franchisor for training and, most importantly, for technical and business support to ensure the commercial success of the franchise operation.<sup>7</sup>

Second, franchisors often have a significant economic advantage in relation to prospective franchisees. Some franchisors require a minimum net worth for franchisees which can range from \$100,000 to over \$300,000 in U.S. dollars.<sup>8</sup> The three largest, publicly traded European franchisors, conversely, have an average market capitalization equivalent to 1.131 trillion U.S. dollars.<sup>9</sup>

Third, the parties typically have unequal bargaining power both during the negotiation stage and throughout the duration of the contract.<sup>10</sup> In the

<sup>5</sup> Mark Abell, Eur. Parl. Comm. on Internal Mkt. & Consumer Prot., *Legal Perspective of the Regulatory Framework and Challenges for Franchising in the EU*, at 13 (Sept. 2016), [https://www.europarl.europa.eu/RegData/etudes/STUD/2016/587317/IPOL\\_STU\(2016\)587317\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2016/587317/IPOL_STU(2016)587317_EN.pdf) (noting self-regulation of franchising in the European Union does not work due to a clear, consistent, and effective approach to enforcement).

<sup>6</sup> See 16 C.F.R. § 436.2 (articulating the disclosure requirement); see also Norma D. Bishara & Cindy A. Schipani, *A Corporate Governance Perspective on the Franchisor–Franchisee Relationship*, 19 STAN. J. L. BUS. & FIN. 303, 326–27 (2014) (discussing the franchise relationship as one built on trust and the material disclosure requirements).

<sup>7</sup> Sean Obermeyer, *Resolving the Catch 22: Franchisor Vicarious Liability for Employee Sexual Harassment Claims Against Franchisees*, 40 IND. L. REV. 611, 617 (2007) (explaining the various ways franchisees are dependent on franchisors throughout the contract life cycle).

<sup>8</sup> Bill Bradley, *Net Worth Requirements and Franchise Opportunities*, AM.'S BEST FRANCHISES (Jan. 31, 2013), <https://americasbestfranchises.com/blog/net-worth-requirements-and-franchise-opportunities/>.

<sup>9</sup> See *Top 500 European Franchises – Ranking*, FRANCHISE EUR. (May 2020), <https://www.franchiseeurope.com/top-500/> (noting that the three largest publicly-traded European franchises are 7-Eleven (60,000 units), Subway (44,819 units), and McDonald's (36,500 units)).

<sup>10</sup> Unequal bargaining power can originate in different places, including unequal economic right. ROBERT M. GRANT, CONTEMPORARY STRATEGY ANALYSIS: TEXT AND CASES 265 (10th ed. 2019) (“How risk is shared is dependent partly on bargaining power and partly on efficiency considerations. In franchise agreements, the franchisee (as the weaker partner) bears most of the risk—it is the franchisee’s capital that is at risk and the franchisee pays the franchiser.”). Just as unequal bargaining power can come from economic might, unequal bargaining power can increase the franchisor’s bargaining power by taking steps towards tapered integration and franchisee selection. Steven C.

United States, many states have adopted some form of legislation to help protect franchisees. Among the laws passed are numerous acts attempting to create more equal bargaining power between franchisees and franchisors during the negotiation phase and the life of the franchise agreement.<sup>11</sup>

In this article, we first look at the call made by the European Parliament for reform of regulation governing franchises (“franchise regulation”). After considering the justifications underpinning franchise regulation, we proceed to look at the binary legal framework that has emerged in the United States to ensure the protection of franchisees and would-be franchisees. Finally, we critically review the solutions proposed by the European Parliament and provide our own recommendations for reform of EU franchise regulation.

#### PART I: THE EUROPEAN PARLIAMENT CALLS FOR REFORM OF EU FRANCHISE REGULATION

Some parts of the EU and UK have functioning systems of franchises without complex regulatory regimes in place. Indeed, the UK does not have specific legislation dealing with franchises.<sup>12</sup> In contrast, France has, effectively, franchise regulation and an extensive history of franchising,<sup>13</sup> and it functions with only two sections of the Commercial Code dedicated to the business model.<sup>14</sup> The methods used by France and the UK, however,

Michael, *Investments to Create Bargaining Power: The Case of Franchising*, 21 STRATEGIC MGMT. J. 497, 497–502, 508–10 (2000).

<sup>11</sup> Robert W. Emerson & Jason R. Parnell, *Franchise Hostages: Fast Food, God and Politics*, 19 J.L. & POL. 353, 374 (2014); see George F. Carpinello, *Testing the Limits of Choice of Law Clauses: Franchise Contracts as a Case Study*, 74 MARQ. L. REV. 57, 70 (1990) (stating unequal bargaining power held by franchisors over franchisees have led to laws, such as the Automobile Dealer Franchise Act, which require a franchisor “to act in good faith in the performance of the agreement, or in the termination, or refusal to renew the agreement.”). Benjamin A. Levin & David G. Gunther, *New Jersey*, in *FRANCHISE DESKBOOK: SELECTED STATE LAWS, COMMENTARY, AND ANNOTATIONS* 501, 504 (Michael W. Garner ed., 3d ed. 2019) (noting one of the first statutes to address the unequal bargaining power between franchisees and franchisors was the New Jersey Franchise Practices Act in 1971).

<sup>12</sup> Iain Bowler, *England & Wales: Franchise 2020*, ICLG (Oct. 21, 2019), <https://iclg.com/practice-areas/franchise-laws-and-regulations/england-and-wales> (noting that general English contract law, intellectual property, real estate, and competition law apply to franchising instead).

<sup>13</sup> France’s Loi Doublin, Code de commerce [C. com.] [Commercial Code] art. L.330-3 (Fr.), “relates to all forms of commercial arrangements whose contracts contain exclusivity clauses [and] therefore, details requirements that apply to franchisors as well as other licensors.” Robert W. Emerson, *An International Model for Vicarious Liability in Franchising*, 50 VAND. J. TRANSNAT'L L. 245, 274 (2017); National Regulation by Country, EUR. FRANCHISE FED’N, at tbl.1 (Nov. 28, 2018), <https://www.unidroit.org/guide-franchise-2nd-national-info/131-instruments/franchising/guide/guide-2edition/national-information-2nd-franchise/country/299-france-legislation-and-regulations-relevant-to-franchising>; 8 ODAVIA BUENO DIAZ, *FRANCHISING IN EUROPEAN CONTRACT LAW* 33 (2008) (highlighting that the first franchise network in France became operational in 1930).

<sup>14</sup> Cecile Peskine & Clémence Casanova, *France: Franchise 2020*, ICLG (Oct. 21, 2019), <https://iclg.com/practice-areas/franchise-laws-and-regulations/france>.

do not work for everyone as has been shown in the current systems of many Member States.<sup>15</sup> Many parts of Europe do not have laws dedicated to franchises, which has led to underperformance, among other issues. Based on these problems, we propose a less laissez-faire approach that models the more effective U.S. system.

In September 2007, as a result of the underperformance of the EU franchise sector relative to the United States and Australia, the European Parliament (“EP”) passed a Motion calling upon the European Commission to open a public consultation to gather information on the “real situation in franchising.”<sup>16</sup> The information was to be used to draft non-legislative guidelines to improve the state of the EU franchising sector.<sup>17</sup> In response, the European Franchise Federation (“EFF”) published the EFF European Code of Ethics for Franchising in December 2016.<sup>18</sup>

Due to the underutilization of the franchising model in the EU when compared with the United States and Australia, the Motion aims to find ways to increase the use of franchising as a business model throughout the entire EU retail sector.<sup>19</sup> While franchising represents 5.95 percent of GDP in the United States and 10.83 percent of GDP in Australia, it represents a mere 1.89 percent of the EU’s GDP,<sup>20</sup> with the bulk of the turnover (83.5 percent) generated by the franchise sector coming from only seven Member

<sup>15</sup> Javier Fernandez-Laquette Quintana & Alberto Lopez Cazalilla, *Franchising in the European Union*, LEXOLOGY (June 25, 2019) (noting that with the absence of an EU regulation on franchising, technical barriers for trade and growth are generated as a result). Abell, *supra* note 5, at 9 (underscoring the lackluster effort by the European Union to facilitate uniformity in its Member States’ franchise regulation).

<sup>16</sup> Report on the Functioning of Franchising in the Retail Sector, *supra* note 1, ¶ 26; see Aneta Wiewiórowska-Domagalska, Eur. Parl. Comm. on Internal Mkt. & Consumer Prot., *Franchising*, at 13 (Apr. 2015), [http://www.europarl.europa.eu/RegData/etudes/STUD/2016/578978/IPOL\\_STU\(2016\)578978\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2016/578978/IPOL_STU(2016)578978_EN.pdf) (stating “public consultation of hard law solutions is biased (the franchisors present their view, whereas the franchisees present no view”).

<sup>17</sup> Report on the Functioning of Franchising in the Retail Sector, *supra* note 1, ¶ 26.

<sup>18</sup> EUR. CODE OF ETHICS FOR FRANCHISING pmbl. (EUR. FRANCHISE FED’N 2016) (A “practical ensemble of essential provisions for the governance of the relations between a franchisor and each of its franchisees . . . [t]he overarching principles of ethics that underline this set of provisions are good faith and fair dealings . . . transparency and loyalty.”). Notably, it took nine years for the Code to be updated; and some argue that, while competing interests between parties held back the revision, the update finally arrived in order to alleviate both the fear of heavier regulation at the continental level and the pressing industry concerns. Nicola Broadhurst, *Changes to the European Code of Ethics*, STEVENS & BOLTON (May 15, 2017), <https://www.stevens-bolton.com/site/insights/articles/changes-to-the-european-code-of-ethics-for-franchising>.

<sup>19</sup> Report on the Functioning of Franchising in the Retail Sector, *supra* note 1, ¶ C.

<sup>20</sup> *Id.*

States.<sup>21</sup>

The franchising sector makes a significant contribution to the GDP of a select number of Member States. Approximately 9,971 franchise networks operate in the EU, with nearly 405,000 outlets scattered across the EU, generating a turnover of almost €215 billion (\$300 billion).<sup>22</sup> With the withdrawal of the UK from the EU, the gross turnover generated by this sector is likely to drop, widening the chasm even further.<sup>23</sup> The turnover of the franchise sector in the UK amounts to 7.48 percent of the overall turnover for the franchise sector in the EU.<sup>24</sup>

Franchising is a business model with a significant cross-border dimension,<sup>25</sup> able to enhance cross-border activity and competition within a Single Market for the retail sector of Member States. The EU's Single Market eliminates barriers and other regulatory obstacles that can stand in the way of the movement of goods and services.<sup>26</sup> The Single Market system is designed to encourage competition and trade, improve efficiency, raise the quality of goods and services, and help decrease prices.<sup>27</sup> This system has helped EU economic growth and improved the lives of European business owners and consumers.<sup>28</sup> Further, it spurs business development by permitting venture through shared investment in a franchise agreement. This in turn leads to<sup>29</sup> job creation, SME<sup>30</sup> and entrepreneurship development, and the acquisition of new skills.<sup>31</sup> There are many advantages of opening up a franchise, such as access to capital, motivated management, speed of growth, staffing leverage, ease of supervision, increased profitability, improved valuations, penetration of secondary and tertiary markets, and reduced risk.<sup>32</sup>

<sup>21</sup> *Id.*

<sup>22</sup> Abell, *supra* note 5, at 11 (citing LAW AND REGULATION OF FRANCHISING, *supra* note 2, at 26).

<sup>23</sup> Since the UK accounts for \$18.7 Billion out of the EU's total franchising turnover of \$250 Billion, should the UK withdraw from the EU, the gap between the EU on the one hand, and the United States and Australia on the other hand will become even more stark. *Id.* at 12.

<sup>24</sup> Franchising in the UK accounted for \$18.7 billion of the total franchising turnover of the EU in 2016. Abell, *supra* note 5, at 12.

<sup>25</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ D.

<sup>26</sup> *The European Single Market*, EUR. COMM'N, [https://ec.europa.eu/growth/single-market\\_en](https://ec.europa.eu/growth/single-market_en) (last visited June 18, 2021).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ C.

<sup>30</sup> The SME label refers to micro, small, and medium-sized enterprises and is determined by "staff headcount and financial ceiling criterion." Commission Recommendation of 6 May 2003 Concerning the Definition of Micro, Small and Medium-Sized Enterprises, art. 2, 2003 O.J. (L 124) 39.

<sup>31</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ D.

<sup>32</sup> Mark Siebert, *The 9 Advantages of Franchises*, ENTREPRENEUR (Dec. 4, 2015),

In order to lay the groundwork for reform, the EP flags certain key causes for the relative underperformance of the sector in the EU.<sup>33</sup> Among the key inhibiting factors flagged by the EP are the variations in both the existing franchise legislation in Member States<sup>34</sup> and measures against unfair trading practices.<sup>35</sup>

The EP suggests that these variations in legislation create technical barriers that often discourage franchisees and franchisors from expanding operations across borders. This in turn undermines cross-border activity within the EU, which impedes the functioning of the Single Market and limits consumer choice within the EU.<sup>36</sup>

In a union of twenty-seven Member States (after the UK's withdrawal), only six countries have franchise-specific national regulation.<sup>37</sup> Much of the franchise legislation introduced on a national level protects the interests of prospective franchisees by focusing on the pre-contractual disclosure by the franchisor, without the enactment of enforcement provisions ensuring the continuation of the franchise relationship.<sup>38</sup> Such regulation focuses on disclosure laws which are intended to reduce risk for franchisees by ensuring that key information relating to the franchise operation and the franchisor is disclosed to the prospective franchisee prior to the signing of the franchise contract.<sup>39</sup> These disclosure laws aim to reduce long-term risks to which franchisees are exposed during the course of the franchise relationship by insisting that franchisors provide prospective franchisees with a detailed and comprehensive account of information deemed crucial to the decision-making process.<sup>40</sup> By ensuring this information is provided

<https://www.entrepreneur.com/article/252591>. Franchisors such as TCBY, a frozen yogurt store chain based in Little Rock, Arkansas, have successfully utilized the franchising model to penetrate alternative venues such as universities and hospitals in order to reach new markets. ANDREW J. SHERMAN, FRANCHISING & LICENSING: TWO POWERFUL WAYS TO GROW YOUR BUSINESS IN ANY ECONOMY 19 (3rd ed. 2004). Opening a franchise can also reduce business risks. *Id.* at 12–13 (“[R]isk of failure of the franchisor is further reduced by the improvement in competitive position, reduced vulnerability to cyclical fluctuations, the existence of a captive market for the franchisor’s proprietary products and services . . . and the reduced administrative and overhead costs enjoyed by a franchisor.”).

<sup>33</sup> These are enumerated in Abell, *supra* note 5, at 13 (summarizing key findings relating to why franchising is not achieving its full potential in the EU), and in the Resolution of the European Parliament released in 2017.

<sup>34</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ E.

<sup>35</sup> *Id.* ¶ 2.

<sup>36</sup> *Id.* ¶ E.

<sup>37</sup> Abell, *supra* note 5, at 13.

<sup>38</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ 5.

<sup>39</sup> *Id.* ¶ 14.

<sup>40</sup> More robust disclosures are associated with higher survival rates. Robert W. Emerson & Lawrence J. Trautman, *Lessons About Franchise Risk from Yum Brands and Schlotzsky’s*, 24 LEWIS &

to franchisees with adequate time before the conclusion of the franchise agreement, the laws allow franchisees to assess the adequacy of the business format and the support infrastructure before entering into the franchise.<sup>41</sup>

The present system of self-regulation used in various Member States lacks transparency and consistent enforcement, and heavily favors franchisors.<sup>42</sup> This, coupled with the lack of uniformity among the national franchise laws, has a dampening effect on the efforts of franchisors looking to roll out across the Single Market and creates barriers to cross-border activity.<sup>43</sup>

The focus on the macro-economic concerns in EU regulation has resulted in a failure to appreciate the contribution of franchising to the Single Market.<sup>44</sup> This undermines the ability of franchisors or SMEs to expand across the EU, while dampening the entrepreneurial plans and activities of individual franchisees in the EU.<sup>45</sup> It also dampens inward investment in the EU from non-EU players, notably franchisors looking for external investment and resources to expand their operations.<sup>46</sup> Though variance among the EU nations in social structures and economic power certainly undermines EU-wide substantive legislation, efforts have been undertaken to develop consistent franchise regulation and ethics codes across Member States. Given these limitations, the focus has been and should be elaborate, comprehensive disclosure uniformity with only very basic laws on franchise agreements or relationships post-contract.

Although European Member States have typically self-regulated, efforts have been undertaken pursuant to the EP's call to remedy the issues facing

CLARK L. REV. 995, 998 (2020).

<sup>41</sup> Abell, *supra* note 5, at 14.

<sup>42</sup> *Id.*; see also *The Benefits of Franchising Overseas – A Country-By-Country Overview*, HARPER JAMES SOLS. (Aug. 1, 2016), <https://hjsolicitors.co.uk/article/benefits-franchising-overseas/> (noting there are no EU Member States that have a law that meet all the criteria for a good form of regulation: transparency, proportionality, consistency, and accountability).

<sup>43</sup> Abell, *supra* note 5, at 6, 21.

<sup>44</sup> *Id.* at 6.

<sup>45</sup> *Id.*

<sup>46</sup> The resource scarcity theory, as applied to franchising, finds that new franchisors lack the requisite investment capital and the crucial information about local conditions to thrive in a given area, both in terms of industry and geography; that motivates franchisors to reach potential franchisees. Alfred R. Oxenfeldt & Anthony O. Kelly, *Will Successful Franchise Systems ultimately become Wholly Owned Chains?*, 44 J. RETAILING 69 (1968); Alfred R. Oxenfeldt & Donald N. Thompson, *Franchising in Perspective*, 44 J. RETAILING 3–13 (1968); Richard E. Caves & William F. Murphy II, *Franchising: Firms, Markets and Intangible Assets*, 42 S. ECON. J. 572–86 (1976); James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401–20 (1987); Lin Shih-Chuan & Yoo Ri Kim, *Diversification Strategies and Failure Rates in the Texas Lodging Industry: Franchised Versus Company-Operated Hotels*, 88 INT'L J. HOSP. MGMT. 102525 (2020).

the franchising regulatory environment.<sup>47</sup> Among these efforts have been those led by collaborative bodies proposing or promulgating standards which may serve as models for European Member States to enact franchise-specific legislation. Most notable among these entities is the International Institute for the Unification of Private Law (“UNIDROIT”), which has member countries spanning the six, inhabited continents.<sup>48</sup>

UNIDROIT is an intergovernmental organization which promulgates nonbinding principles and rules that are instituted based on a country’s willingness to adopt the principles and rules.<sup>49</sup> Notably, “the Governing Council of UNIDROIT established the Study Group on Franchising, which ultimately produced two documents: the *Model Franchise Disclosure Law*, submitted to the Governing Council on September 25, 2002, and the *Guide to International Master Franchise Arrangements*, initially published in February 1998 and republished in 2007.”<sup>50</sup>

UNIDROIT’s Guide to International Master Franchise Arrangements (the “Guide”) looks at the structure of franchise agreements, including negotiations, drafting, and legal effects of the agreement.<sup>51</sup> A comparative analysis of recently adopted franchise-specific legislation revealed that, except for the Russian Civil Code, every country’s disclosure requirements reflect UNIDROIT’s Guide in some way.<sup>52</sup> Additionally, most national franchise laws require the same type of information as the UNIDROIT recommends.<sup>53</sup> The Guide also reveals the countries’ considerable variance in disclosure law.<sup>54</sup>

Much of the international expansion achieved by U.S. franchisors is accomplished by a robust business format called master franchising.<sup>55</sup> In

<sup>47</sup> For example, Member States such as France, Italy, Romania, Spain, and Sweden each have provisions regarding pre-contractual disclosure of information. See Quintana & Cazalilla, *supra* note 15.

<sup>48</sup> *Membership*, UNIDROIT (June 4, 2021), <https://www.unidroit.org/about-unidroit/membership> (identifying the sixty-three member states, including the United States, that constitute UNIDROIT).

<sup>49</sup> Emerson, *supra* note 13, at 260.

<sup>50</sup> *Id.* at 261.

<sup>51</sup> INT’L INST. FOR THE UNIFICATION OF PRIV. L., GUIDE TO INTERNATIONAL MASTER FRANCHISE AGREEMENTS 34–50 (2d ed. 2007) [hereinafter MASTER FRANCHISE GUIDE].

<sup>52</sup> Emerson, *supra* note 13, at 271.

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> Eddy Goldberg, *Master Franchising: Entering the Game at a Higher Level*, FRANCHISING.COM (Dec. 2019), [https://www.franchising.com/guides/master\\_franchising\\_entering\\_the\\_game\\_at\\_a\\_higher\\_level.html](https://www.franchising.com/guides/master_franchising_entering_the_game_at_a_higher_level.html) (“For U.S. franchise companies, master franchising is most commonly used for international expansion, although it is also used domestically, most commonly by commercial real estate service and maintenance companies to develop territories in major U.S. cities.”).

master franchising, the franchisor “grants the master franchisee (also called a sub-franchisor) the right to franchise to individual unit franchisees.”<sup>56</sup> The master franchisee thus often acts like a franchisor in a foreign country and pays the franchisor for this right.<sup>57</sup> The franchisor provides this master franchisee the franchisor’s business model and training, while the master franchisee provides the capital and human resources to grow the franchise.<sup>58</sup>

In this type of arrangement, there are two agreements: an international agreement between the franchisor and sub-franchisor, and a domestic franchise agreement between the sub-franchisor and sub-franchisee.<sup>59</sup> This type of relationship has advantages and disadvantages for the parties. One advantage is the franchisor’s ability to expand the network without the financial cost of setting up the franchise location.<sup>60</sup> The three areas where franchisors have mainly shown dissatisfaction with master franchising are “limited control of the franchisor over the franchise network, the problems associated with the terminating of the master franchise agreement, and the sharing of income derived from fees.”<sup>61</sup> Other forms of franchising internationally are “bare bones” license agreements, scaled-down versions of master franchise agreements, hybrid franchise/license agreements, and joint ventures.<sup>62</sup>

The 2002 Model Franchise Disclosure Law requires the franchisor to disclose to a prospective franchisee detailed information regarding various qualities of the potential franchisor, but this law “only addresses disclosure issues and excludes the relationship of the parties at the international level.”<sup>63</sup> When countries impose franchise-specific legislation, the regulations most often involve disclosure rules but do not address the regulation of the relationship between the parties.<sup>64</sup> A majority of legislatures favor limiting regulation to pre-contractual disclosures and not including post-formation relationships: this is because of the difficulties in

<sup>56</sup> Emerson, *supra* note 13, at 262.

<sup>57</sup> INT’L INST. FOR THE UNIFICATION OF PRIV. L., UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS 166–69 (2016).

<sup>58</sup> Emerson, *supra* note 13, at 262.

<sup>59</sup> *Id.*

<sup>60</sup> MASTER FRANCHISE GUIDE, *supra* note 51, at 4–5.

<sup>61</sup> *Id.* at 5.

<sup>62</sup> *Id.* at 11–13.

<sup>63</sup> Emerson, *supra* note 13, at 263–64. The Model Law applies to domestic and international franchising, and to different types of franchise agreements. MASTER FRANCHISE GUIDE, *supra* note 51, at 305. The Model Law has 10 articles and a Preamble, which deals with scope of application, definitions, delivery of disclosure documents, format of disclosure document, exemptions for disclosure, information that must be disclosed, acknowledgement of disclosure document, remedies, temporal scope of law, and waivers. *Id.*

<sup>64</sup> Emerson, *supra* note 13, at 270; see also MASTER FRANCHISE GUIDE, *supra* note 51, at 281.

establishing uniform regulations applicable to post-formation relationships.<sup>65</sup> While the legislatures want to limit the laws, there is a consensus that disclosures are critical.<sup>66</sup>

Annex Three of the *Guide to International Master Franchise Agreements* (“Annex Three”) states that the degree and detail of information to be disclosed varies from country to country, but the disclosure laws “will require the franchisors to provide prospective franchisee with information on a number of points that will enable the franchisee to make an informed decision on whether or not to enter into the agreement.”<sup>67</sup> This idea is linked to the duty of good faith and fair dealing.<sup>68</sup>

Annex Three suggests that the following should be disclosed to a potential franchisee: “the franchisor and the directors of the enterprise; the history of the enterprise; the legal constitution of the enterprise; the intellectual property concerned; the financial situation, with audited financial statements for the two or three preceding years; the other franchisees in the network; information on the franchise agreement, such as the duration of the agreement, conditions of renewal, termination and assignment of the agreement; as well as information on any exclusivities.”<sup>69</sup> Likewise, while disclosure from them is not as likely to be officially required, prospective sub-franchisors and franchisees also have a duty to disclose that relevant information.<sup>70</sup> This disclosure allows a franchisor to make an informed decision as to whether the prospective sub-franchisor or franchisee meets the requirements to join the network.<sup>71</sup>

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<sup>65</sup> MASTER FRANCHISE GUIDE, *supra* note 51, at 304–05.

<sup>66</sup> *Id.*

<sup>67</sup> MASTER FRANCHISE GUIDE, *supra* note 51, at 281; *see also* Emerson, *supra* note 13, at 270–71.

<sup>68</sup> MASTER FRANCHISE GUIDE, *supra* note 51, at 24.

<sup>69</sup> *Id.* at 281; *see also* Emerson, *supra* note 13, at 271 n.181.

<sup>70</sup> MASTER FRANCHISE GUIDE, *supra* note 51, at 281.

<sup>71</sup> *Id.* at 281–82.

## PART II: JUSTIFICATIONS FOR FRANCHISE REGULATION

To understand the justifications underscoring regulation in the context of franchising, it is first necessary to develop a working definition of the term “regulation.”<sup>72</sup> “Regulation” has multiple definitions.<sup>73</sup> For our purposes, we propose a working definition of “regulation” broad enough to encompass the various forms of regulation typically associated with franchise relationships. One such definition is provided by Professor Julia Black, who defines regulation as “sustained and focused attempts to change the behavior of others in order to address a collective problem or attain an identified end or ends, usually through a combination of rules or norms and some means for their implementation and enforcement.”<sup>74</sup>

The multifaceted approach of this definition in the context of franchise regulation makes it appealing for two major reasons. First, this definition encompasses the acts of different types of actors (national, regional and international), which reflects the reality in (1) the United States, where franchise regulation has been introduced at both the federal and state levels, and (2) the EU, where regional law sits side-by-side with national law, informing the latter (in specific areas that fall within the competence of the EU). Second, the multifaceted approach includes interventions which are sustained, focused, and intended to change the behavior of others. Franchise regulation in the United States has emerged through a sustained and focused process of intervention. The earliest body of regulation was introduced in California,<sup>75</sup> followed later that decade by a federal counterpart: the FTC

<sup>72</sup> Julia Black, *Critical Reflections on Regulation*, 27 AUSTL. J. LEGAL PHIL. 1, 1 (2002).

<sup>73</sup> The conceptualization of “regulation often depends on the problem or issue that the writer is focusing on.” *Id.* at 13. The question of the term’s meaning is “still on the table” with some scholars agreeing to disagree. Christel Koop & Martin Lodge, *What is Regulation? An Interdisciplinary Concept Analysis*, 11 REGUL. & GOVERNANCE 95, 108 (2017). Black speaks of “regulation” as an ever-expanding concept which she classifies into five categories, namely: “what is assumed ‘regulation,’ who or what is performing it, what institutional or organisational form the regulation is assumed to take; with respect to what actors or areas of social life is it occurring, and how regulation is conducted, through what mechanisms, instruments, techniques.” Black, *supra* note 72, at 15–16. Robert Baldwin, Colin Scott, and Christopher Hood suggest three main conceptions of regulation: 1) regulation as “the promulgation of an authoritative set of rules, accompanied by some mechanism . . . for monitoring and promoting compliance with these rules”; 2) regulation as “all the efforts of state agencies to steer the economy”; and 3) regulation as “all mechanisms of social control – including unintentional and non-state processes.” A READER ON REGULATION 3–4 (Robert Baldwin, Colin Scott & Christopher Hood eds., 1998).

<sup>74</sup> Julia Black, *Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes*, 2 REGUL. & GOVERNANCE 137, 139 (2008).

<sup>75</sup> For these reasons, the California legislature adopted the California Franchise Investment Law (“CFIL”) in 1970. *About the Franchise Investment Law*, CAL. DEP’T FIN. PROT. & INNOVATION, <https://dfpi.ca.gov/about-the-franchise-investment-law/> (last updated Feb. 7, 2020).

Rule.<sup>76</sup> This binary system—coupling both federal and state regulation—provides dual protection through pre-sale disclosure rules, which are implemented at the federal level<sup>77</sup> and supplemented (in some states) by state regulation requiring registration,<sup>78</sup> the incorporation of certain mandatory protections,<sup>79</sup> and the provision of a system of remedies.<sup>80</sup>

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<sup>76</sup> 16 C.F.R. §§ 436, 437 (2007).

<sup>77</sup> Promulgated by the Federal Trade Commission, the FTC Rule is entitled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures,” 16 C.F.R. § 436 (2007).

<sup>78</sup> California provides the earliest, best example of franchise regulation at the state level. The California Franchise Investment Law (“CFIL”), CAL. CORP. CODE § 31000 (West 2020), supplements the obligation to provide the *Franchise Disclosure Document* (“FDD”—the pre-sale disclosure document mandated by the FTC Rule, 16 C.F.R. §§ 436.2, 436.3 (2007)—to the prospective franchisee. The CFIL imposes mandatory provisions regulating the sale of the franchise, fraudulent and prohibited practices, and enforcement (Parts 2, 3 and 4 of the CAL. CORP. CODE, respectively). Franchisors are required to register with the State (through the California Department of Business Oversight) before offering and selling franchises in California, making it unlawful for any person to offer or sell any franchise in the State of California without the offer of the franchise being registered pursuant to the CFIL. CAL. CORP. CODE § 31110 (West 2020). This registration must be accompanied by the proposed FDD. *Id.* § 31114 (West 2014).

<sup>79</sup> Beyond the obligation to provide prospective franchisees with the FDD and a copy of all proposed agreements relating to the sale of the franchise at least fourteen days prior to either the sale (“the execution by the prospective franchisee of any binding franchise [agreement]”) or payment of consideration to the franchisor (“the receipt of any consideration”) whichever occurs first, there are other obligations a Franchisor must meet. CAL. CORP. CODE § 31119(a) (West 2005). Franchisors offering franchises for sale in California must keep and maintain a complete set of books, records and accounts for these sales. *Id.* § 31150 (West 2020). Any attempts by a franchisor to “restrict or inhibit the right of franchisees to join a trade association or to prohibit the right of free association among franchisees for any lawful purposes” are prohibited. *Id.* § 31220. California is one of several states that adopted a franchise relationship law. See Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. L. 289, 289 (1989) (noting that these laws were adopted “to correct a perceived inequality in bargaining power, and thereby to protect franchisees against perceived abuses by franchisors”). Subject to very narrow grounds justifying early termination, detailed in CAL. BUS. & PROF. CODE § 20021 (West 2016), California limits the ability of franchisors to terminate the franchise without “good cause” (pursuant to *id.* § 20020) or to prevent various modifications to the agreement. See *id.* §§ 20025–26 (West 2020) (preventing a franchisee from renewing franchise agreements); see also CAL. BUS. & PROF. CODE §§ 20028(a), 20029(b)(1) (West 2016) (preventing a franchisee from transferring a franchise to another person).

<sup>80</sup> Private remedies are available to aggrieved franchisees when the franchisor has violated certain of its obligations. For example, “[a]ny person offering or selling a franchise in violation of § 31101 [disclosure obligation], §31110 [registration obligation], § 31119 [obligation to provide relevant documentation at least 14 days prior to the sale or payment], § 31200 or § 31202 [obligation not to engage in fraudulent behavior when filing official documents or communicating information to the prospective franchisee, respectively] . . . shall be *liable* to the franchisee who may sue for *damages* caused thereby, and if the violation is *wilful*, the franchisee may also sue for *rescission*.” CAL. CORP. CODE § 31300 (West 2005) (emphasis added). In contrast, *criminal liability* will be imposed when any person is either engaged in *fraudulent practices or prohibited practices*. Fraudulent practices, in general, are defined as “any untrue statement of material fact in any application, notice or report filed with the [Commission] . . . or willfully to omit to state in any such application, notice, or report any material fact which is required to be stated therein, or fail to notify the [Commission] of any material change as required by § 31123.” *Id.* § 31200 (West 2020); see *id.* §§ 31201–04 (defining and elaborating on types

Support for franchise regulation is aimed at changing the behavior of others, redressing the imbalance of power, and protecting those deemed deserving of it (franchisees and would-be franchisees) while also correcting market failures. In this context, advocates for franchise regulation speak of multiple needs: (1) to correct the inequality in bargaining power,<sup>81</sup> (2) to counter opportunism and abuse by enterprising franchisors;<sup>82</sup> (3) to address the problems of dependency<sup>83</sup> and regulatory arbitrage;<sup>84</sup> (4) to address informational asymmetry; and (5) to counter incomplete contracts and unconscionable and adhesive contracts.<sup>85</sup> While there is some evidence that a dual-regulatory scheme provides greater franchisee protection, there is no evidence that the federal Franchise Rule performs worse in states that regulate franchise sales.<sup>86</sup> In fact, a federal preemption system need not remove the states from an important regulatory role and actually provides uniform remedies for franchisees regardless of where they operate.<sup>87</sup>

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of fraudulent practices); *id.* §§ 31210–11 (defining and elaborating on types of prohibited practices). Indeed, it is “unlawful for any person to effect or attempt to effect a sale of a franchise, except in transactions exempted under Chapter 1 (commencing with § 31100) of Part 2, unless such person is: (1) identified in an application . . . filed with the [Commission] pursuant to Part 2 (commencing with § 31100).” *Id.* § 31210 (West 2017). Further, if “in the opinion of the [Commission] any person is acting in violation of § 31210, [it] may order that such a person desist and refrain from further activity.” *Id.* § 31211 (West 2020).

<sup>81</sup> Robert W. Emerson, *Franchise Terminations: “Good Cause” Decoded*, 51 WAKE FOREST L. REV. 103, 107 (2016) (stating the public policy rationale behind states creating franchise laws “is to balance the unequal bargaining power between franchisors and franchisees”).

<sup>82</sup> Andrew Terry, Cary Di Lernia & Rozenn Perrigot, *The Obligation of Good Faith and its Role in Franchise Regulation*, in HANDBOOK OF RESEARCH ON FRANCHISING 171 (Frank Hoy, Rozenn Perrigot & Andrew Terry eds., 2017) (noting the independent nature of franchise relationships leaves franchisors vulnerable to opportunistic conduct like “encroachment, kickbacks, churning, non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement”); Terry et al., *supra*, at 171.

<sup>83</sup> See generally Mark Abell, *The Regulation of Franchising Around the World*, in THE FRANCHISE LAW REVIEW (Mark Abell ed., 7th ed. 2020).

<sup>84</sup> Hossein Nabilou, *Regulatory Arbitrage and Hedge Fund Regulation: The Need for a Transnational Response*, 22 FORDHAM J. CORP. FIN. L. 557, 595–602 (2017).

<sup>85</sup> See generally Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 43 STAN. L. REV. 927 (1990).

<sup>86</sup> Rochelle Spandorf, *Can Federal Preemption Solve What’s Wrong with Franchise Sales Laws?*, 39 FRANCHISE L.J. 477, 486 (2020).

<sup>87</sup> *Id.* at 487. Certainly, any new or reformed federal law must be carefully crafted so as to not undermine the basic protections already afforded to franchisees. Peter C. Lagarias, *Franchise Sales Laws Need Revisions to Further Their Objectives, But Federal Preemption Is Not the Solution*, 40 FRANCHISE L.J. 201, 219 (2020) (concluding that federal preemption cannot resolve all of franchising’s problems – “There is a need for stronger, not weaker, disclosure laws and, not mentioned in [a preemption proposal – Spandorf, *supra* note 86], for franchise relationship laws providing basic rights and remedies for all franchisees”).

*A. Legislative Motivations for Implementing Pre-Sale Disclosure and Franchise Relationship Regulation in the United States*

*1. Pre-Sale Disclosure Regulation*

The California legislature decided that regulatory protection was necessary to protect persons investing in franchises for several reasons. First, regulation was a response to perceived widespread abuses relating to the sale of franchises.<sup>88</sup> Second, the new California franchise statute came in recognition of the fact that the sale of franchises created an array of investment and business problems in the state.<sup>89</sup> Finally, the successful drive for legislation stemmed from the substantial losses sustained by franchise investors as a result of failures by franchisors and their representatives to provide full and comprehensive information about the franchise relationship, to furnish details about the proposed franchise contract, and to give information about the franchisor's credentials and prior business experience.<sup>90</sup>

For these reasons, the state legislature in 1970 adopted the California Franchise Investment Law<sup>91</sup> ("CFIL"), which became effective in January 1971.<sup>92</sup> Since its adoption, the CFIL has served as a model for similar legislation in other jurisdictions such as the Franchise Sales Act adopted by the New York legislature.<sup>93</sup>

In 1979, several years after the State of California introduced the CFIL, the FTC Rule was enacted.<sup>94</sup> The Federal Trade Commission brought the FTC Rule into effect by § 5 of the FTC Act, which addresses unfair and deceptive acts or practices in or affecting commerce.<sup>95</sup> The FTC Rule

<sup>88</sup> CAL. CORP. CODE § 31001 (West 2005); *see* MARTIN MENDELSOHN, THE GUIDE TO FRANCHISING 316 (7th ed. 2004) (referring to an unnamed legislator).

<sup>89</sup> RONALD K. GARDNER, HAROLD BROWN, J. MICHAEL DADY & JEFFERY S. HAFF, FRANCHISING: REALITIES AND REMEDIES 84 (rev. vol. 2003) (citing CAL. CORP. CODE § 31001 (West 1971)).

<sup>90</sup> Susan A. Grueneberg & Jonathan C. Solish, *Franchising 101: Key Issues in the Law of Franchising*, 19 BUS. L. TODAY 11, 11–13 (2010) (explaining the basic legal framework of franchising in the United States).

<sup>91</sup> CAL. CORP. CODE § 31000 (West 2020).

<sup>92</sup> LAW AND REGULATION OF FRANCHISING, *supra* note 2, at 13, 15; *See* CAL. CORP. CODE §§ 31000–516 (West 2020).

<sup>93</sup> GARDNER ET AL., *supra* note 89, at 84. Prior to the enactment of CFIL, "the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to such transactions." CAL. CORP. CODE § 31001 (West 2005).

<sup>94</sup> The FTC Rule became effective in July 1979 and was revised in 2007. 16 C.F.R. § 436 (2007).

<sup>95</sup> Enforcement of the Franchise Rule, 2001 WL 865426 (Comp. Gen. July 31, 2001); 16 C.F.R. §§ 436, 437 (2007).

applies in each of the fifty states, the District of Columbia, and all U.S. territories<sup>96</sup> in accordance with the Supremacy Clause of the U.S. Constitution.<sup>97</sup> The FTC Rule aims to empower prospective franchisees as would-be investors by mandating that franchisors provide them with twenty-three items of disclosure.<sup>98</sup> These items of disclosure cover the information they need in order to clearly assess the potential risks and benefits associated with the contemplated investment. These items of disclosure also make it possible to make meaningful comparisons with other investment opportunities and to investigate the business opportunity.

## *2. The Debate on Franchise Relationship Laws*

A pioneer in the field of franchise regulation, the California legislature introduced two bodies of regulation protecting the interests of franchisees: the California Franchise Investment Law<sup>99</sup> (“CFIL”)—a registration and disclosure statute – and the California Franchise Relations Act (“CFRA”)<sup>100</sup>—governing the relationship between the franchisee and franchisor throughout the contract life cycle.<sup>101</sup> California is one of eighteen states that have adopted relationship laws limiting the right of the franchisor to end a franchise or to refuse to renew the franchise agreement without good cause.<sup>102</sup> It is one of just a handful of states to enact a broad, new franchise law in the past decade.<sup>103</sup> California’s former Governor Jerry

96 16 C.F.R. § 436.2 (2007) sets out the franchisor’s obligation to furnish documents by stating that it applies “[i]n connection with the offer or sale of a franchise to be located in the United States of America or its territories . . .” The Supremacy Clause provides Congress the ability to preempt state law as long as it is exercising its legitimate authority. *La. Pub. Serv. Comm’n v. FCC*, 476 U.S. 355, 368 (1986); U.S. CONST. art. VI, cl. 2.

97 Babette Märzheuser-Wood & Brian Baggott, Dentons, *Franchise Law in the United States* (June 12, 2015), <https://www.dentons.com/en/insights/articles/2015/june/12/franchise-law-in-the-united-states>; U.S. CONST. art. VI, cl. 2.

98 16 C.F.R. § 436.5 (2020) (detailing the disclosure items).

99 CAL. CORP. CODE § 31000 (West 2020).

100 CAL. BUS. & PROF. CODE § 20000 (West 1981).

101 GARDNER ET AL., *supra* note 89, at 84.

102 Approximately fourteen states have adopted a franchise sales law. THOMAS M. PITEGOFF & W. MICHAEL GARNER, *Franchise Relationship Laws*, in FUNDAMENTALS OF FRANCHISING 18 (Rupert M. Barkoff & Andrew C. Selden eds., 2008); GARDNER ET AL., *supra* note 89, at 84.

103 Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Utah, Virginia, Washington, and Wisconsin are the states that have franchise relationship laws. David J. Kaufmann, *How Does the Law Regulate Franchising?*, MSA WORLDWIDE, <https://www.msaworldwide.com/blog/how-does-the-law-regulate-franchising/> (last visited June 19, 2021). The new California law has people worried about how it will affect franchises in the state because it alters who is an employee and who is an independent contractor. Natalma M. McKnew & Eleanor Vaida Gerhards, *New California Law Imperils Franchise Model*, FOX ROTHSCHILD, LLP (Sept. 24, 2019), <https://www.foxrothschild.com/publications/new-california-law-imperils-franchise-model/>.

Brown signed Assembly Bill 525 into law on October 11, 2015,<sup>104</sup> substantially amending the CFRA, which had been in effect in California since 1980.

The U.S. Congress, franchising community, and others have long disputed the merits of proposed national legislation, and no such bills have been enacted<sup>105</sup> except for regulations governing automobile sales franchises and petroleum-related service franchises.<sup>106</sup>

A range of general franchise relationship bills have been proposed by Democratic and Republican members of Congress, but all have been rejected to date.<sup>107</sup> One of the earliest proposed bills was put forward in 1971—the same year the first state franchise relationship law, the CFRA, was introduced.<sup>108</sup> More recently, in 2007, the FTC, which is responsible for the federal disclosure rules, considered but ultimately rejected a federal “instrument” regulating franchise relationships.<sup>109</sup>

Much of the debate about proposed franchise laws centers on the relative disparity in the bargaining power of franchisees when dealing with franchisors over a range of issues arising during the course of the franchise. These issues include the location of new franchised-outlets, restrictions on the franchisor’s ability to terminate a franchise (a “good cause” requirement), and the parties’ right to advance written notice of termination and an opportunity to cure any defects which may constitute a material breach of the franchise agreement.<sup>110</sup> One rejected Congressional bill would

<sup>104</sup> GARDNER ET AL., *supra* note 89, at 84.

<sup>105</sup> Enforcement of the Franchise Rule, *supra* note 95, at 1.

<sup>106</sup> Congress enacted the Automobile Dealer Franchise Act (commonly known as the “Dealers’ Day in Court Act”) in 1956, which imposed a good faith obligation on automobile producers when carrying on the terms of the agreement and when terminating or not renewing the franchise (*see* 15 U.S.C. §1222 (2006)) and in 1978, granted protection to parties operating service stations under the Petroleum Marketing Practices Act (“PMPA”) (*see* 15 U.S.C. §§ 2801–06 (2006)). Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 199 (2012). The PMPA effectively prohibits termination or non-renewal of the franchise if the cause for termination is not based on one of the grounds articulated in the PMPA. David Hess, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333, 345–46 n.96 (1995) [*hereinafter Hess*].

<sup>107</sup> See Emerson & Benoliel, *supra* note 106, at 198–99 (listing all the bills up to 2012).

<sup>108</sup> *Id.* at 198 (citing PITEGOFF & GARNER, *supra* note 102, at 185). As with all such Congressional attempts at enacting a general federal franchise law, the bill failed to pass.

<sup>109</sup> Emerson & Benoliel, *supra* note 106, at 199 (citing PITEGOFF & GARNER, *supra* note 102, at 186).

<sup>110</sup> Enforcement of the Franchise Rule, *supra* note 95, at 1; Emerson, *supra* note 13, at 265; Kaufmann, *supra* note 103 (stating some states require reasonable or just cause in order to terminate or not renew the franchise agreement); *see also* KEELEY, KUENN & REID, *Rights and Obligations in a Distributor Termination Case* (Mar. 2020), <http://www.kkrlaw.com/distributortermination.htm> (noting

have introduced “minimum standards of fair conduct in franchise sales and business relationships” with the goals of promoting “fair and equitable franchise agreements,” establishing “uniform standards of conduct in franchise relationships,” and creating “uniform private Federal remedies for violations of Federal law.”<sup>111</sup>

### *B. Regulatory Justifications in the Context of Franchising*

As we have seen, franchise regulation falls into two categories - pre-sale disclosure rules (sales law) and relationship rules. The aims of each set of rules differ but also overlap to a certain degree.

#### *1. Franchise Regulation Exists to Combat Informational Deficits*

“[K]nowledge is a ruler and wealth is its subject,” said Imam Al Nahj Al-Balagha.<sup>112</sup> A main question arises in developing an efficient economic system: “what is the best way of utilizing knowledge initially dispersed among all the people?”<sup>113</sup> Knowledge is important in planning the allocation of available resources; it may seem to be circular reasoning,<sup>114</sup> but in turn, knowledge is dependent upon the planner’s ability to access available knowledge and thereby help the decision-making process.<sup>115</sup> Indeed, “knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.”<sup>116</sup>

states that have enacted franchise termination laws include Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Virginia, Washington, and Wisconsin).

111 Enforcement of the Franchise Rule, *supra* note 95, at 10 (citing the Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. (1999)). Some unenacted federal bills dealing with franchises are the Fair Conduct in Franchise Sales, H.R. 3308, 106th Cong. (2000), the Fair Franchise Act of 2017, H.R. 470, 115th Cong. (2017) (as referred to the H. Judiciary Subcomm. on the Const. & Civ. Just., Feb. 6, 2017), the Fair Franchise Act of 2015, H.R. 3196, 114th Cong. (2015) (as referred to the H. Judiciary Subcomm. on the Const. & Civ. Just., Sept. 8, 2015), and the SBA Franchise Loan Transparency Act of 2015, H.R. 3195, 114th Cong. (2014) (as referred to the H. Energy & Com. Subcomm. on Com., Mfg., & Trade, July 24, 2015).

112 Fatima Kermali, *Faith and Values*, MORNING CALL (July 14, 2017, 8:20 PM), <https://www.mccall.com/opinion/mcfea-faith-kermali-20170716-story.html>.

113 F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 520 (1945). A related question closely connected to this question is *who* is to do the planning. *Id.*

114 *I.e.*, knowledge is necessary for effective planning, and good planning lays the groundwork for discernment of facts and the attendant acquisition of knowledge.

115 Hayek, *supra* note 113, at 521.

116 *Id.* at 519. In the words of Hayek “[t]he peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must

For buyers, this knowledge begins with a recognition of the products and services which are available to them for purchase. Buyers must identify the range of buying choices open to them and understand the characteristics of these choices they confront.<sup>117</sup> Buyers looking around for different suppliers will expend time, money, and effort in their search.<sup>118</sup> To make known its identity and the qualities of its product, the seller will spend money on research, labelling and advertising.<sup>119</sup> In a well-functioning market, “one would expect to find as much information available as consumers are willing to pay for in order to lower the cost or to improve the quality of their choices.”<sup>120</sup> U.S. Supreme Court Justice Stephen Breyer identified one way that a free market fails is when buyers do not have adequate “information to evaluate competing products.”<sup>121</sup>

For a variety of reasons, markets for information may occasionally not function well. First, the incentives to produce and to disseminate information may be skewed.<sup>122</sup> Second, one of the parties to the transaction may set out to mislead the other, by producing or by providing false information or by omitting crucial facts.<sup>123</sup> Someone looking to take a health or life insurance policy, for instance, may lie when asked about his health, his alcohol consumption, or his use of tobacco products. A franchisor looking for investors may omit key facts relating to the competitiveness of the market, its plans for the future, its expenditures on marketing, and the background of its key personnel. Beyond the potential reputational damage,

make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.” *Id.*

<sup>117</sup> STEPHEN BREYER, REGULATION AND ITS REFORM 26 (1984).

<sup>118</sup> *Id.* Businesses tend to compare pricing, suppliers, and quality of goods and services before completing a sale. David Weedmark, *8 Steps of a Business Organization’s Purchasing Process*, CHRON (Mar. 9, 2019), <https://smallbusiness.chron.com/8-steps-business-organizations-purchasing-process-2267.html>.

<sup>119</sup> BREYER, *supra* note 117, at 26; Weedmark, *supra* note 118 (stating a company may look online, attend trade shows, or contact suppliers to find new suppliers).

<sup>120</sup> BREYER, *supra* note 117, at 26.

<sup>121</sup> Edward A Fallone, *The Clinton Court is Open for Business: The Business Law Jurisprudence of Justice Stephen Breyer*, 59 MO. L. REV. 857, 862–63 (1994) (noting Justice Breyer identified one way a free market fails, and government regulation is justified, as when “buyers have inadequate information to evaluate competing products”).

<sup>122</sup> BREYER, *supra* note 117, at 26.

<sup>123</sup> *Id.*; see also James B. Kinsel, *Unfair Business Practices – Lying to Induce Franchise Agreement Can Result in Broad Protection for the Deceived*, PROTORAE LAW PLLC (June 17, 2014), <https://protoraelaw.com/unfair-business-practices-lying-to-induce-franchise-agreement-can-result-in-broad-protection-for-the-deceived/> (referring to *Bans Pasta, LLC v. Mirko Franchising, LLC*, No. 7:13-cv-00360, 2014 WL 637762, at \*1–2 (W.D. Va. Feb. 12, 2014), where franchisees brought a lawsuit against the franchisors’ for alleged misrepresentations related to inaccurate financial documents depicting what the franchisees could expect to make from the business).

false statements or active misrepresentations may also be grounds for rescission of the contract or for claiming compensation,<sup>124</sup> however, the cost of court action is often sufficiently high to weaken this deterrent.<sup>125</sup>

The logic underpinning governmental action to prevent false or misleading information rests upon the assumption that court remedies and competitive pressures are insufficient to guarantee that the consumers are provided with true, necessary information (something the consumer would willingly pay for).<sup>126</sup> While the Securities and Exchange Commission (“SEC”) regulates the issuances of securities,<sup>127</sup> the Federal Trade Commission (“FTC”) regulates the provision of investment information by the franchisor to the prospective franchisee.<sup>128</sup> Third, even in the presence of perfect information, individuals may be unable to accurately evaluate the scale of risks that they face; once the buyer locates the potentially competing sellers, the buyer may be unable to evaluate accurately the characteristics of the products offered.<sup>129</sup> Just as a layperson cannot readily assess the competence of a surgeon or a lawyer, the unaided buyer cannot thoroughly and astutely evaluate the potential effectiveness or dangers of a drug, an investment, or a franchise. The creation of objectively applied labels to aid evaluation by means of formal or informal agreement on the supply side is likely to be problematic or impossible.<sup>130</sup>

Although some legislation, such as the South African Consumer Protection Act of 2008, mandates that franchise agreements must be in “plain and understandable language,” “in writing and signed by both parties,”<sup>131</sup> further governmental intervention may be necessary in order to prescribe the type of information that must be furnished and to help buyers evaluate the information that is furnished.<sup>132</sup> EU investment law obliges financial institutions to determine the level of information that must be provided by financial institutions after assessing the class of investor before them. Fourth, on the supply side, the market may not necessarily be competitive enough to provide all the information for which the consumer would be willing to pay. Until the government required disclosure, accurate

<sup>124</sup> Adam Hayes, *Misrepresentation*, INVESTOPEDIA (Mar. 16, 2021), <https://www.investopedia.com/terms/m/misrepresentation.asp>.

<sup>125</sup> BREYER, *supra* note 117, at 27.

<sup>126</sup> *Id.*

<sup>127</sup> *What We Do*, U.S. SEC. & EXCH. COMM’N (Dec. 18, 2020), <https://www.sec.gov/Article/whatwedo.html>.

<sup>128</sup> 16 C.F.R. §§ 436.10, 437.9 (2007).

<sup>129</sup> BREYER, *supra* note 117, at 27–28, 396.

<sup>130</sup> *Id.* at 28.

<sup>131</sup> Consumer Protection Act 68 of 2008 §§ 7(1)(a), 22 (S. Afr.).

<sup>132</sup> BREYER, *supra* note 117, at 27–28; *see also* Consumer Protection Act 68 of 2008 § 7(3).

information was not available to most buyers about the nicotine content of cigarettes, the fuel economy of cars, the durability of light bulbs, and the care requirements of textiles.<sup>133</sup>

Fraud in the sale of franchises has historically been a recognized problem,<sup>134</sup> with the FTC initially using litigation to combat fraud in the sale of franchises.<sup>135</sup> In his statement to the Committee on Franchise Licensing of the New York Legislature on September 28, 1970, former New York Attorney General Lefkowitz remarked that while thousands of people have been bilked of hundreds of thousands of dollars “by glib salesmen and misleading literature selling worthless franchises . . . in almost every instance the franchise offering literature was either inadequate, misleading, wholly lacking or blatantly false as to material facts necessary to make an intelligent investment decision.”<sup>136</sup> In the early 1970s numerous legislative efforts requiring full disclosure in the sale of franchises were pending.<sup>137</sup> Some argued that a franchise should be classified as an investment and should, accordingly, be treated as a security under existing security laws.<sup>138</sup> In effect, most concerns stemmed from fear of fraud and worries about a power imbalance. This concern about a power imbalance has led to sweeping regulations that attempt to balance the franchisor-franchisee relationship.

## 2. *Franchise Regulation Exists to Rectify Power Imbalance*

Franchises are inherently unbalanced relationships.<sup>139</sup> Franchisors often abuse their superior bargaining position using their status, knowledge, and the contract to take advantage of prospective and actual franchisees.<sup>140</sup> This

<sup>133</sup> BREYER, *supra* note 117, at 27–28.

<sup>134</sup> *Fraud, Misrepresentations – Oral and in FDDs*, GOLDSTEIN L. FIRM, <https://www.goldlawgroup.com/fraud-misrepresentations-oral-and-in-fdds/> (last visited June 19, 2021).

<sup>135</sup> Harold Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650, 652–53, 652 n.16 (1971) (citing to various cases like Century Brick Corp., 3 TRADE REG. REP. ¶ 19,391 (F.T.C. 1970), Universal Credit Acceptance Corp., 8 TRADE REG. REP. ¶¶ 19,340, 19,371 (F.T.C. 1970) (credit card), Success Motivation Inst., Inc., 3 TRADE REG. REP. ¶ 19,306 (F.T.C. 1970) (academy), and Meal or Snack Sys., Inc. [1967–68 Transfer Binder], TRADE REG. REP. ¶ 18,671 (F.T.C. 1969) (fast food)).

<sup>136</sup> *Id.* (citing the statement by N.Y. Att'y Gen. Lefkowitz to Comm. on Franchise Licensing of the N.Y. Leg., Sept. 28, 1970 and the Staff Report on Franchising to N.Y. Att'y Gen., Jan. 7, 1970).

<sup>137</sup> *Id.* at 652 n.16.

<sup>138</sup> *Id.* (citing 49 OPS. CAL. ATT'Y GEN. 124 (1967); 1969 OPS. GA. ATT'Y GEN. 661 (1969); Bernard Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); *cf.* Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640, (CCH) FED. SEC. L. REP. ¶ 92,838 (D. Colo. Sept. 30, 1970).

<sup>139</sup> GARDNER ET AL., *supra* note 89, at 519.

<sup>140</sup> *Id.* at 519.

situation is made worse by the heavy reliance franchisees place on franchisors—a situation compounded by the financial reality and the emotional pull of the dream to own and run a business of one's own.

In his testimony to the Select Committee on Small Business in 1970, John Y. Brown, then President of Kentucky Fried Chicken, called on the U.S. Government and the Senate for positive action to address the perils of the American dream by saying:

the desire of every American to own his own business, to be his own boss, has many pitfalls. He is easy prey for the hot-spot promoter because the stakes are so high. These small businessmen very often scrape up every dime they can borrow, beg or steal in a lifetime of earnings, and put it all on one dream and hope of a franchise concept that very likely could have been misleading, misrepresentative, and fraudulent.<sup>141</sup>

Beyond the inequality in bargaining power, franchisee protection laws are necessary in order to protect franchisees against potential opportunism by franchisors.<sup>142</sup> Brown suggests regulation of franchises in the same fashion as other business structures.<sup>143</sup> He calls for a more effective remedy to abusive conduct, rejecting the argument that this conduct may, in the context of franchises, be largely addressed under criminal laws against fraud.<sup>144</sup> From his point of view, the problem of protecting franchisees from wrongdoing goes far beyond the reach of existing law, since “neither criminal process nor common-law actions for fraud or breach of contract provide a remedy for many dealings that are unfair, overbearing in bad faith, or even unconscionable.”<sup>145</sup> Bearing in mind the leading complaints of franchisees in various leading industries, there is a clear need for a cohesive body of franchise law to address this conduct.<sup>146</sup>

<sup>141</sup> *The Impact of Franchising on Small Business Hearings Before the Subcomm. on Urban and Rural Economic Development of the S. Select Comm. on Small Bus.*, S. REP. NO. 91-1344, at 18-19, 190 (1970) (statement of John Y. Brown, President, Kentucky Fried Chicken).

<sup>142</sup> Robert W. Emerson & Uri Benoliel, *Can Franchisee Associations Serve as a Substitute for Franchisee Protection Laws?*, 118 PENN ST. L. REV. 99, 105 (2013). The European Parliament acknowledge the existence of unfair contract terms. *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ B.

<sup>143</sup> Brown, *supra* note 135, at 654.

<sup>144</sup> *Id.* at 652.

<sup>145</sup> GARDNER ET AL., *supra* note 89, at 121.

<sup>146</sup> Carmen D. Caruso, Int'l Franchise Ass'n, *Franchisee Litigation Perspective: A Practical Guide to Franchise Litigation*, at 7-19, 23-25 (May 5-7, 2019), <https://www.franchise.org/sites/default/files/2019-05/FranchiseeLitigationPerspective.pdf> (stating unfair, unconscionable, fraud, or deception can be plead as violations of Little FTC Acts).

For example, the major complaints made by franchisees against the Big Three<sup>147</sup> car producers include: operating abuses such as inadequate reimbursement for pre-delivery and warranty work carried out by the dealers; inequitable delivery of products; forced purchase of parts, accessories, supplies, and unwanted models; forced participation in national, advertised sales; and direct retail competition with stores owned or controlled by the franchisor.<sup>148</sup> Other abusive conduct complained of includes attempts by the auto manufacturers to deny that the dealer has any goodwill in his business.<sup>149</sup> Accordingly dealers are prohibited, during the sale of a dealership, from making a charge for the goodwill.<sup>150</sup> Dealers also complain that they “have minimal control over the selection of a successor,” and are unable to capitalize “their businesses in the many ways available to others.”<sup>151</sup>

As a result, the key forms of franchisor opportunistic behavior which franchisee protection laws aim to counter include attempts to terminate without just cause; to oblige a franchisee to arbitrate disputes out of state; and to encroach on the market of the franchisee.<sup>152</sup> Attempts by a franchisor to unjustly terminate a franchise contract—specifically in the absence of a material breach—in order to appropriate the profits generated by the franchisee unit may arise when the franchisor either operates the outlet directly or sells the unit to a new franchisee as a going concern in exchange

<sup>147</sup> This is in reference to the three largest automobile manufacturers in North America: General Motors, Chrysler, and Ford. See Elizabeth Blessing, *Big Three Automakers*, INVESTOPEDIA (Dec. 6, 2020), <https://www.investopedia.com/terms/b/bigthree.asp>.

<sup>148</sup> Jason R. Parnell & Robert W. Emerson, *Bankruptcies and Bailouts: The Continuing Impact of the Financial Crisis on the Franchise Auto Dealer Industry*, 21 U. PA. J. BUS. L. 288, 309 (2018) (stating one reason Congress enacted the Federal Automobile Dealers Franchise Act was to “prevent manufacturers from forcing dealers to accept automobiles, parts, accessories, and supplies, which the dealers did not need, want, or believe they could absorb in their markets”).

<sup>149</sup> Brown, *supra* note 135, at 655.

<sup>150</sup> Jerry Ellig & Jesse Martinez, *These Laws Should Hit the Road*, U.S. NEWS (Jan. 19, 2015, 8:00 AM), <https://www.usnews.com/opinion/economic-intelligence/2015/01/19/laws-protecting-auto-franchises-are-bad-for-consumers-and-innovation>.

<sup>151</sup> Brown, *supra* note 135, at 655.

<sup>152</sup> Emerson & Benoliel, *supra* note 106, at 197; see also Terry et al., *supra* note 82 (noting the independent nature of franchise relationships leaves franchisors vulnerable to opportunistic conduct like “encroachment, kickbacks, churning, non-renewal, transfer, termination at will, and unreasonable unilateral variations to the agreement”); Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 289 (2010) (concluding that franchise parties should be free, in their franchisee contract, to choose either: (1) a franchisee-as-employee analogy, with the franchisee quite possibly subject to encroachment but protected by employment-like guarantees such as minimum salaries, buyout plans, and other safety-net measures, or (2) the franchisee is indeed an independent contractor - not entitled to franchisee-as-employee protections but, in return, able to avail itself of anti-encroachment statutes or case law).

for higher fees.<sup>153</sup>

A franchisor may mandate a prospective franchisee to accept certain coercive terms under the franchise agreement. For example, there may be a clause requiring that any dispute be arbitrated or adjudicated outside the state of the franchisee, with the result being to drive up the franchisee's potential costs and thus perhaps deter the franchisee from suing the franchisor or from defending claims brought by the franchisor.<sup>154</sup> Also, the franchisor may place contractual limits on the franchisee's ability to freely associate with other franchisees.<sup>155</sup>

The franchisor may likewise attempt to encroach on the franchisee's territory in order to force the franchisee to abandon its franchise unit. For example, the franchisor may set up a new franchise unit in unreasonable proximity to the unit of the franchisee, thus reducing the profitability of the franchisee's unit and forcing them out of business.<sup>156</sup> This encroachment strategy may be used to evade a contractual or statutory obligation to pay termination damages to the franchisee<sup>157</sup> or to reduce the value of a franchisee's unit so the franchisor can repurchase at a lower cost.<sup>158</sup>

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153 Emerson & Benoliel, *supra* note 142, at 105.

154 *Franchisors Really Want Forced Arbitration Clauses*, STOP FRANCHISE FRAUD (Oct. 17, 2019), <https://www.stopfranchisefraud.com/franchisors-really-really-want-forced-arbitration-clauses/> ("A recent report by the American Association of Justice documents what franchisees who have lost everything to forced arbitration already know: that forced arbitration is a scam that favors corporations. It doesn't save everyone time and money. It can be expensive, take a long time, and — worse — it virtually guarantees the larger corporate party (the franchisor in this case) a win.").

155 Emerson & Benoliel, *supra* note 106, at 197.

156 Emerson & Benoliel, *supra* note 142, at 106.

157 W. Michael Garner, *A Termination by Any Other Name*, BLUE MAUMAU (Feb. 14, 2008, 5:22 PM), <https://www.bluemaumau.org/blog/2008/02/14/termination-any-other-name>.

158 GARDNER ET AL., *supra* note 89, § 4.02[1] (citing *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 719 (7th Cir. 1979), *cert denied* 445 U.S. 917 (1980)).

**PART III: COMPARING FEDERAL AND STATE REGULATION OF FRANCHISES  
IN THE UNITED STATES<sup>159</sup>**

Having looked at the EP call for reform of franchise regulation (Part I), we will proceed to analyze the binary legal framework that has emerged in the United States, exploring the configuration developed at the federal and state levels, beginning with a look at federal regulation in Part III(a), then exploring the intricacies of franchise regulation in California in Part III(b).

Beyond the fact that the EP has referred to the United States as a yardstick for effective performance in the franchise sector, we have chosen to look at U.S. franchise regulation as a paradigm for the reform of EU regulation for a number of reasons. First, the contemporary franchise model that has emerged in Europe is heavily influenced by the U.S. franchise model that emerged and evolved across the United States starting at the end of the Civil War.<sup>160</sup> Second, in a bid to optimize the investment of U.S.-based franchisors in the EU, it would be prudent for the EU legislatures to emulate a legislative framework familiar to such U.S.-based franchisors who may be looking to increase their future levels of investment in the EU-based franchise sector.

Third, notwithstanding the progressive introduction of franchise regulation at both the state and federal levels in the United States since the 1970s,<sup>161</sup> there is a demonstrated growth in the size of this sector, and in the

<sup>159</sup> FED. TRADE COMM’N, FRANCHISE RULE 16 C.F.R. PART 436 COMPLIANCE GUIDE 1–6 (2008), <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>; see 16 C.F.R. § 436.2 (2007). See generally List of Advisory Opinions of the Federal Trade Commission, FED. TRADE COMM’N, [www.ftc.gov/bcp/franchise/netadopin.shtm](http://www.ftc.gov/bcp/franchise/netadopin.shtm) (last visited June 19, 2021); Enforcement of the Franchise Rule, *supra* note 95, at 5–10.

<sup>160</sup> The contemporary concept of franchising is generally believed to have emerged in the United States after the end of the Civil War, expanding across to Europe in the aftermath of World War II. The franchise structures developed post World War II in the United States—with the likes of McDonalds (1955), KFC (1955), and IHOP (1959)—expanded swiftly into Europe; in the United Kingdom with the opening of Wimpy (1955), Service Master (1958), Golden Egg Restaurants (1965), and Dyno Rod (1965); and in Germany with the launch of Ihr Platz, Nordsee, and OBI (in the 1960s). MICHALA MEISELLES & HUGO WHARTON, INTERNATIONAL LICENSING AGREEMENTS §5.02 (2018).

<sup>161</sup> Following California’s lead, fourteen other states introduced their own franchise disclosure and registration laws: Washington (1972); Virginia and Wisconsin (1972); Rhode Island (1973); Minnesota (1973); Oregon (1973); Illinois (1974); South Dakota (1974), Michigan (1974); Hawaii (1975); Indiana and North Dakota (1975); Maryland (1978); and New York (1980). John R.F. Baer & Susan Grueneberg, *United States*, in INTERNATIONAL FRANCHISE SALES LAWS 499, 504 (Andrew P. Loewinger & Michael K. Lindsey eds., 2d ed. 2015). All 15 states require provision of a disclosure document to the prospective franchisee pre-sale. *Id.* Every one of these states (excluding Oregon) stipulate that some form of registration or filing take place with the state authorities. *Id.*

At the time that the states were adopting laws governing franchises, the FTC was promulgating its own rule on franchising. *Id.* at 502. The process which began in 1971 with a notice of proposed rule-

popularity of this business model.<sup>162</sup> Fourth, the level of maturity for the U.S. legislative model in place since the 1970s and the level of success experienced by the franchise sector in the United States are important determinants in our choice of jurisdiction.

Bearing in mind the longevity of this combined structure, introduced over 50 years ago (1970 in California, and 1980 at the federal level), and the similarities between the systems in the EU and U.S., we would suggest that the legislative framework developed in the United States could serve as a tried and tested model for any proposed reform of franchise regulation at the EU level. Franchising can enhance the Single Market generally benefitting, *inter alia*, the retail sector.<sup>163</sup> As of 2016, the EU is underperforming, with franchising comprising only 1.89% of GDP in the EU, compared to 5.95% in the United States.<sup>164</sup> Finally, the EP has taken steps and moved toward considering a uniform approach in correcting unfair trading practices that impact franchising, advising a “best practices” guideline at the EU level.<sup>165</sup>

Two bodies of franchise regulation - sales and relationship law - have emerged side-by-side in the United States. Several states have adopted sales regulation, which addresses the initial offer for sale of the franchise to the prospective franchisee and mandates pre-contractual disclosure. The goal of such regulation is to protect prospective franchisees by requiring franchisors to provide pre-contractual disclosure.<sup>166</sup> Some states require advance registration of the franchise offer prior to sale. Other states have gone further by adopting relationship regulation, which supplements the pre-contractual disclosure and registration regulation with a body of regulation governing the franchise relationship itself.<sup>167</sup> Notably, state laws that govern

making lasted seven years (the FTC Rule finally became effective in July 1979). MENDELSOHN, *supra* note 88, at 317.

162 In the 1950s, fewer than one hundred companies in the United States used the franchise model, but according to recent statistics over 780,000 U.S.-based franchise establishments exist in the United States. Enforcement of the Franchise Rule, *supra* note 95, at 5.

163 The EP’s focus is on the franchise retail sector, as indicated in the very title of the EU resolution. *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ C.

164 *Id.* More data is furnished *supra* notes 20–21 and accompanying text.

165 Carl E. Zwisler, Gary Plant Moody, *Global Franchise Regulation Update: Regulatory Developments and Proposals Since 2016* (Feb. 28, 2019), <https://www.franchise.org/sites/default/files/2019-05/5BPUB%5D%20Global%20Franchise%20Regulation%20Update%204844-9080-8395%20v.25.pdf> (citing to the EU Parliament Committee report/motion, *supra* note 1, that blames the uncoordinated regulatory approach to franchising as a reason for a relative lack of success of franchising in the EU franchising, as compared with U.S. and Australia).

166 Robert W. Emerson, *Franchise Contracts and Territoriality: A French Comparison*, 3 ENTREPRENEURIAL BUS. L.J. 315, 324 (2009); Pitegoff, *supra* note 79, at 314–15.

167 W. MICHAEL GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE § 8:2, n.4 (2020)

franchising generally extend a private right of action that permits franchisees to bring lawsuits in relation to violations under their respective state's law.<sup>168</sup>

#### *A. Federal Regulation*

At the federal level, franchise regulation has been promulgated by the FTC. The regulation, which governs the franchise relationship, is commonly referred to as the FTC Rule.<sup>169</sup> It applies in every U.S. state and territory.<sup>170</sup>

Promulgated under § 5 of the FTC Act addressing unfair and deceptive acts or practices in or affecting commerce,<sup>171</sup> the FTC Rule took effect in 1979<sup>172</sup> and was revised in 2007.<sup>173</sup> In the United States, most states depend on the FTC Rule to define franchising and to require a disclosure from franchisor to franchisee, with no mandatory public filing or franchising-specific substantive regulation.<sup>174</sup> Notably, the FTC Rule does not give a private cause of action right to franchisees.<sup>175</sup>

The applicability of the FTC Rule is determined by reference to whether the underlying relationship meets the stipulated definition of a franchise set out in the FTC Rule, as well as if an exemption or exclusion applies.<sup>176</sup> Regardless of the label the parties themselves use to describe their relationship, a relationship can qualify as a franchise under federal regulation if it meets the requirements defined in the FTC Rule.<sup>177</sup>

(stating “[s]eventeen states and Puerto Rico have statutes regulating the relationship between franchisors and franchisees generally”) (citing ARK. CODE ANN. § 4-72-202(7); CAL. BUS. & PROF. CODE § 20020; CONN. GEN. STAT. § 42-133f; DEL. CODE ANN. tit. 6, § 2552; HAW. REV. STAT. § 482E-6(2); ILL. REV. STAT. ch. 1211/2, ¶ 719; IND. CODE § 23-2-2.7-1; IOWA CODE § 523H.1–17); M.S.A. § 19.854(27); M.C.L. § 445.1527; MISS. CODE ANN. § 75-24-53; MO. REV. STAT. § 407.410.1; MINN. STAT. § 80C.14, subdiv. 3(b); NEB. REV. STAT. § 87-404; N.J. REV. STAT. § 56:10-5; VA. CODE ANN. § 13.1-564; WASH. REV. CODE § 19.100.180(2)(j); WIS. STAT. §§ 135.01–07.).

168 Enforcement of the Franchise Rule, *supra* note 95, at 9.

169 16 C.F.R. § 436.1 (2007).

170 *Id.* § 436.2; *supra* notes 96–97 and accompanying text.

171 16 C.F.R. §§ 436, 437; *supra* note 95 and accompanying text.

172 In 1971, the FTC announced its intention to commence a proceeding concerning the promulgation of a trade regulation rule on franchise sales and pre-sales disclosures. In 1972, public hearings commenced. Enforcement of the Franchise Rule, *supra* note 95, at 5; *supra* notes 94 and accompanying text; *supra* note 162.

173 16 C.F.R. §§ 436, 437.

174 See Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 2013 MICH. ST. L. REV. 641, 661–62 (2013).

175 *Id.* at 661.

176 FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 1.

177 16 C.F.R. § 436.1(h)(1)–(3); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 1.

Conversely, an arrangement referred to by the contracting parties as a franchise will not be such unless these prerequisites are met.<sup>178</sup> About one-third of the states in the United States define franchisees the same way.<sup>179</sup> Twelve states<sup>180</sup> find the existence of a franchise if three elements are met: “a marketing plan, an association with a trademark, and a required fee.”<sup>181</sup> Additionally, Hawaii, Minnesota, Mississippi, Nebraska and South Dakota require three elements to show a franchise: “trademark license, community of interest, and a required fee.”<sup>182</sup> The FTC definition of a franchise also includes trademark and a required fee, but additionally requires control or assistance.<sup>183</sup>

The FTC Rule,<sup>184</sup> applicable to the offer and sale of a franchise,<sup>185</sup> sets out the pre-contractual disclosure obligations of the franchisor and addresses the substance of the mandated pre-contractual disclosure document: the Franchise Disclosure Document (“FDD”). Under the amended FTC Rule, the franchisor must provide a FDD to the franchise candidate at least fourteen calendar-days before a binding agreement is signed.<sup>186</sup> Further, the FTC Rule provides for a mandated disclosure procedure, expressly making the franchisor responsible for preparing the FDD and for furnishing the FDD to prospective franchisees. It also reviews the means by which prospective franchisees must receive the FDD and the period of review that should be afforded to prospective franchisees.<sup>187</sup> The

<sup>178</sup> FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 1.

<sup>179</sup> Robert W. Emerson & Steven A. Hollis, *Bound by Bias? Franchisees' Cognitive Biases*, 13 OHIO ST. BUS. L.J. 1, 5 (2019).

<sup>180</sup> Those States are California, Illinois, Indiana, Iowa, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington, and Wisconsin. Emerson & Hollis, *supra* note 179.

<sup>181</sup> Emerson & Hollis, *supra* note 179; see also Richard L. Rosen, Leonard Salis & John A. Karol, USA: *Franchise 2020*, ICLG (Oct. 21, 2019), <https://iclg.com/practice-areas/franchise-laws-and-regulations/usa>.

<sup>182</sup> Emerson & Hollis, *supra* note 179; see also Rosen et al., *supra* note 181 (noting “community of interest” replaces the “marketing plan” element for Hawaii, Minnesota, Mississippi, Nebraska, and South Dakota).

<sup>183</sup> Emerson & Hollis, *supra* note 179, at 5 n.20.

<sup>184</sup> 16 C.F.R. § 436.2 (2007); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 1–16.

<sup>185</sup> FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 1. 16 C.F.R. § 436.1(t) states that a “sale of a franchise includes an agreement whereby a person obtains a franchise from a franchise seller for value by purchase, license, or otherwise.” § 436.1(t) (2007). Note further: An existing franchise agreement extended or renewed with no interruption in the franchisee’s operation of the business is not a “sale of franchise” unless the terms in the new agreement differ materially from those in the original agreement. *Id.*

<sup>186</sup> 16 C.F.R. § 436.2(a); see FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 20.

<sup>187</sup> Under the FTC Rule, the FDD must be furnished in writing, though in this context the terms “written” and “in writing” are widely defined, encompassing “any document or information in printed form or in any form capable of being preserved in tangible form and read. It includes: type-set, word processed, or handwritten document; information on computer disk or CD-ROM; information sent via email; or information posted on the Internet. It does not include mere oral statements.” 16 C.F.R. §

FDD includes items such as the estimated initial investment, the franchisee's obligations, outlet/franchisee information,<sup>188</sup> and other items pertinent to a potential franchisee's decision to buy in.<sup>189</sup>

Unless a transaction is exempted under the FTC Rule, where there is an offer or sale of a franchise situated in the United States or its territories, the prospective franchisee must be furnished with an FDD "at least 14 calendar-days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale."<sup>190</sup> This fourteen day period starts on the day after the delivery of the FDD; in other words, the signing of the agreement or the receipt of payment can only take place on or after the fifteenth day following delivery.<sup>191</sup> Failure to do so will be deemed an unfair or deceptive act or practice in violation of § 5 of the Federal Trade Commission Act.<sup>192</sup> A franchisee is allowed to make a reasonable request to have an FDD delivered earlier in the sales process than fourteen calendar-days before the franchisee signs or pays.<sup>193</sup> If a franchisor fails to comply with a reasonable request for early delivery, that failure will be considered an independent violation of the FTC Rule.<sup>194</sup>

Any franchisor wishing "to alter unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document"<sup>195</sup> must provide the prospective franchisee "with a copy of each revised agreement at least seven calendar-days before the prospective franchisee signs the revised agreement."<sup>196</sup> Where the modifications to the agreement are the result of negotiations initiated by the prospective franchisee, this seven calendar-day period will not be triggered.<sup>197</sup>

436.1(w).

188 See Joel Libava, *These 3 FDD Items Really Matter*, U.S. SMALL BUS. ADMIN. (Feb. 8, 2019), <https://www.sba.gov/blog/these-3-fdd-items-really-matter>.

189 16 C.F.R. § 436.5(a) (detailing the franchisor's required disclosure of itself, and any Parents, Predecessors, & Affiliates). For a discussion on the items, see Uri Benoliel, *Are Disclosures Really Standardized? An Empirical Analysis*, 62 VILL. L. REV. 1 (2017).

190 16 C.F.R. § 436.2(a).

191 FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 20.

192 16 C.F.R. § 436.2.

193 FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 21.

194 *Id.*

195 16 C.F.R. § 436.2(b).

196 *Id.*

197 *Id.* The FDD may be furnished in a variety of ways. FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 19–20. Indeed, the franchisor will be deemed to have provided the necessary documentation to a prospective franchisee by the requisite date if the said documentation is either

### 1. *The Substance of the Franchise Disclosure Document (“FDD”)*

The U.S. franchisee protection laws are primarily designed to govern the ongoing relationship between franchisors and franchisees.<sup>198</sup> The central purpose of such regulation is to address any inequality in bargaining power between franchisors and franchisees,<sup>199</sup> and to protect franchisees against possible franchisor opportunism.<sup>200</sup> To accomplish this goal, the FTC Rule mandates pre-sale disclosure of twenty-three key fields of information (known as “disclosure items”).<sup>201</sup>

The information that must be included in the FDD is comprehensive<sup>202</sup>

dispatched by first-class U.S. mail at least three calendar-days before the requisite date as a paper or tangible electronic copy (computer disk, CD-ROM, & so forth) to the address specified by the prospective franchisee; the documentation is either hand-delivered, faxed, emailed, or otherwise delivered by the requisite date; or instructions are furnished to the prospective franchisee by the said date indicating how the documentation may be accessed on the internet. 16 C.F.R. § 436.2 (c)(1)-(3).

<sup>198</sup> See, e.g., NEB. REV. STAT. § 87–401 (2011); N.J. STAT. ANN. § 56:10-2 (West 2012); 19 R.I. GEN. LAWS § 19-28.1-2 (West 2011); VA. CODE ANN. § 13.1-558 (West 2011); PITEGOFF & GARNER, *supra* note 102, at 184; Hess, *supra* note 106, at 333.

<sup>199</sup> See, e.g., WIS. STAT. § 135.025(2)(b) (West 2011); see also Christopher J. Curran, Note, *Claims Against a Franchisor upon an Unreasonable Withholding of Consent to Franchise Transfer*, 23 J. CORP. L. 135, 152 (1997); Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29 FRANCHISE L.J. 139, 141 (2010); Dennis D. Palmer, *Franchises: Statutory and Common Law Causes of Action in Missouri Revisited*, 62 UMKC L. REV. 471, 491 (1994); Pitegoff, *supra* note 78, at 314–15; Am. Bar Ass’n, *Report of the American Bar Association Section of Antitrust Law on Proposed Small Business Franchise Act*, at n.14 (Dec. 13, 1999), [http://www.americanbar.org/content/dam/aba/administrative/antitrust\\_law/report\\_2e0e95b.authcheckd.am.pdf](http://www.americanbar.org/content/dam/aba/administrative/antitrust_law/report_2e0e95b.authcheckd.am.pdf); Emerson and Trautman, *supra* note 40, at 18 (stating “[a] franchisee is not usually in a place to bargain or negotiate certain provisions in a franchise agreement”).

<sup>200</sup> See, e.g., WIS. STAT. § 135.025(2)(b); Geib v. Amoco Oil Co., 29 F.3d 1050, 1056 (6th Cir. 1994); Bitronics Sales Co., Inc. v. Microsemiconductor Corp., 610 F. Supp. 550, 556 (D. Minn. 1985); Hartford Elec. Supply Co. v. Allen-Bradley Co., No. CV 96562061S, 1997 WL 297256, at \*3 (Conn. Super. Ct. May 28, 1997), *aff’d*, 736 A.2d 824 (Conn. 1999); Holiday Inns Franchising, Inc. v. Branstad, 537 N.W.2d 724, 728–29 (Iowa 1995); McDonald’s Corp. v. Markim, Inc., 306 N.W.2d 158, 162 (Neb. 1981); Kubis & Perszyk Assocs. v. Sun Microsystems, Inc., 680 A.2d 618, 626–27 (N.J. 1996); David L. Cahn & Jeffrey S. Fabian, *Mobility, the Home, and the Scope and Application of State Franchise Relationship and Termination Laws*, 30 FRANCHISE L.J. 107, 107 (2010).

<sup>201</sup> Mark Siebert, *The 23 Items Your Franchise Disclosure Document Must Include*, ENTREPRENEUR (Jan. 15, 2016), <https://www.entrepreneur.com/article/254051> (1. The Franchisor and Any Parents, Predecessors, and Affiliates; 2. Business Experience; 3. Litigation; 4. Bankruptcy; 5. Initial Fees; 6. Other Fees; 7. Estimated Initial Investment; 8. Restrictions on Sources of Products and Services; 9. Franchisee’s Obligations; 10. Financing; 11. Franchisor’s Assistance, Advertising, Computer Systems, and Training; 12. Territory; 13. Trademarks; 14. Patents, Copyrights, and Proprietary Information; 15. Obligation to Participate in the Actual Operation of the Franchise Business; 16. Restrictions on What the Franchisee May Sell; 17. Renewal, Termination, Transfer, and Dispute Resolution; 18. Public Figures; 19. Financial Performance Representations; 20. Outlets and Franchisee Information; 21. Financial Statements; 22. Contracts; 23. Receipts).

<sup>202</sup> Item 23 is merely procedural and is a requirement that franchisors obtain a signed receipt from each prospective franchisee confirming receipt of the FDD and accompanying exhibits.

and intended to give prospective franchisees a panoramic snapshot of the franchise, so they can make an informed decision about whether to proceed with the purchase of the franchise. This panoramic snapshot touches upon the obligations of the franchisor and its business credentials (Items 1–4, 19–21), as well as the obligations and likely costs undertaken by the franchisee and the franchise itself (Items 5–18), including details about the competitive nature of the market where the franchisee will be operating.

The regulation aims to ensure that as a potential investor, the would-be franchisee is able to carry out a cost-benefit analysis by assessing the potential risks of the investment and its overall benefits while having the recourse to make a meaningful comparison with other investments and investigate the business.<sup>203</sup> While each state may differ in its own regulatory requirements, the FDD provides a minimum threshold for disclosing relevant and valuable information to prospective franchisees in considering the cost and nature of their proposed investment. The Rule provides a predictable and transparent process with which franchisors and franchisees have become familiar and have come to expect in the franchise business model.

## 2. *Analyzing the Franchisor's Disclosure Requirements (Items 1–4)*

The FDD provides the prospective franchisees with critical information about the franchisor and parties associated with the franchisor. Item 1 discloses information pertaining to the franchisor as well as its parents, predecessors, and affiliates.<sup>204</sup> Beyond the basic background information about the franchisor and its connected parties, the prospective franchisee is entitled to receive sensitive, material commercial data regarding the franchisee's prospects in a given market and the competition it is likely to face. To better assess a franchise network's future operations, viability, legacy, and know-how (a critical component in a franchise arrangement),<sup>205</sup> this item requires extensive information about the franchisor as well as its parents, predecessors, and affiliates: the names and principal business

<sup>203</sup> Enforcement of the Franchise Rule, *supra* note 95, at 6.

<sup>204</sup> 16 C.F.R. § 436.5(a) (2007); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 29–32.

<sup>205</sup> See Robert W. Emerson, *Franchise Savoir Faire*, 90 TUL. L. REV. 589, 599, 599 n.53 (2016) (concluding that both European and U.S. legislatures and courts tend to react favorably toward requests to protect “franchise know-how,” which is “a subject closely related to trade secrets”); Robert W. Emerson, *Thanks for the Memories: Compensating Franchisee Goodwill after Franchise Termination*, 20 U. PENN. J. BUS. L. 286, 330 (2017) (“a franchisor will license a franchise's know-how or trademark to the franchisee”).

addresses of the franchisor;<sup>206</sup> any parents, predecessors (in the ten-year period leading up to the close of the franchisor's most recent fiscal year),<sup>207</sup> and affiliates offering franchises in any line of business or providing products or services to the franchisor's franchisees;<sup>208</sup> any name(s) the franchisor uses and intends to use to conduct business;<sup>209</sup> the type of business entity employed by the franchisor and the state in which the said entity is organized;<sup>210</sup> information about the business of the franchisor and the franchises it is offering;<sup>211</sup> information about the business experience of the franchisor and its predecessors, franchisees, and affiliates, noting among other things the length of time each conducted the same type of business that the franchisee will be operating;<sup>212</sup> and the number of franchises the franchisor or related entities have sold in other lines of business.<sup>213</sup> In effect, the disclosures should provide the prospective franchisee with facts about the general market for the goods or services that the franchisee will be offering, the competition to which the franchisee will be exposed, and the statutes, established case law, or regulations specific to the industry in which the franchise business will operate.<sup>214</sup>

To enable the franchisee to fully assess its exposure to competition, the franchisor should also clarify the competition to which the franchise will be exposed, any related franchises the franchisor will be offering, and any business activities the franchisor will be conducting. The franchisor should also describe the general market for its franchise offers, noting in particular the developmental stage of the market, if goods or services will be sold primarily to a certain group, and if sales are seasonal.<sup>215</sup> Along these lines, Item 2 discloses business credentials of the franchise's key personnel.<sup>216</sup> This item should note the name and position of the franchisor's directors, trustees, general partners, principal officers and any other individuals with management responsibility, as well as their principal positions and

<sup>206</sup> 16 C.F.R. § 436.5(a)(1).

<sup>207</sup> *Id.* § 436.5(a)(2).

<sup>208</sup> *Id.* § 436.5(a)(1); see also Amy Cheng, Diana Vilmenay & Theresa Leets, Int'l Franchise Ass'n, *Thorny FDD Disclosure Issues*, at 4 (May 6–8, 2018) (noting it is not only affiliates in the United States that must be disclosed, but also foreign affiliates that offer franchises).

<sup>209</sup> 16 C.F.R. § 436.5(a)(3).

<sup>210</sup> *Id.* § 436.5(a)(5).

<sup>211</sup> *Id.* § 436.5(a)(6). For each such entity, does it operate a business of the type being franchised?

<sup>212</sup> *Id.* § 436.5(a)(7).

<sup>213</sup> *Id.* § 436.5(a)(7)(i)–(iii).

<sup>214</sup> *Id.* § 436.5(a)(6)(i)–(vi).

<sup>215</sup> *Id.* § 436.5(a)(6)(iv).

<sup>216</sup> *Id.* § 436.5(b); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 33–34.

employers over the last five years.<sup>217</sup>

Item 3 discloses the litigation history of the franchisor and its connected parties (a predecessor, parent, or affiliate who induce franchise sales).<sup>218</sup> The obligation to provide full disclosure to prospective franchisees<sup>219</sup> extends to actual, pending, and previous lawsuits<sup>220</sup> and includes key litigation information such as the title, case number, and initial filing date; the nature of the relationship between the opposing party and the franchisor, *e.g.*, a supplier, current/former franchisee/class of franchisee; the legal and factual nature of the claim; the relief sought/obtained; the outcome of the case; any conclusions of law or fact; and for pending actions, the status of the action.<sup>221</sup>

Item 4 discloses any information regarding bankruptcy of the franchisor and its connected parties.<sup>222</sup> The franchisor must disclose its full bankruptcy history (dating ten years immediately before the date of the FDD)<sup>223</sup> including its own, that of its connected parties (affiliates, parents, predecessors),<sup>224</sup> and key personnel (any individuals with management responsibilities in the franchise including officers and general partners).<sup>225</sup>

### *3. Analyzing the Franchisee's Commitments (Items 5-10)*

Beyond the financial commitments of the franchisee, the FDD contains details of the franchisor's other obligations. Item 5 requires the franchisor to disclose the franchisee's initial fees and the conditions a franchisee must meet to obtain a refund of such fees.<sup>226</sup> Item 6 mandates disclosure of all

<sup>217</sup> 16 C.F.R. § 436.5(b).

<sup>218</sup> *Id.* § 436.5(c)(1); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 34–41; *see also* Cheng et al., *supra* note 208, at 4–5 (stating “it does not limit disclosure of predecessors to predecessors of the parent in the 10-year period before the end of the franchisor’s last fiscal year”).

<sup>219</sup> Connected parties include predecessors, affiliates offering franchises under the franchisor's principal trademark, parents or affiliates who induce franchise sales “by promising to back the franchisor financially” or guaranteeing the franchisor's performance, and any person identified in § 436.5(b).” 16 C.F.R. § 436.5(c)(1).

<sup>220</sup> *Id.* § 436.5(c)(1)–(2).

<sup>221</sup> *Id.* § 436.5(c)(3), (c)(3)(i).

<sup>222</sup> FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 42–43.

<sup>223</sup> 16 C.F.R. § 436.5(d)(1).

<sup>224</sup> *Id.* § 436.5(d)(1).

<sup>225</sup> *Id.*

<sup>226</sup> *Id.* § 436.5(e); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 43–45. “Initial fees” are defined as “all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sum or installments.” 16 C.F.R. § 436.5(e).

other fees payable to the franchisor or its affiliates by the franchisee.<sup>227</sup> This disclosure obligation includes whether these fees are recurring or occasional, including but not limited to royalties, fees for advertising, audits, accounting, inventory, transfers, and renewals.<sup>228</sup>

Item 7 clarifies what is the estimated initial investment that must be made by the franchisee in order to enter into the franchise agreement.<sup>229</sup> This item includes an illustrative list of expenses that are typical at the initial stage of a franchise<sup>230</sup> (pre-operating expenses like an initial franchise fee; training expenses; initial inventory; security deposits; business licenses; and prepaid expenses).<sup>231</sup> This serves to ensure that prospective franchisees have a more complete picture of their likely investment than they would have from information in Items 5 (initial fees) and 6 (other fees paid to the franchisor or affiliates) alone.<sup>232</sup>

Item 8 outlines mandatory purchases and sourcing restrictions for goods and services.<sup>233</sup> Item 8 lists the franchisee's obligations to buy or lease goods and services related to the establishment or operation of the franchised business either from the franchisor, its designee or approved suppliers; or under the specifications of the franchisor.<sup>234</sup> Item 9 designates the franchisee's key obligations under the terms of the agreement.<sup>235</sup> Item 9 is set out in tabular form: each obligation listed must be cross-referenced to the corresponding provision in the franchise agreement.<sup>236</sup>

Item 10 discloses financing arrangements which are incident to the franchise relationship, noting all the material conditions of any financing arrangement that the franchisor, its agents, or affiliates offer to the franchisee.<sup>237</sup> This includes coverage, lender's identity, the amount of financing offered, rate of interest, finance charges, and prepayment penalty information.<sup>238</sup> Certainly, to be legally safe under law or at least avoid any ethical complications, the franchisor should flag every interest it may have in these arrangements. It does so by disclosing any consideration the

<sup>227</sup> 16 C.F.R. § 436.5(f); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 45–47.

<sup>228</sup> 16 C.F.R. § 436.5(f)(1).

<sup>229</sup> *Id.* § 436.5(g); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 48–51.

<sup>230</sup> 16 C.F.R. § 436.5(g).

<sup>231</sup> *Id.* § 436.5(g)(1)(i)(A)–(B), (E)–(F).

<sup>232</sup> FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 48.

<sup>233</sup> 16 C.F.R. § 436.5(h); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 51–57.

<sup>234</sup> 16 C.F.R. § 436.5(h).

<sup>235</sup> *Id.* § 436.5 (i); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 57–59.

<sup>236</sup> 16 C.F.R. § 436.5(i).

<sup>237</sup> *Id.* § 436.5(j)(1); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 59–63.

<sup>238</sup> 16 C.F.R. § 436.5(j)(1)(i)–(iv), (viii).

franchisor or its affiliates receive with respect to placing financing with a lender.<sup>239</sup>

There are some issues within Items 5–10 that negatively impact the franchisee. For example, Item 8 requires franchisors to disclose their revenue or other material consideration from purchases and leases of products and services.<sup>240</sup> Yet, all too often the scenario occurs with the franchisor deriving substantial revenue from its systems' supply chains through side agreements, which pass along costs to franchisees and result in higher market prices.<sup>241</sup> For example, in *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*,<sup>242</sup> the franchisees alleged that sourcing restrictions yielded annual revenue to the franchisor of \$450 million.<sup>243</sup> Since the ingredients and supplies at issue were sold to the 3,500 franchisees at a markup—in some cases as high as 40%—each franchisee paid between \$3,000 and \$10,000 per year more for ingredients and supplies than they would have in an open and competitive market.<sup>244</sup> The nature and materiality of this hidden *de facto* royalty could not be discerned from the disclosure document. While the FDD offers guidance and uniformity, there are still some holes that a uniform regulatory structure from Congress may be able to address.

#### 4. Exploring the Franchisor's Commitments (Items 11–16, 21–22)

The FDD also contains information pertaining to the franchisor's commitments. Item 11 informs the prospective franchisee of assistance, support, and training provided by the franchisor,<sup>245</sup> including any support and training provided pre-opening,<sup>246</sup> and during the operation of the franchise.<sup>247</sup> Item 11 goes on to disclose the advertising program for the

<sup>239</sup> *Id.* § 436.5(j)(4).

<sup>240</sup> *Id.* § 436.5(h)(6).

<sup>241</sup> 241 Witmer, Karp, Warner & Ryan LLP, Comment on Franchise Regulatory Review, 16 C.F.R. pt. 436, Matter No. R511003 (Apr. 25, 2019), <https://www.regulations.gov/comment/FTC-2019-0014-0010>.

<sup>242</sup> *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430 (3d Cir. 1997).

<sup>243</sup> *Id.* at 434.

<sup>244</sup> *Id.* at 435.

<sup>245</sup> 16 CFR. § 436.5(k); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 69–72.

<sup>246</sup> 16 C.F.R. § 436.5(k)(1). For instance, helping to locate a site; negotiating the purchase or lease of the site; ensuring conforming of the premises with local ordinances and building codes; constructing, remodeling, or decorating the premises; hiring and training staff; supplying equipment, opening inventory, and supplies. *Id.* § 436.5(k)(1)(i)–(v).

<sup>247</sup> *Id.* § 436.5(k)(3)(ii)–(vi) (mentioning disclosures relating to the franchisor's obligations to the franchisee in helping with staff hiring and training; development of the franchised business; and resolution of operating problems encountered by the franchisee).

franchise by outlining any autonomy enjoyed by the franchisee and any contributions to the advertising budget payable by the franchisee.<sup>248</sup>

The franchisee's exclusive territory is disclosed in Item 12,<sup>249</sup> which includes the following information: whether the franchise covers one or more specific locations to be approved by the franchisor; details of any minimum territory granted to the franchisee (noting, for example, the specific radius); the conditions, if any, under which the franchisor will approve the relocation of the business of the franchisee; and whether an exclusive territory will be granted by the franchisor and any conditions that must be met to retain exclusivity (for example, any target(s) for sales or/and market penetration).<sup>250</sup> Item 12 further requires that the franchisor disclose: the conditions (if any) under which the franchisor will permit the franchisee to establish more outlets; any plans the franchisor or its affiliates have to operate a competing franchise, noting whether these outlets will be company-owned outlets or franchises, along with the timetable for the plan; and how the franchisor will resolve disputes between itself and the franchisees regarding territory, customers, and franchisor support.<sup>251</sup>

Item 13 lists all of the franchise's associated trademarks.<sup>252</sup> The obligation to disclose these trademarks encompasses details of each principal trademark that the franchisee will license,<sup>253</sup> whether the trademarks are registered with the U.S. Patent and Trademark Office (including details of each registration noting date, identification number, filings and renewals), and any pending litigation affecting the franchisee's use of the trademark(s).<sup>254</sup>

Other associated intellectual property (patents or copyrights) retained by the franchisor is disclosed in Item 14.<sup>255</sup> The disclosure must include information relating to any intellectual property ("IP") of the franchise which is owned or licensed to the franchisor (including information about the nature of any IP such as the term, ownership rights/licenses, details of agreements limiting use of such property and details of infringements which

<sup>248</sup> *Id.* § 436.5(k)(4)(iv)–(v).

<sup>249</sup> *Id.* § 436.5(l); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 72–74.

<sup>250</sup> 16 C.F.R. §§ 436.5(l)(1)–(3), (5)(ii).

<sup>251</sup> *Id.* §§ 436.5(l)(5)(ii), (6)(iii)(C), (6)(iii)(E)–(F).

<sup>252</sup> *Id.* § 436.5(m); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 74–76.

<sup>253</sup> 16 C.F.R. § 436.5(m)(1) defines "principal trademark" as "the primary trademarks, service marks, names, logos, and commercial symbols the franchisee will use to identify the franchised business. It may not include every trademark the franchisor owns."

<sup>254</sup> *Id.* § 436.5(m)(2), (m)(5)–(6).

<sup>255</sup> *Id.* § 436.5(n); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 76–77.

may affect the franchisee).<sup>256</sup>

Item 15 discloses the franchisee's participation duties.<sup>257</sup> The franchisor must disclose to the franchisee any obligation to participate personally in the actual operation of the franchise business<sup>258</sup> and should also indicate whether it recommends participation.<sup>259</sup>

Item 16 places restrictions on what the franchisee may sell.<sup>260</sup> The franchisor must disclose any franchisor-imposed conditions or restrictions concerning the goods and services the franchisee is permitted to sell, noting any obligation on the franchisee to sell only goods or services approved by the franchisor, and the franchisor's right to change the types of authorized goods or services.<sup>261</sup>

Audited financial statements are disclosed in Item 21.<sup>262</sup> The franchisor is required to provide audited financial statements, prepared in line with the generally accepted accounting principles ("GAAP"),<sup>263</sup> showing its financial condition, thus providing prospective franchisees with the information needed to assess the financial trends in a franchise system.<sup>264</sup> Contracts are disclosed in Item 22<sup>265</sup>; this includes copies of all proposed agreements relating to the franchise offering,<sup>266</sup> including the franchise agreement, leases, options, financial and purchase agreements.<sup>267</sup>

##### *5. Renewal, Termination, Transfer and Dispute Resolution (Item 17)<sup>268</sup>*

Among other things, the FDD should note (in tabular form, cross-referencing each enumerated franchise-related item with a provision in the franchise agreement) the following: the duration of the franchise; requirements that must be met by the franchisee to renew or extend the franchise; termination by the franchisee; termination by the franchisor (with

<sup>256</sup> *Id.* § 436.5(n)(1)(i), (n)(4), (n)(6)(i)–(iv).

<sup>257</sup> *Id.* § 436.5(o)(1); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 78–79.

<sup>258</sup> *Id.* § 436.5(o)(1).

<sup>259</sup> *Id.*

<sup>260</sup> *Id.* § 436.5(p); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 79–80.

<sup>261</sup> 16 C.F.R. § 436.5(p)(1), (p)(3).

<sup>262</sup> *Id.* § 436.5(u)(1); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 112–16.

<sup>263</sup> 16 C.F.R. § 436.5(u)(1).

<sup>264</sup> FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 112.

<sup>265</sup> 16 C.F.R. § 436.5(v); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 116–17.

<sup>266</sup> 16 C.F.R. § 436.5(v).

<sup>267</sup> *Id.*

<sup>268</sup> *Id.* § 436.5(q); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 80–83.

or without cause); franchisee's obligations on termination or non-renewal; assignment by the franchisor; transfer by the franchisee (the pre-approval process, the conditions, the franchisor's right of first refusal);<sup>269</sup> any in-term and post-term non-compete terms; and boilerplate clauses including modification, integration, alternative dispute resolution, and choices of law and forum.<sup>270</sup>

#### *6. A Public Figure's Involvement (Item 18)<sup>271</sup> and Financial Performance Representations (Item 19)<sup>272</sup>*

Public figures are often used to promote franchises and are typically viewed as the face of a brand. To ensure the would-be franchisee is made fully aware of that personality's involvement in the business, where a public figure<sup>273</sup> is involved, the FDD should set out the stake that this person has in the franchise, mentioning the consideration (monetary or otherwise) received by the person in exchange for endorsing the franchise to prospective franchisees, or the use of the public figure in the franchise name or symbol,<sup>274</sup> as well as the public figure's involvement in management or control of the franchisor and the public figure's total investment in the franchisor.<sup>275</sup>

Franchisor representations to prospective franchisees regarding future<sup>276</sup> and past<sup>277</sup> financial performance must "have a reasonable basis and written substantiation for the representation at the time the representation is made."<sup>278</sup> Also, representations must be recorded in Item 19 of the FDD.<sup>279</sup> Where the representation is a forecast of future financial performance, the material bases and assumptions upon which the projection is based must be disclosed,<sup>280</sup> including any "significant factors upon which a franchisee's future results are expected to depend."<sup>281</sup>

<sup>269</sup> 16 C.F.R. § 436.5(q)(3).

<sup>270</sup> *Id.*

<sup>271</sup> *Id.* § 436.5(r); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 80–83.

<sup>272</sup> 16 C.F.R. § 436.5(s); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 85–95.

<sup>273</sup> 16 C.F.R. § 436.5(r)(4) defines a "public figure" as "a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located."

<sup>274</sup> *Id.* § 436.5(r)(1).

<sup>275</sup> *Id.* § 436.5(r)(2)–(r)(3).

<sup>276</sup> *Id.* § 436.5(s)(3)(i), (3)(iii).

<sup>277</sup> *Id.* § 436.5(s)(3)(i)–(ii).

<sup>278</sup> *Id.* § 436.5(s)(3).

<sup>279</sup> *Id.*

<sup>280</sup> *Id.* § 436.5(s)(3)(iii).

<sup>281</sup> *Id.*

7. *Outlets and Franchisee Information (Item 20)*<sup>282</sup>

The information recorded in the FDD in tabular form must include: the total number of franchised and company-owned outlets for each of the franchisor's preceding three fiscal years, noting the number at the start and end of each fiscal year and logging the net change;<sup>283</sup> transfer data logging the number of outlets transferred<sup>284</sup>—from franchisees to new owners other than the franchisor or its affiliate—executed in each state for each one of the franchisor's last three fiscal years;<sup>285</sup> status of franchised outlets<sup>286</sup> and company-owned outlets;<sup>287</sup> and the number of projected franchised and company-owned outlet openings over the coming fiscal year.<sup>288</sup>

The importance of the FDD to the franchisee and the lending community is simple: investment in a franchise carries risks and liabilities that can lead to financial destruction without properly vetting the franchisor's disclosures.<sup>289</sup> While the FDD provides a robust disclosure system, there are some areas where improvement can be seen. For example, the Coalition of Franchisee Associations (CFA), which represents more than thirty-five thousand franchisees and is the largest franchisee-only association in the United States, proposes a modification to the Rule. The CFA calls for a verification process to be put in place that no longer leaves the prospective franchisee figuratively alone in its quest to determine whether all the necessary franchise information has been disclosed.<sup>290</sup> Further, the CFA calls for the FDD to be a legally binding document for the terms of the agreement, remaining valid and providing much needed recourse for the franchisee.<sup>291</sup> Of course, changes to the FDD may surely be warranted if bargaining power is to truly be equal between franchisors and franchisees. California, a perennial stalwart in producing generally pro-franchisee changes, has taken the reins on state regulations, paving the way for

<sup>282</sup> *Id.* § 436.5(t); FRANCHISE RULE COMPLIANCE GUIDE, *supra* note 159, at 95–112.

<sup>283</sup> 16 C.F.R. § 436.5(t)(1).

<sup>284</sup> *Id.* § 436.5(t)(2)(i).

<sup>285</sup> *Id.*

<sup>286</sup> *Id.* § 436.5(t)(2)(ii).

<sup>287</sup> *Id.* § 436.5(t)(2)(iii).

<sup>288</sup> *Id.* § 436.5(t)(3).

<sup>289</sup> Coal. of Franchisee Ass'ns, Comment to FTC Franchise Rule, Matter No. R511003 (May 9, 2019), <https://www.regulations.gov/document?D=FTC-2019-0014-0020>.

<sup>290</sup> *Id.*

<sup>291</sup> Currently, the FDD is only valid the day that it is received by the franchisee. A franchisor may change prices at a certain rate, making the FDD invalid but leaving the franchisee with no recourse. *See id.*

disclosure and franchisee resource reform.

### *B. Franchise Regulation in California*

A pioneer in the field of franchise regulation, the California legislature introduced two bodies of regulation protecting the interests of potential and actual franchisees: CFIL,<sup>292</sup> a registration and disclosure statute; and CFRA,<sup>293</sup> which governs the relationship between the franchisee and franchisor throughout the contract lifecycle.<sup>294</sup> It seems clear that the California legislature still recognizes that the franchise relationship begins with genuine, comprehensive disclosure and has taken steps to protect the franchisee's equity position with respect to its franchise business.<sup>295</sup>

#### *1. California's Registration and Disclosure Statute*

The California legislature has determined that persons investing in franchises require regulatory protection from pervasive, abusive franchise sales practices,<sup>296</sup> that franchising practices present numerous investment and business difficulties,<sup>297</sup> and that—to prevent the large losses franchisees frequently have sustained—franchisors must fully inform all concerned parties about everything relevant to the purchase and operation of their franchised businesses.<sup>298</sup>

Notably, California's franchise-specific laws pre-date the federal Franchise Rule enacted by the FTC. To combat the abuses, problems, and losses of franchising in the state, the California legislature in 1970 adopted the CFIL,<sup>299</sup> which quickly became an example for other state legislatures to consider and possibly follow.<sup>300</sup> Unlike the FTC's Revised Rule, in which violations can only be enforced by the FTC, the CFIL provides individual franchisees with a private right of action.<sup>301</sup>

<sup>292</sup> CAL. CORP. CODE § 31000 (West 1977).

<sup>293</sup> CAL. BUS. & PROF. CODE § 20000 (West 1981).

<sup>294</sup> GARDNER ET AL., *supra* note 89, at 84.

<sup>295</sup> Peter C. Lagarias, *Why the CFRA was Amended: It's All about Franchise Equity*, 19 FRANCHISE LAW. 8, 8 (2016).

<sup>296</sup> CAL. CORP. CODE § 31001 (West 1977); MENDELSON, *supra* note 88, at 316.

<sup>297</sup> GARDNER, *supra* note 89, at 84 (citing CAL. CORP. CODE § 31001 (West 1971)).

<sup>298</sup> Grueneberg & Solish, *supra* note 90, at 11–13; MENDELSON, *supra* note 88, at 316 (citing CAL. CORP. CODE § 31001).

<sup>299</sup> LAW AND REGULATION OF FRANCHISING, *supra* note 2, at 13, 15; CAL. CORP. CODE §§ 31000–516.

<sup>300</sup> *Supra* note 93 and accompanying text.

<sup>301</sup> Granted in CAL. CORP. CODE §§ 31300, 31301, and 31302.5. Kevin Albert Adams, *Navigating the Private Right of Action Under the California Franchise Investment Law*, Avvo (July 19, 2017),

The California legislature had a number of objectives when enacting the CFIL. It aspired to ensure that each prospective franchisee had the necessary information to make an intelligent decision regarding the franchise being offered.<sup>302</sup> It intended to curb fraudulent sales by prohibiting the sale of franchises where the sale would lead to fraud or a likelihood that the promises made by the franchisor would not be fulfilled.<sup>303</sup> Set out in the California Corporations Code (beginning at § 31000),<sup>304</sup> the CFIL contains mandatory provisions regulating the sale of the franchise (Part 2 of the Code), fraudulent and prohibited practices (Part 3 of the Code), and enforcement (Part 4 of the Code). In this context, the CFIL imposes several obligations on franchisors which will be considered in more depth in Part IV of this article.

First, the CFIL requires franchisors to register with the California Department of Business Oversight before offering and selling franchises in California. It also makes it unlawful for any person to offer or sell any franchise in the State of California without the offer of the franchise being registered pursuant to the CFIL.<sup>305</sup> Such registration should also be accompanied by the proposed franchise disclosure document.<sup>306</sup>

Second, it obligates franchisors to provide prospective franchisees with the franchise disclosure document and a copy of all the proposed agreements relating to the sale of the franchise at least fourteen days prior to either the sale (“the execution by the prospective franchisee of any binding franchise agreement”), or at least fourteen days prior to the payment of consideration to the franchisor (“the receipt of any consideration”) whichever occurs first.<sup>307</sup>

Third, it insists that franchisors offering franchises for sale in California keep and maintain a complete set of books, records, and accounts for these sales.<sup>308</sup>

<https://www.avvo.com/legal-guides/ugc/navigating-the-private-right-of-action-under-the-california-franchise-investment-law>.

<sup>302</sup> *About the Franchise Investment Law*, *supra* note 75 (stating that the purpose of pre-sale disclosure is “to provide, fully and truthfully, material information about the franchisor and its franchise offering to the prospective franchisee, prior to the prospective franchisee making a purchase decision.”); *see also* LAW AND REGULATION OF FRANCHISING, *supra* note 2, at 183.

<sup>303</sup> CAL. CORP. CODE § 31001.

<sup>304</sup> CAL. CORP. CODE § 31110 (West 1977).

<sup>305</sup> *Id.*

<sup>306</sup> *Id.* § 31114.

<sup>307</sup> *Id.* § 31119.

<sup>308</sup> *Id.* § 31150.

Fourth, it imposes criminal liability on any person engaged in fraudulent or prohibited practices.<sup>309</sup> When such a person willfully makes an untrue statement of a material fact, or willfully omits any material fact required to be stated therein, or fails to notify the Commissioner of any material change in any official document required by the CFIL and filed with the Commission,<sup>310</sup> they engage in fraudulent practices under the CFIL. It is unlawful for any person to effect or attempt to effect a sale of a franchise if that person is not identified in an application filed with the Commission pursuant to Part 2 of the CFIL (starting at §3100), unless the transaction is exempted by Chapter 1 of Part 2 of the CFIL.<sup>311</sup> If the Commission is of the view that a person is acting in violation of §31210, it “may order such person desist and refrain from further activity.”<sup>312</sup>

Fifth, it aims to provide certain rights to franchisees by prohibiting attempts by a franchisor to either “restrict or inhibit the right of franchisees to join a trade association or to prohibit the right of free association among franchisees for any lawful purposes.”<sup>313</sup>

Sixth, it provides aggrieved franchisees with private remedies where the franchisor has violated certain obligations, which contrasts with the position under the FTC Rule. Any person who offers or sells a franchise in violation of §31101 (disclosure obligation), §31110 (registration obligation), §31119 (obligation to provide relevant documentation at least 14 days prior to the sale or payment), § 31200 or § 31202 (obligation not to engage in fraudulent behavior when filing official documents or communicating information to the prospective franchisee) is liable to “the franchisee . . . who may sue for damages caused thereby . . . if the violation is willful, the franchisee may also sue for rescission.”<sup>314</sup>

## *2. A Model for Franchise Relationship Laws: The CFRA*

Though some federal legislation governing industry-specific franchises was available prior to the 1970s, no federal laws existed in the United States governing all types of franchises until the 1970s (with the introduction of the FTC Rule).<sup>315</sup> In 1956, Congress enacted the Automobile Dealer

<sup>309</sup> Fraudulent practices are defined at *id.* §§ 31200–204. Prohibited practices are outlined at *id.* §§ 31210–211.

<sup>310</sup> “Commissioner” is “the Commissioner of Business Oversight.” *Id.* § 31004.

<sup>311</sup> *Id.* § 31210.

<sup>312</sup> *Id.* § 31211.

<sup>313</sup> *Id.* § 31220.

<sup>314</sup> *Id.* § 31300.

<sup>315</sup> Hess, *supra* note 106, at 345–46.

Franchise Act<sup>316</sup> (commonly known as the “Dealers’ Day in Court Act”),<sup>317</sup> which imposes a good faith obligation on automobile manufacturers when carrying out the terms of the agreement and when terminating or not renewing the franchise.<sup>318</sup> In 1978, Congress granted protection to parties operating service stations under the Petroleum Marketing Practices Act (“PMPA”),<sup>319</sup> effectively prohibiting termination or non-renewal of the franchise if the cause is not based on one of the grounds articulated in the PMPA.<sup>320</sup>

Save for these two bodies of industry-specific relationship rules, efforts to introduce blanket relationship protection to franchisees at the federal level have failed. Although Congress and various commentators have debated the need for federal legislation to regulate franchises, addressing not only pre-contractual disclosure but also the concerns arising between the franchisors and franchisees after the franchise agreement is signed, this has not yet occurred at the federal level.<sup>321</sup> One of the earliest bills proposed was put forward in 1971, the same year California introduced relationship laws, but this and all subsequent Congressional attempts have failed,<sup>322</sup> as have possible franchise relationship FTC regulations.<sup>323</sup>

Much of the debate in this context is centered around the relative disparity in the bargaining power of franchisees when dealing with franchisors over a range of issues arising during the course of the franchise, including the location of new franchised outlets, and the franchisor’s right to terminate the franchise agreement without good cause and advance, written notice.<sup>324</sup> One such bill would have introduced “minimum standards of fair conduct in franchise sales and franchise business relationships” with the goals of promoting “fair and equitable franchise agreements,” establishing “uniform standards of conduct in franchise relationships” and creating “uniform private Federal remedies for violations of Federal

<sup>316</sup> 15 U.S.C. § 1222 (1982).

<sup>317</sup> Emerson & Benoliel, *supra* note 106, at 199.

<sup>318</sup> Hess, *supra* note 106, at 345–46 n.96.

<sup>319</sup> 15 U.S.C. §§ 2801–06 (1986).

<sup>320</sup> Hess, *supra* note 106, at 346 n.96.

<sup>321</sup> Enforcement of the Franchise Rule, *supra* note 95, at 1.

<sup>322</sup> Emerson & Benoliel, *supra* note 106, at 198–99 (citing PITEGOFF & GARNER, *supra* note 102, at 185–86).

<sup>323</sup> *Supra* text accompanying note 109 (referring to the FTC’s possible relationship regulations).

<sup>324</sup> Enforcement of the Franchise Rule, *supra* note 95, at 1–2.

Law.”<sup>325</sup>

Amendments to the California Franchise Relations Act (“CFRA”) are applicable to franchise agreements concluded or renewed on or after January 2016 and to franchise agreements of an indefinite period that may be terminated without cause.<sup>326</sup> In sum, the CFRA governs various aspects of the relationship between the parties to the franchise agreement.<sup>327</sup> This body of regulation addresses, *inter alia*, termination,<sup>328</sup> non-renewal,<sup>329</sup> transfers,<sup>330</sup> notices,<sup>331</sup> offers to repurchase,<sup>332</sup> arbitration,<sup>333</sup> and venue for disputes.<sup>334</sup>

### *3. Termination and Non-Renewal under the CFRA*

The revised CFRA makes termination more difficult. Subject to the very narrow grounds justifying early termination,<sup>335</sup> under the CFRA, a franchisor is prohibited from terminating a franchise agreement before expiration of its terms without good cause.<sup>336</sup> Good cause in this context is “limited to a failure by the franchisee to substantially comply with the lawful requirements imposed on [them] by the franchise agreement.”<sup>337</sup> For instance, prior to termination, the franchisor must provide the non-compliant franchisee with a notice of noncompliance at least sixty days in advance of the termination, during which time the franchisee is given a reasonable opportunity to cure the failure.<sup>338</sup>

At least 180 days prior to non-renewal of the franchise, the franchisor must inform the franchisee (by written notice) of its intention not to

<sup>325</sup> *Id.* at 10 (citing the unenacted Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. (1999)).

<sup>326</sup> CAL. BUS. & PROF. CODE § 20041(b) (West 1981).

<sup>327</sup> PITEGOFF & GARNER, *supra* note 102, at 18.

<sup>328</sup> CAL. BUS. & PROF. CODE §§ 20020–21.

<sup>329</sup> *Id.* §§ 20025–26.

<sup>330</sup> *Id.* § 20027(a).

<sup>331</sup> *Id.* § 20030.

<sup>332</sup> *Id.* § 20035.

<sup>333</sup> *Id.* § 20040.

<sup>334</sup> *Id.* § 20040.5, invalidated by *Bradley v. Harris Rsch., Inc.*, 275 F.3d 884 (9th Cir. 2001) (finding that this Section was preempted by the Federal Arbitration Act).

<sup>335</sup> The twelve permissible grounds for early termination are detailed in § 20021.

<sup>336</sup> *Id.* § 20020.; PITEGOFF & GARNER, *supra* note 102, at 18.

<sup>337</sup> CAL. BUS. & PROF. CODE § 20020. Under the former CFRA, good cause was simply articulated to include, but not be limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being provided with notice and a reasonable opportunity to cure. PITEGOFF & GARNER, *supra* note 102, at 18.

<sup>338</sup> CAL. BUS. & PROF. CODE § 20020.

renew.<sup>339</sup> During this period, the franchisor must allow the franchisee to “sell his business to a purchaser [who meets] the franchisor’s then current requirements for granting new franchises.”<sup>340</sup> Such a refusal to renew must not be motivated by a desire to convert the franchisee’s business into a company-owned outlet run by the employees or agents of the franchisor, though nothing prevents the franchisor from exercising a right of first refusal to buy the franchisee’s business.<sup>341</sup>

#### *4. Buyback Obligations under the CFRA*

Franchisees invest heavily in their franchise, often buying substantial amounts of goods and services from the franchisor. Where there has been a lawful termination or non-renewal of the franchise, the franchisor is obliged to purchase from the franchisee, at the value of price paid minus depreciation, any inventory, supplies, equipment, fixtures, and furnishings bought by or paid for by the franchisee to the franchisor or its approved supplier, pursuant to the terms of the franchise agreement or any ancillary or collateral agreement, that are in the franchisee’s possession or used in the franchised business, at the time of the notice of termination or non-renewal.<sup>342</sup> Due to the difficulties associated with the resale of the goods bought and the inability of franchisees to recoup this expenditure, such a provision effectively ensures that franchisees receive some redress for these expenses.

#### *5. The Death of a Franchisee under the CFRA*

When a franchisee dies, a franchisor cannot deny the surviving spouse, heirs or estate of a deceased franchisee the opportunity to participate in the ownership of the franchise under a valid franchise agreement for a reasonable period of time after the death of the franchisor.<sup>343</sup> Nothing prevents the franchisor from exercising the right of first refusal to buy the franchise after a *bona fide* offer to buy the franchise by a proposed buyer of the franchise.<sup>344</sup>

<sup>339</sup> *Id.* § 20025.

<sup>340</sup> *Id.* § 20025(a).

<sup>341</sup> *Id.* § 20025(b)(1).

<sup>342</sup> *Id.* § 20022(a).

<sup>343</sup> *Id.* § 20027(a).

<sup>344</sup> *Id.* § 20027(b).

### *6. A Right to Sell the Franchise under the CFRA*

When a franchisee has sought the franchisor's written consent to the sale or transfer of all or a substantial part of a franchise (or a controlling interest therein), the franchisor cannot lawfully prevent such a sale or transfer that meets the franchisor's existing standards for new franchisees.<sup>345</sup> In such circumstances, the franchisor cannot withhold its consent to this sale or transfer, unless the proposed buyer, transferee, or assignee fails to meet the aforementioned standards for new franchisees, or there is a failure by the buyer, transferee or assignee to comply with the transfer conditions stipulated in the franchise agreement.<sup>346</sup> If the franchisor has a contractual right of first refusal to purchase the franchise, or owns critical elements of the franchise (assets of the franchise business or a controlling or non-controlling interest in the franchise business), the franchisor may exercise this right after it receives a *bona fide* offer from a proposed buyer to purchase the franchise, assets, or interest.<sup>347</sup>

Prior to the sale, assignment, or transfer to another person, the franchisee must provide written notice to the franchisor confirming its intention to sell, to transfer or to assign the franchise, assets or interest in the franchise.<sup>348</sup> This notice should include the name and address of the proposed transferee along with copies of all agreements pertaining to the sale, assignment or transfer of the franchise, assets or interest, and the application of the proposed transferee for approval to become the successor franchisee.<sup>349</sup> The franchisor must notify the franchisee in writing, within sixty days after receipt of this information package from the franchisee, of the approval or disapproval of the proposed sale, assignment, or transfer.<sup>350</sup>

Unless the franchisor disapproves in the manner prescribed below, the proposed sale, assignment, or transfer is deemed approved.<sup>351</sup> If the franchisor disapproves the proposed sale, assignment, or transfer, the franchisor must include a statement of the reasons for the disapproval in the disapproval notice.<sup>352</sup> "In any action in which the franchisor's disapproval of a sale, assignment, or transfer ... is an issue, the reasonableness of the franchisor's decision shall be a question of fact *requiring consideration of*

<sup>345</sup> *Id.* § 20028(a)–(b).

<sup>346</sup> *Id.* § 20028(b).

<sup>347</sup> *Id.* § 20028(c).

<sup>348</sup> *Id.* § 20029(a).

<sup>349</sup> *Id.* § 20029(a)(1)–(3).

<sup>350</sup> *Id.* § 20029(b)(1).

<sup>351</sup> *Id.*

<sup>352</sup> *Id.*

*all existing circumstances.”<sup>353</sup>*

#### 7. Arbitration and Legality of Out-of-State Venue Provisions under the CFRA

Going to arbitration is at the discretion of the parties and may be agreed upon either before or after a dispute has arisen, so long as the arbitrator(s) are selected from a list of impartial arbitrators supplied by the American Arbitration Association, or by another impartial person.<sup>354</sup> Franchisors can include arbitration provisions in the franchise agreement, but whether the provision is enforceable is another question. Courts tend to enforce arbitration agreements.<sup>355</sup> Arbitration agreements waive both parties’ fundamental right to have a court resolve their dispute.<sup>356</sup> Some states do not allow franchise agreements to include a waiver of the right to file a lawsuit. For example, Maryland forbids franchise agreements from containing a waiver of a right to file a lawsuit in court.<sup>357</sup> California prohibits franchise contract provisions that restrict venue to a forum outside of California when the franchise agreement involves a business operating in California.<sup>358</sup> This law is supported by the public policy of wanting “to protect California franchisees from the expense, inconvenience, and possible prejudice of litigating in a non-California venue.”<sup>359</sup>

A state law that invalidates an arbitration agreement should not be preempted by the Federal Arbitration Act (“FAA”) when “the law is ‘generally applicable’ or applies to ‘any contract.’”<sup>360</sup> Whether this provision is preempted by the FAA would depend on the analysis of “any contract.”<sup>361</sup> However, the Ninth Circuit has held in favor of the FAA’s preemption of the California anti-foreign-venue-clause.<sup>362</sup>

<sup>353</sup> *Id.* § 20029(b)(2) (emphasis added).

<sup>354</sup> *Id.* § 20040(b).

<sup>355</sup> Megan B. Center, *Is Your Agreement to Arbitrate Valid?*, FRANCHISE L. UPDATE (June 24, 2017), <https://franchiselaw.foxrothschild.com/2017/06/articles/legal-decisions/valid-arbitration-title/>.

<sup>356</sup> *Id.*

<sup>357</sup> *Chorley Enters. Inc. v. Dickey's Barbecue Rests., Inc.*, 807 F.3d 553, 562–64 (4th Cir. 2015).

<sup>358</sup> CAL. BUS. & PROF. CODE § 20040.5, invalidated by *Bradley v. Harris Rsch., Inc.*, 275 F.3d 884 (9th Cir. 2001) (finding that this Section was preempted by the Federal Arbitration Act).

<sup>359</sup> *Aguilera v. Matco Tools Corp.*, No. 3:19-cv-01576, 2020 WL 1188142, at \*10 (S.D. Cal. Mar. 12, 2020) (citing *Jones v. GNC Franchising, Inc.*, 211 F.3d 495, 498 (9th Cir. 2000)).

<sup>360</sup> *Bell Prods., Inc. v. Hosp. Bldg. & Equip. Co.*, No. 16-cv-04515-JSC, No. 2017 WL 282740, at \*3 (N.D. Cal. Jan. 23, 2017).

<sup>361</sup> *Id.* at \*3–4.

<sup>362</sup> *Bradley*, 275 F.3d at 890, 892 (holding that “§ 20040.5 is preempted by the FAA.”); see *Bell Products, Inc.*, 2017 WL 282740, at \*4 (concluding that “Neither the Ninth Circuit sitting en banc nor

#### 8. *Violations of the CFRA Termination and Non-Renewal Provisions*

Where, in violation of the aforementioned provisions, the franchisor terminates or fails to renew the franchise, the franchisee is entitled to receive from the franchisor the fair market value of the franchised business and its assets, along with any other damages caused by the violation of the aforementioned provisions.<sup>363</sup> In addition, a court has the discretion to grant an injunction (preliminary or permanent) for a violation or threatened violation of these provisions.<sup>364</sup> California, while one of only a few zealously regulatory states, offers a glimpse of a governing system that aims to balance the franchisor-franchisee relationship with a federal scheme as the “floor” of basic disclosure requirements. Lessons learned from California’s regulatory changes along with the FTC may offer guidance to the EU in promulgating a more uniform system for the EU’s own Member States.

#### PART IV: A CRITICAL ASSESSMENT OF SOLUTIONS PROPOSED BY THE EUROPEAN PARLIAMENT: POSSIBILITIES FOR REFORM

In order to encourage a broader dissemination of the franchise business model across the EU, the EP has called for a reform of the regulatory environment applicable to franchise arrangements with an eye on two specific concerns—legal divergence and lack of uniformity. To address these issues, the EP has put forward a multifaceted approach for reform with a number of key priorities, including: informational transparency; homogenization of guidelines; establishment of associations promoting the interests of franchisees; collation and sharing of strategic information; and a review of competition law and its impact on franchising.<sup>365</sup> In this section, we will critically assess the EP’s suggestions relating to franchisee protection while making our own recommendations for reform. The following analysis will focus on the protective framework that could be introduced in the EU using the regulatory system in the United States as a comparative paradigm. Important parallels rest in U.S. federal preemption and EU preemption with the laws of a Member State. The principle of supremacy of EU law ensures effectiveness and uniform application of laws

the Supreme Court have overruled *Bradley* . . . . Absent an order overruling the decision, *Bradley* remains good law in the Ninth Circuit and binding precedent on the Court”).

<sup>363</sup> CAL. BUS. & PROF. CODE § 20035(a) (West 1981).

<sup>364</sup> *Id.* § 20035(b).

<sup>365</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ I.

and can aid in the success of an EU regulatory system.<sup>366</sup>

The EP acknowledges that *harmonization* of the protections afforded to the contracting parties, notably the franchisee, under national law in the Member States will enable the EU to effectively address the lack of legislative and regulatory convergence at the national level.<sup>367</sup> Such protection, suggests the EP, can be achieved using a two-pronged trajectory consisting of the formulation of homogenous guidelines of a non-legislative nature reflecting best practices,<sup>368</sup> coupled with enhancement of enforcement at the national level.<sup>369</sup>

To better shape the normative environment applicable to such arrangements, the EP calls upon the European Commission to introduce guidelines on franchise contracts<sup>370</sup> addressing existing unfair trade practices.<sup>371</sup> In addition, the EP has suggested the creation of an informational platform accessible to the public that issues guidance on unfair contract terms and unfair implementation of contracts.<sup>372</sup>

To tackle the problems flagged by the EP in its Motion (discussed *infra*, in Part I) and to guarantee the effective harmonization of national measures across the EU protecting prospective and actual franchisees, we call for a multifaceted *regulatory* European level approach inspired by the binary regulatory framework developed at the federal and state level in the United States. The U.S. system could offer what the EU is lacking for franchises, such as informational transparency,<sup>373</sup> uniformity of disclosures,<sup>374</sup> and a clear, well-defined franchise and business regulatory system.<sup>375</sup> The U.S. system, while imperfect, is a tried-and-true method of providing a franchise network that works towards fostering successful relationships between franchisors and franchisees; and as a result, both parties thrive. For example,

<sup>366</sup> Case 6/64, Costa v. ENEL, 1964 E.C.R. 585.

<sup>367</sup> Report on the Functioning of Franchising in the Retail Sector, *supra* note 1, ¶ 4.

<sup>368</sup> *Id.* ¶ 2.

<sup>369</sup> *Id.* ¶ 5.

<sup>370</sup> *Id.* ¶ 3.

<sup>371</sup> *Id.* ¶ 4.

<sup>372</sup> Presently, such information is either not written down or is found in confidential side letters which accompany the franchise agreement. *Id.* ¶ G.

<sup>373</sup> Abell, *supra* note 5, at 13. That is not to say that the U.S. system is sufficiently “transparent.”

Robert W. Emerson, *Transparency in Franchising*, 2021 COLUM. BUS. L. REV. 172 (2021).

<sup>374</sup> Don Daszkowski, *The Franchise Disclosure Document (FDD): Formerly Known as the UFOC*, BALANCE SMALL BUS. (Dec. 10, 2018), <https://www.thebalancesmb.com/the-franchise-disclosure-document-fdd-1350608>.

<sup>375</sup> Michael Seid, *Bringing Your Franchise Concept to the United States*, BALANCE SMALL BUS. (June 25, 2019), <https://www.thebalancesmb.com/bringing-franchises-to-us-1350641>.

when creating a regulatory framework with the United States in mind, the EU should focus on allowing the current Member States to have their own state franchise administrative agencies enforce rules against franchise activities within their borders.<sup>376</sup> Then, instead of having many states enforcing different franchise sales laws, there will be many states enforcing a uniform system.<sup>377</sup>

The EU could improve on the fractured federal system in the United States, which has spotty enforcement at times, and move to deputize their Member States as the enforcement vehicles for a more uniform and standard franchise sales law.<sup>378</sup> It is through a more conjoined dual system that mutual, systemic benefits can be obtained. This mutual benefit is achieved through pre-sale disclosure and registration laws, business opportunity laws, industry-specific laws, and state franchise relationship laws.<sup>379</sup> It is because of the regulatory requirements, like pre-sale disclosures, that both franchisors and franchisees thrive in the United States.<sup>380</sup> It is also because of the regulations in the United States that franchisees are able to have more equal footing with franchisors, who generally enjoy the upper hand when it comes to bargaining power. Without such regulations, franchisors would be able to run rampant with power. The next segment of the article looks at each one of these recommendations with an eye to U.S. law.

First, the EU should give due consideration to introducing a system akin to California's covering registration and disclosure, while setting out the basic and inalienable remedies available to aggrieved franchisees and establishing the mandatory brass-tacks of the franchise relationship. As we have seen, California's CFIL obliges franchisors to follow a two-step process, registration and disclosure, before offering and selling franchises, while making it unlawful for any person to offer or sell any franchise without the offer first being registered with the State.<sup>381</sup> Any person offering or selling a franchise in California must register *and* file the proposed franchise disclosure document with the designated State authority (in California, the California Department of Business Oversight) before

<sup>376</sup> Davis Wright Tremaine LLP, Comment on Franchise Rule Regulatory Review, 16 C.F.R. pt. 436, Matter No. R511003 (May 12, 2019), <https://www.regulations.gov/comment/FTC-2019-0014-0023>.

<sup>377</sup> *Id.*

<sup>378</sup> *Id.*

<sup>379</sup> Mark Kirsch, Julia C. Colarusso & Karli B. Hussey, *Franchising in the USA*, LEXOLOGY (Jan. 24, 2019), <https://www.lexology.com/library/detail.aspx?g=024cd701-1433-4077-9ac4-b465f9824da0>; see also Zwisler, *supra* note 165.

<sup>380</sup> Seid, *supra* note 375.

<sup>381</sup> CAL. CORP. CODE § 31110 (West 1977).

offering and selling franchises.<sup>382</sup> By using a similar model adapted to the European market, a system of registration and disclosure could be introduced and administered at either the European or Member State level.

Importantly, regardless of the growing economic importance of franchising, most EU Member States have not established a specific code on franchise law, relying on relevant general laws.<sup>383</sup> Member State level registration and disclosure, with a designated national authority, affords certain advantages over a European level system of registration and disclosure. While the latter system will ensure uniformity, the creation of a designated national authority is likely to be expeditious as structures often exist which may be adapted to this new role; the administration of a smaller number of applications is likely to be swifter and efficacious, and oversight more effectual. Moreover, these national structures will allow for registration and disclosure in the official language or languages of the Member State. However, reliance on general consumer regulation and the uniqueness of each state may prove disadvantageous to a uniform scheme that does not embody the states as “laboratories of democracy.”<sup>384</sup> Each state can be said to have its own tailored franchise system for a reason, each addressing its own concerns and values.<sup>385</sup> But, while the United States still has some concerns to be addressed by Congress, the EU can learn from the U.S. approach and use federal preemption as a means to allow the Member States to regulate under a common framework.<sup>386</sup> Member States could still have their own regulatory agencies, except that they could enforce a uniform set of regulations and thereby offer more certainty in the franchise relationship.<sup>387</sup>

Second, in the event that a Member State level registration and disclosure system is opted for, defining at the European level of the substance of the disclosure document and the processes associated with the national system of registration and disclosure would ensure informational transparency, uniformity of disclosure, procedure and remedies, and the

<sup>382</sup> See *id.* §§ 31110, 31114 (West 2014) (registration and filing of disclosure document, respectively).

<sup>383</sup> Karsten Metzlaff & Mark Abell, *European Union*, in FUNDAMENTALS OF FRANCHISING EUROPE 40 (Robert A. Lauer & John Pratt eds., 2017).

<sup>384</sup> Caroline B. Fichter, Andrew M. Malzahn & Adam Matheson, *Don't Treat on Me: A Defense of State Franchise Regulation*, 38 FRANCHISE L.J. 23, 24 (2018)

<sup>385</sup> *Id.*

<sup>386</sup> *Id.*

<sup>387</sup> *Id.* at 25.

collation and sharing of strategic information.<sup>388</sup> To ensure a disclosure that is clear, coherent and consistent, the EU could develop a template disclosure form modeled on the Franchise Disclosure Document used in the United States, providing the prospective franchisee with information about the obligations of the franchisor and its business credentials, the obligations and likely costs that a franchisee will incur alongside material information pertaining to the franchise itself, including details on the competitive nature of the market where the franchisee will be operating.<sup>389</sup> Ultimately, such a disclosure would permit the prospective franchisee to make an informed decision about whether to enter into the proposed franchise arrangement<sup>390</sup> by enabling the would-be franchisee to assess the possible risks and benefits, make meaningful comparisons with other investments, and further investigate the business.<sup>391</sup>

While potential franchisees owe themselves a measure of due diligence before buying a franchise, the FDD should reinforce the duty to oneself: requiring such disclosures ensures franchisees obtain pertinent information and are not misguided about expectations of the return on a franchise.<sup>392</sup>

Beyond the obligation to register and disclose, a framework defining the responsibilities of the franchisor in relation to registration and disclosure should be formulated by the EU to ensure operational uniformity, transactional security, and procedural transparency across Member States. Such a framework should seek to address the procedures associated with registration and disclosure by defining the timings of registration and disclosure, the identity of person or persons responsible for collating the requisite information and documentation, liability for failure to file and for inaccuracies, the right to update information and documentation, and so

<sup>388</sup> A similar system is used in EU corporate law. In this context, several directives have been introduced at the European level, which are then left to the Member States themselves to implement into national law. These directives allow the EU to define minimum requirements applicable at Member State level (*inter alia*, the minimum disclosure and structural requirements which must be adhered to by corporations) while leaving the Member States to introduce and administer the procedures set out in these directives (including the establishment of a central depositary of information, a system for the centralised collation and disclosure of corporate information, and the oversight of this system at the national level).

<sup>389</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶¶ 20, 23.

<sup>390</sup> *Id.* ¶ 20.

<sup>391</sup> Enforcement of the Franchise Rule, *supra* note 95, at 6.

<sup>392</sup> Anya Nowakowski, FRANData, Int'l Franchising Ass'n Franchise Educ. & Rsch. Found., *Financial Performance Representation: Market Demand Pushing Higher Levels of Transparency*, at 2–8 (Apr. 2017), [http://franchise.org/sites/default/files/2017-Financial\\_Performance\\_Representations\\_final.pdf](http://franchise.org/sites/default/files/2017-Financial_Performance_Representations_final.pdf) (The Financial Performance Representation(s) (“FPR”) is intended to be a more nuanced, updated term for that which the Uniform Franchise Offering Circular (“UFOC”) called “earnings claims.”).

forth.

Modeled upon the procedures used in the FTC Rule, such a procedure could require the franchisor to furnish prospective franchisees with the FDD and a copy of all related agreements either at least fourteen days before the sale of the franchise (execution of any binding franchise) or the payment of consideration to the franchisor (whichever takes place first).<sup>393</sup> Such a period of reflection would enable the prospective franchisees to reflect on their investment. This would provide them with time to seek specialized legal advice on the investment and on the terms of the proposed franchise agreement, together with guidance on the commercial and strategic information provided in the disclosure document as well as the precise benefits and risks associated with this arrangement.

Third, in order to ensure the existence of a balanced set of rights and obligations, the EU should consider specific principles covering not only pre-contractual disclosure and confidentiality of information,<sup>394</sup> but also the ongoing parameters of the contractual relationship itself.<sup>395</sup> Relationship laws governing the substantive relationship of the contracting parties articulate the commitments of the franchisor and franchisee, but principally govern the obligations owed by the franchisor to the franchisee.<sup>396</sup> The two key purposes of relationship laws are to counteract any serious inequality of bargaining power between the franchisor and its franchisees, and to protect franchisees against abusive conduct on the part of the franchisor.<sup>397</sup> The main types of abuse<sup>398</sup> addressed by franchise relationship laws are attempts to unjustly terminate the franchise relationship without reasonable cause or the provision of sufficient notice,<sup>399</sup> restricting free association among

<sup>393</sup> CAL. CORP. CODE § 31119(a) (West 2005).

<sup>394</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ 20.

<sup>395</sup> Throughout the term of the agreement, the EP acknowledges the need for the provision of initial training, of continuous support and commercial and technical assistance. *Id.* ¶¶ 20–21.

<sup>396</sup> Emerson, *supra* note 166, at 329; see *State Franchise Laws*, GOLDSTEIN L. FIRM, <https://www.goldlawgroup.com/franchise-laws/> (last visited June 19, 2021) (noting there are franchise relationship laws at the state level that tend to try to control general terminations and non-renewals of franchisees).

<sup>397</sup> Emerson & Benoliel, *supra* note 106, at 196–97; see also PITEGOFF & GARNER, *supra* note 102, at 185 (stating that in the 1950s and 1960s franchisees argued that franchisor abuse was not adequately addressed in common law or antitrust law, which led to early franchise relationship laws in the 1970s).

<sup>398</sup> Emerson & Benoliel, *supra* note 106, at 197 n.19 (listing sources).

<sup>399</sup> See ARK. CODE ANN. § 4-72-209 (West 2012); CAL. BUS. & PROF. CODE §§ 20020–21 (West 2012); HAW. REV. STAT. § 482E-6(H) (2012); 815 ILL. COMP. STAT. 705/19 (2012); IOWA CODE §§ 523H.7(1), 537A.10(7)(c) (2012); MINN. STAT. § 80C.14(3)(b) (2012); MISS. CODE ANN. § 75-24-57 (2012); MO. REV. STAT. § 407.405(1) (2012); NEB. REV. STAT. § 87-404(1) (2018); N.J. STAT. ANN. § 56:10-5 (West 1971); N.D. CENT. CODE § 51-20.1-03 (2012); P.R. LAWS ANN. tit. 10, § 278(a) (2008);

franchisees;<sup>400</sup> requiring that franchisees agree to out-of-state arbitration;<sup>401</sup> and attempts to encroach on the territory allocated to the franchisee by establishing a new company-owned outlet in close proximity to the franchisee's franchised-outlet.<sup>402</sup>

To ensure the protection of franchisees against unfair terms, any EU legislative framework should provide certain inalienable rights to franchisees addressing these key types of abuse. Modeled on the CFRA, such a regulatory framework could provide for inalienable relationship laws that apply regardless of the express terms set out in the franchise agreement.<sup>403</sup> These protections should be warranted beyond the termination or refusal to renew stage, protecting the franchisee from owing substantial amounts of money due to early terminations and requiring the franchisor to provide value to a departing franchisee.<sup>404</sup>

Such a framework could address the most prevalent forms of abuse by addressing termination; securing access to dispute resolution mechanisms and local law and in turn European regulation by, respectively, curtailing the ability of the franchisor to limit or to deny the franchisee's access to local courts and to circumvent the benefit of the law of the Member State (where the franchisee is based or operating) by attempting to use the governing law of another jurisdiction; guaranteeing provision for the franchisee's family and descendants on the death of the franchisee; imposing duties on the franchisor if she decides not to renew the franchise agreement; imposing an obligation on the franchisor to buyback inventory, supplies, equipment, fixtures and furnishings bought or paid for by the franchisee; and securing a right for the franchisee to sell the franchise. This framework could also protect the right of franchisees to join trade associations or to associate with other franchisees by preventing franchisors from curtailing or forbidding such activities.<sup>405</sup> Beyond the benefit to the

R.I. GEN. LAWS § 6-50-4(a) (1956); WASH. REV. CODE § 19.100.180(2)(j) (2012); WIS. STAT. § 135.03 (2020).

<sup>400</sup> See ARK. CODE ANN. § 4-72-206(2) (West 2019); CAL. CORP. CODE §§ 31220, 31302.5 (West 2012); HAW. REV. STAT. § 482E-6(2)(A) (1978); 815 ILL. COMP. STAT. 705/17 (1988); IOWA CODE § 523H.9 (2020); MICH. COMP. LAWS § 445.1574(g) (2012); MINN. STAT. 2860.4400(A); NEB. REV. STAT. § 87-406(2) (2020); N.J. STAT. ANN. § 56:10-7(b) (West 2020); R.I. GEN. LAWS § 19-28.1-16 (1956).

<sup>401</sup> See CAL. BUS. & PROF. CODE § 20040 (West 2012); MICH. COMP. LAWS § 445.1527(f) (2020); MINN. STAT. § 80C.21 (1989); R.I. GEN. LAWS § 19-28.1-14 (2016).

<sup>402</sup> See HAW. REV. STAT. § 482E-6(2)(E) (1978); IND. CODE § 23-2-2.7-1(2) (2012); IOWA CODE § 523H.6(1) (2009); MINN. R. § 2860.4400(C) (2020); WASH. REV. CODE § 19.100.180(2)(f) (2011).

<sup>403</sup> Emerson & Benoliel, *supra* note 106, at 197; see also Rosen et al., *supra* note 181.

<sup>404</sup> Matthew J. Kreutzer, *California Amends its Franchise Relations Act*, 37 CAL. BUS. L. REP. 116, 117 (2016); Emerson, *Compensating Franchisee Goodwill*, *supra* note 205.

<sup>405</sup> CAL. CORP. CODE § 31220 (2018).

franchisee, such a commitment arguably elevates the effectiveness of the franchise network itself, positively contributing to the market sector, the Single Market, and the economy at large.

### CONCLUSION

In the United States, where franchising has been present since the Civil War,<sup>406</sup> legislation has been adopted incrementally from the 1970s onward at the state and federal levels; this has created, to some extent, a safety net for protecting the interests of prospective franchisees during the pre-contractual bargaining phase and, to a lesser extent, during the term of the franchise relationship. This regulation has done nothing to dampen the interest in franchising. Indeed, the number of franchises established in the United States has, over the years, grown significantly; and the economic performance of this sector has tended to be robust, with franchises now present in over three hundred categories of U.S. business industries such as products and services, food, beverage, lodging, health, educational services, car maintenance, and real estate.<sup>407</sup> With a demonstrated growth pattern (the total annual sales of the top two hundred franchises based in the United States grew by \$55.9 billion from 2011 to 2016 reaching \$616.4 billion in 2016)<sup>408</sup> and an estimated economic output of \$713.3 billion (in 2017),<sup>409</sup> the U.S. franchise sector is comprised of over 780,000 franchise establishments<sup>410</sup> that directly employ over 8.8 million people.<sup>411</sup> According to data released in 2016 by the U.S. Department of Trade, franchising “will outperform the U.S. economy for the sixth consecutive year in terms of overall growth”<sup>412</sup> and added roughly one million jobs to the U.S. economy

<sup>406</sup> See *supra* notes 3, 160.

<sup>407</sup> Richard Boll, U.S. Dep’t of Com. Int’l Trade Admin., *2016 Top Markets Report Franchising*, at 5 (May 2016), <https://legacy.trade.gov/topmarkets/franchising.asp>.

<sup>408</sup> TOP 200+: RANKING THE 500 BIGGEST BRANDS IN FRANCHISING, FRANCHISE TIMES (Oct. 2017), <http://www.franchisetimes.com/pdf/2017/2017-Top-200.pdf>. These statistics come from the Top 200+ Report published by Franchise Times in 2017, covering 2016. The Franchise Times produce annual reports ranking the largest franchise systems in the U.S., based on global *systemwide sales* in the previous year; according to Franchise Times *systemwide sales* are defined “as the total sales for both franchise and company units . . . [representing] sales to customers.” FRANCHISE TIMES, *Methodology*, <http://www.franchisetimes.com/Resources/Top-200/Methodology/> (last visited June 19, 2021).

<sup>409</sup> In 2017, the estimated economic output of all U.S. franchise establishments was \$720.44 Billion. Elena R. Mazareanu, *Economic Output of Franchise Establishments in the U.S. 2007–2020*, STATISTA, <https://www.statista.com/statistics/190318/economic-output-of-the-us-franchise-sector/> (last visited June 19, 2021).

<sup>410</sup> In 2015, there were over 780,000 U.S.-based franchise establishments in operation. Boll, *supra* note 407, at 7.

<sup>411</sup> *Id.*

<sup>412</sup> *Id.*

over a five-year period (2010–2015).<sup>413</sup>

Franchise arrangements in the United States are addressed by a binary system combining federal and state law. Together they define the franchise relationship itself, while establishing the commitments of the parties during the bargaining phase and as the contract develops in actual practice.<sup>414</sup> This patchwork quilt of franchise regulation means that a person (natural or legal) doing business in the United States needs to consider federal law alongside state law.<sup>415</sup> A franchisor (domestic or foreign) is accordingly required to ensure compliance with both sets of laws when determining whether to operate in the United States and in particular states.<sup>416</sup>

Due to the underperformance of the franchise sector in the EU relative to the United States and Australia and drawing on the binary framework developed in the United States, we argue that the EU legislature should adopt or otherwise move toward the implementation of a uniform EU-wide legal framework guaranteeing protection to franchisees both during the bargaining phase as well as contractual performance. To accomplish that purpose, in this article, we have put forward numerous proposals to reform the system governing franchises in the EU.

By introducing mandatory disclosure rules, potential investors in franchise operations are furnished with the information needed to make an informed decision; this is further reinforced by means of a system of national, centralized registration – that provides for procedural oversight and enforcement. Together these systems of registration and disclosure would go a long way towards the creation of a more effective national system of enforcement, as promoted by the EP.<sup>417</sup> Going beyond the pre-contractual mandatory disclosure requirements and a system of registration, the EU's legislature should also introduce a framework of mandatory provisions delineating the ongoing substantive contractual obligations and rights of both parties to the franchise agreement. This would ensure consistent franchisee protection, stable franchisor/franchisee relationships, and the economic strength of the franchise sector in both the Single Market and the global economy. Primarily redressing the unequal economic power of the parties and opportunistic behavior on the part of some franchisors, this framework should ensure that certain contract provisions are standard

<sup>413</sup> *Id.*

<sup>414</sup> Emerson, *supra* note 166, at 329.

<sup>415</sup> MENDELSON, *supra* note 88, at 316.

<sup>416</sup> Märzheuser-Wood & Baggott, *supra* note 97, at 2.

<sup>417</sup> *Report on the Functioning of Franchising in the Retail Sector*, *supra* note 1, ¶ 5.

(*i.e.*, legally required); in fact, as franchising is a long-term, relational contract, a “best-practices-now-compulsory” continuing protection of franchisees should be present throughout the term of the contract.

To this end, in this article, we have provided a number of recommendations for reforming franchising in the EU. In turn, the European reforms may provide lessons for franchise regulation worldwide.

