Regulating the Franchise Relationship

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REGULATING THE FRANCHISE RELATIONSHIP

DONALD P. HORWITZ*
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The views expressed in this article are solely the authors' and are not necessarily those of McDonald's Corporation.
I. INTRODUCTION

To date, fifteen states have passed legislation regulating the franchise relationship; similar legislation has frequently been proposed in Congress. This deceptively simple and superficially appealing legislation seeks to regulate the franchise relationship by prohibiting a franchisor from requiring “unreasonable” standards of franchisee performance and from terminating or declining to renew a franchisee without “good cause.” Proponents of the legislation claim it is necessary to protect franchisees who otherwise would continue to be victimized by franchisors.

Examination of the premises upon which existing and proposed legislation regulating the franchise relationship is based reveals serious misconceptions about the nature of the franchise relationship. 

1 Legislation imposing restrictions on a franchisor’s right to terminate or decline to renew a franchise according to the terms of the franchise agreement is referred to in this Article as “legislation regulating the franchise relationship.” Such laws currently in effect are listed in note 202 infra, and are collected in the compilation of franchise laws published by Commerce Clearing House in State Business Franchise Disclosure and Relationship Laws (CCH)(1978) [hereinafter cited as CCH], and in 1 G. Glickman, Franchising § 3.03, 4.02[7] n.45 (1978) [hereinafter cited as G. Glickman]; 2 G. Glickman at § 13.03[11].


3 See, e.g., N.J. STAT. ANN. § 56:10-7(e) (West Supp. 1979-1980); Mikva Bill, supra note 2, § 3(3)(A).

4 See, e.g., Conn. Gen. Stat. § 42-133[3](a) (1979); Mikva Bill § 5(2).

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The relationship and the practices sought to be prohibited or controlled. The thesis of this paper is that this legislation is the product of an overreaction to a specific practice—overpromotion—once prevalent in franchising but today largely eliminated. The subject legislation not only poses a crippling threat to franchising as an effective method of doing business but, more important, is being advanced without due regard to its potentially adverse effects on our economy and legal system.

The first substantive part of this paper (Part II) is devoted to an analysis of the nature of the franchise relationship and the two principal forms franchising has taken: product and trade name franchising and business format franchising. In Part III, the past overpromotion of franchising is discussed, with particular focus on the once prevalent abuse of misrepresentation by some franchisors, and the resultant obscuring of the benefits of franchising.

Part IV of this paper consists of a compilation and analysis of the available facts regarding the benefits of franchising, which frequently run counter to many of the assumptions held by the proponents of legislation regulating the franchise relationship. Part IV demonstrates that, despite its problems, franchising significantly benefits society, the franchisor, and the franchisee.

Part V of this paper discusses a critical issue in franchising—bargaining power between franchisor and franchisee. It is concluded that proven franchisor abuses which may stem from a disparity of bargaining power—misrepresentation, nondisclosure and other forms of overpromotion—may be cured by requiring full and fair disclosure by the franchisor, and that other franchisor abuses which may occur are not widespread and are susceptible of correction by the enforcement of existing remedies.

Part VI examines the overreaction to the overpromotion of franchising—existing and proposed legislation regulating the franchise relationship. The unfortunate consequences of this legislative overkill are set forth in Part VII.

Finally, Part VIII presents a balanced approach to the problems existing in franchising—full and fair disclosure, the enforcement of existing remedies, remedial legislation where necessary to correct specific, proven abuses, and the development and maintenance of a healthy franchise relationship.

II. The Nature of Franchising

A. Definitional Problems

Sales of franchised goods and services are expected to reach
$338 billion in 1980, an eighteen percent increase over 1978.\(^6\) Despite its clear importance to the economy, franchising is a frequently misunderstood concept. There appears to be a common belief that franchising is itself a business or industry, rather than a way of doing business in many different industries.\(^7\) Franchising is not a business or industry;\(^8\) it is only one of several different techniques for achieving certain business goals by contractual agreement rather than by vertical integration.\(^9\) Essentially, franchising is a method of allocating costs and decisionmaking in a marketing channel.\(^10\)

It is difficult to formulate a definition of franchising sufficiently broad to encompass all its various forms yet restrictive enough to avoid including other ways of doing business.\(^11\) Typically

\(^6\) U.S. Dep’t of Commerce, Franchising in the Economy 1978-1980, at 1 (1980) [hereinafter cited as FRANCHISING-1980]. The Commerce Department publishes a comprehensive annual analysis of statistics regarding franchising; the series is called "Franchising in the Economy." The data reported by the Commerce Department is collected from nearly all franchisors. Some data are not strictly comparable with earlier reported data due to revisions in types of franchised business categories. Id. at vi.


\(^8\) See Franchising—1980, supra note 6, at 1; Bennison, Franchising's Current Legal and Regulatory Issues, Restaurant Bus., Mar., 1978, at 152; Fels, Legal Problems in Franchising—An Overview, Business and Legal Problems of the Franchise 7, 9 (P.L.I. 1968); Stephenson & House, A Perspective on Franchising, Bus. Horizons, Aug., 1971, at 35, 36. Indeed, it has been suggested that the term "industry" should be reserved for categories of businesses that the Department of Commerce lists as separate industries, e.g., fast food restaurants are segments of the fast food service industry. Vaughn, Growth and Future of the Fast Food Industry, Cornell Hotel & Rest. Ad. Q., Nov., 1976, at 31, 32.


\(^10\) See Stephenson & House, supra note 8, at 36.

\(^11\) See Axelrad, Franchising—Changing Legal Skirmish Lines or Armageddon?, 26 Bus. Law. 695, 696 (1971). Sample definitions of franchising include: "Franchising generally is understood to contemplate a relationship wherein the franchisor provides the franchisee with technical know-how and operating assistance on a continuing basis, while monitoring the franchisee's operations so as to maintain the integrity of the franchisor's trademark (which ordinarily is the keystone of a traditional franchising relationship)." Mikva Bill Hearings, supra note 5, at 678 (statement of Lee Abrams). Franchising is "a continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising, and management in return for a consideration from the franchisee." Swart & Carter, Negroes in Franchising, J. Retailing 101 (Special Issue on Franchising, 1974) (quoting the International Franchise Ass'n definition).

Franchising is a system of distributing goods and services that has three distinguishing characteristics: (1) one party (the franchisor) grants to another party
characterized by a strong cooperative relationship between franchisor and franchisee, franchising uses a voluntary contract as a vehicle for obtaining centralized administration and control over the marketing efforts of participants in a marketing channel.\textsuperscript{12} Franchising thus may be defined as a continuing contractual relationship in which the franchisor grants to the franchisee the right to conduct business according to a marketing and operations plan substantially prescribed by the franchisor, including the right to use the franchisor's trademark or tradename in return for a consideration from the franchisee.

The fundamental concept in franchising is that the franchisee operates its business according to a marketing and operations plan substantially prescribed by the franchisor, and thereby participates in a uniform distribution system identified by the franchisor's trademark. The franchisor's trademark is valuable because it identifies for consumers the nature and quality of the goods sold or services rendered by all franchisees operating under that trademark. Consumer identification associated with the trademark can be maintained only when the franchisor ensures that goods or services are available and quality standards are adhered to uniformly throughout the franchise system by enforcing franchisee conformity to its marketing and operations plan. In order to enforce such conformity, the franchisor must retain substantial controls over the franchisee's business.\textsuperscript{13}

Without franchisor controls, an individual franchisee would be free to disregard the franchisor's marketing and operations plan by deviating from the franchisor's product line or by allowing the quality of its franchise to deteriorate. If it should do so, what economists call an externality problem would arise because the eco-

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\textsuperscript{12} See Mikva Bill Hearings, supra note 2, at 272-73 (statement of Philip F. Zeidman); Stephenson & House, supra note 8, at 35-36.

\textsuperscript{13} Note, Constitutional Obstacles to State "Good Cause" Restrictions on Franchise Terminations, 74 COLUM. L. REV. 1487, 1499-1500 (1974) [hereinafter cited as Constitutional Obstacles].
nominal cost of such deviation would be spread over all the franchisees and would scarcely be felt by the individual franchisee.\textsuperscript{14} Of course, generalized product line deviation from the marketing or operations plan by many franchisees, acting independently, will in the aggregate be felt by all, for the consumer identification associated with the franchisor's trademark would be lessened and the value of the trademark correspondingly eroded.

Accordingly, all franchisees within a franchise system have a vital interest in having the franchisor police each individual franchisee's adherence to the franchisor's marketing and operations plan in order to protect the trademark. Only the franchisor is in a position to take prompt enough steps to prevent erosion of trademark value because the short-term benefits of deviation from the marketing and operations plan, absent policing, ordinarily would overcome an individual franchisee's incentive to prevent long-term trademark erosion.

Franchising therefore depends on the voluntary agreement by each franchisee to relinquish to the franchisor a certain amount of its freedom of action in order to obtain the benefits of a uniform system. The agreement is enforced by the franchisor for the benefit of all the franchisees by the franchisor's exercise of controls over the franchisees' businesses. By enforcing this agreement, the cost of any deviation from the marketing and operations plan by an individual franchisee may be internalized to it.

B. Types of Franchising

Two principal types of franchising, each quite different from the other, have developed: product and trade name franchising, described as traditional franchising by the United States Department of Commerce,\textsuperscript{15} and business format franchising, sometimes called enterprise franchising.\textsuperscript{16} Product and trade name franchising consists primarily of product distribution arrangements in which a distributor (franchisee) is to some degree identified with the supplies of a manufacturer (franchisor).\textsuperscript{17} Typical of this segment of franchising are automobile, truck, farm implement, tire and bicycle dealers, gasoline service stations (manufacturer-retailer fran-
chising), and soft drink bottlers and beer distributors (manufacturer-wholesaler franchising). Contrary to an apparently popular impression, product and trade name franchising dominates franchising, currently accounting for almost seventy-seven percent of all franchise sales. In business format or enterprise franchising, the type of franchising that is perhaps most familiar to the public, the franchisor licenses a franchisee to operate an entire retail business under the franchisor’s trademark or trade name according to a marketing and operations plan substantially prescribed by the franchisor. Volume food retailers, automobile parts and drug stores (wholesaler-retailer franchising), hotels and motels, fast food restaurants, and business services systems (service sponsor-retailer franchising) are examples of business format or enterprise franchising.

Franchising spans a broad range of industries: at least forty according to the Commerce Department. Critical elements of the franchise relationship, such as the extent of the franchisor’s controls over the franchisee’s business, the franchisor’s and franchisee’s required initial investments, the franchised area of operations, the duration of the agreement, and the franchisor’s compensation, are not the same throughout franchising. Instead, they vary according to the terms of the franchise agreement from industry to industry and from franchise system to franchise system.

Most important, perhaps, is the fundamental difference between product and trade name franchising and the many forms of business format franchising. In product and trade name franchising, the product sold by the franchisees usually is manufactured by the franchisor and thus is uniform throughout the system. Some forms of wholesaler-retailer franchising excepted, ordinarily there is no such inherent uniformity present in business format franchising. Consequently, the business format franchisor must retain substantial controls over the franchisees to ensure uniform quality.

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18 Id.
throughout the system. Although franchisor controls are necessary in many forms of product and trade name franchising to ensure uniform quality of service and the like, in contrast to business format franchising, a product and trade name franchisor ordinarily requires fewer and less substantial controls over the franchisees to maintain uniform quality.22

Viewing franchising as an industry or business rather than a way of doing business in many different industries reinforces the misconception that the franchising "industry" can be regulated by broad, all-encompassing legislation. FTC Commissioner Paul Rand Dixon has pointed out the impracticality of this notion: "The many varieties of franchise systems differ among themselves so widely that any attempt to state rules applicable to all franchise systems must either be so broad as to approach the meaningless or tailored with numerous qualifications in order to fit all varieties of franchises."23 Once it is recognized that franchising is not an industry or business but a way of doing business in many different industries, the impracticality of "industry"-wide legislation regulating the franchising relationship becomes apparent.

The misconception that franchising is itself a business rather than a way of doing business was probably granted and undoubtedly encouraged as a result of the practices of highly publicized, aggressive entrepreneurs whose businesses seemed to consist of little more than selling franchises and rights to subfranchise. This sort of activity was hardly franchising, but, as a result of the notoriety given such practices, franchising may have come to be viewed by the public as a business itself—the business of selling franchises.

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22 See generally id. at 28; Thompson, supra note 7, at 50. State and federal regulators have recognized that product and trade name franchising differs fundamentally from business format franchising. Many states have passed relationship legislation pertaining to automobile dealerships, gasoline service stations, beer distributorships, and farm implement dealerships. These statutes are collected in CCH, supra note 1. On the federal level, Congress has passed legislation regulating the franchise relationship in such industries as automobile dealerships, Automobile Dealers Day in Court Act, 15 U.S.C. §§ 1221-1225 (1976), and gasoline service stations; Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2806, 2821-2824, 2841 (Supp. II 1978).

23 Axelrad, supra note 11, at 712 n.41.
III. THE OVERPROMOTION OF FRANCHISING: EXAGGERATED PROMISES AND UNREALIZED EXPECTATIONS

The franchise "boom" of the 1960's-early 1970's was caused in part by some franchise promotors' exaggerated promises to prospective franchisees of instant financial success without need of prior business experience, of total independence and, sometimes, of association with a glamorous celebrity. A kind of euphoria was encouraged by numerous rags-to-riches stories in the business and consumer press and by the prices of some franchisors' securities being bid up to unrealistic heights.

According to a 1971 report on fast food franchising prepared for the Senate Select Committee on Small Business by Professors Urban B. Ozanne and Shelby D. Hunt of the Graduate School of Business of the University of Wisconsin (the Ozanne-Hunt report), over thirty-seven percent of the responding franchisees stated that their franchisors had overestimated potential profits during the pre-purchase negotiations, while only 6.5% reported an underestimation. (It is noteworthy that a majority of the franchisees reported an inaccurate estimation.)

Ozanne and Hunt reported that in many cases, prospective franchisees were not shown profit and loss statements representative of the system's franchises, but were given only pro forma statements reflecting unrealistic profit estimates. (The majority of responding franchisees, however, reported that they were presented with actual profit and loss statements prior to signing.) It was also

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3 See Axelrad, supra note 11, at 704; Hunt, supra note 25, at 37.

4 See Axelrad, supra note 11, at 704; Burck, supra note 7, at 118.

5 Senate Select Comm. on Small Business, 92d Cong., 1st Sess., THE ECONOMIC EFFECTS OF FRANCHISING (Comm. Print 1971) [hereinafter cited as OZANNE & HUNT]. Ozanne and Hunt studied franchising as used in three industries: fast food, laundry-dry cleaning, and convenience groceries. Id. at 257, 284, 290. While the study is comprehensive and generally well done, because of franchising's dynamic development since 1971 many of the trends reported are no longer evident. In addition, in some instances the study's findings do not support the authors' conclusions.

6 Id. at 121-22.

7 Id. at 122.

8 Id. at 142.

9 Id. at 121. 84.6% of the responding franchisors stated that they showed actual profit
found that over seventy-two percent of the franchisees earned less than the minimum which would naturally be expected on the basis of their franchisors' pro forma income statements, over ninety percent earned less than the average income expected, and over ninety-eight percent earned less than the maximum income expected.\textsuperscript{33} Ozanne and Hunt concluded from these figures that a large number of fast food franchisors were misleading potential franchisees on the potential profitability of their franchises.\textsuperscript{34}

Similarly, the Ozanne-Hunt report concluded that fast food franchisors were also misleading potential franchisees about the potential sales volume of their franchises.\textsuperscript{35} This conclusion was based upon a finding that almost seventy percent of the responding franchisees failed to reach the minimum sales figure which would naturally be expected on the basis of their franchisors' pro forma statements, that almost eighty-seven percent failed to achieve the average sales expected, and that ninety-eight percent failed to reach the maximum sales expected.\textsuperscript{36}

Misrepresentation of the degree of autonomy enjoyed by franchisees was also prevalent during the franchise boom.\textsuperscript{37} In many cases, prospective franchisees were persuaded by franchisor sales talk that as franchisees, they would be almost totally independent businessmen. Some franchisors, either through ignorance or by design, inadequately informed prospective franchisees about the extent of franchisor controls over their businesses necessary to achieve uniformity throughout the franchise system.\textsuperscript{38}

Some promoters of franchising, with little more than hope and an untested idea, sought to attain instant consumer identification and allure by associating their franchise systems with prominent celebrities, notably from the sports and entertainment worlds.\textsuperscript{39} These promoters and prospective franchisees alike assumed that a celebrity's association with the franchise system would generate

\textsuperscript{33} Id. at 143.

\textsuperscript{34} Id. at 142.

\textsuperscript{35} Id. at 145-46.

\textsuperscript{36} Id.

\textsuperscript{37} See FTC Rule, supra note 11, at 59,626; Burck, supra note 7, at 120.

\textsuperscript{38} See FTC Rule, supra note 11, at 59,626.

\textsuperscript{39} See note 25 supra. Examples of celebrity-promoted franchise systems include: Broadway Joe's (Joe Namath); Al Hirt's Sandwich Saloons; Dizzy Dean's Beef & Burger; Mickey Mantle's Country Cookin' Restaurants; James Brown's Gold Platter Pantries; Tony Bennett Spaghetti Houses; Johnny's America Inns (Johnny Carson); and Mahalia Jackson's Glori-Fried Chicken System. Elliot, supra note 25, at 3.
consumer patronage. While often depicted as active managers of the franchise operation, many celebrities lent little more than their names and whatever attendant glitter.

One relatively common practice during the franchise boom contributed to the ballooning prices of franchisor securities and the general euphoria surrounding franchising: accounting for franchise fees as current net income even though the franchise agreement provided for payment over a term of several years. Franchisors using this practice were forced to concentrate heavily on selling franchises in order to keep profit figures rising; overpromotion naturally resulted.

As stated by the Small Business Reporter, the overpromotion of franchising, "even though attributable to perhaps a small number of franchisors, account[s] for much of the franchise disappointment and bitterness, official censure and bad press that has hurt franchising in general." Overpromotion not only generated unrealistic franchise expectations fated for unfulfillment but also obscured the real benefits of franchising. It has become almost impossible to separate fact from fiction about franchising. Accordingly, before examining the reaction to the overpromotion of franchising, it is necessary to analyze critically the franchise method of doing business to determine, as accurately as possible, the true extent of its benefits to society, the franchisor, and the franchisee. Following this analysis, much of the reaction may be seen for what it is: an overreaction to the overpromotion of franchising.

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40 See Axelrad, supra note 11, at 705.

41 The use by franchisors of a celebrity name enabled them to sell franchises and to go public but failed to induce the necessary consumer patronage. Axelrad, supra note 11, at 705. By 1972, use of a celebrity to promote franchises had diminished and many of those franchising systems that had used celebrity promotions found themselves in financial trouble. Hunt, supra note 25, at 38.


43 See Coyle, supra note 42, at 32.

IV. THE BENEFITS OF FRANCHISING

A. The Benefits of Franchising to Society

1. The Creation of Small, Independently Owned Businesses

The available evidence indicates that franchising substantially encourages the creation of relatively small, independently owned businesses\(^4\) and therefore contributes to decreased economic concentration in the channels of distribution. Indeed, franchising is perhaps the only way of doing business that by its very nature contributes to the creation of new business units.\(^5\) The 1971 Ozanne-Hunt report concluded that fast food franchising alone was responsible for the creation of between 13,700 and 25,800 small, independently owned businesses.\(^6\)

This benefit is not merely transitory.\(^7\) While there may have


\(^5\) FRANCHISING-1980, supra note 6, at 1; Mikva, Franchise Reform Will Protect Small Business, Food Service Marketing, Aug., 1978, at 28. Franchising's contribution to the creation of independently owned businesses was noted in Susser v. Carvel Corp., 206 F. Supp. 636 (S.D.N.Y. 1962), aff'd, 332 F.2d 505 (2d Cir. 1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965): "The franchise system creates a class of independent businessmen; it provides the public with an opportunity to get a uniform product at numerous points of sale from small independent contractors, rather than from employees of a vast chain." Id. at 640.

The 1971 Ozanne-Hunt study of fast food franchising supports these observations, providing several estimates of the net effect of fast food franchising on the creation of new businesses. Ozanne & Hunt, supra note 28, at 37-38, 114. About 68% of the responding franchisees were not self-employed in their last prior employment, thus suggesting fast food franchising's maximum contribution to the establishment of independently owned businesses. Id. at 37-38.

\(^6\) See Ozanne & Hunt, supra note 28, at 114. Although the Commerce Department has reported a trend toward multi-unit ownership, see text accompanying note 111 infra, most franchisees are small businessmen when compared to large, vertically integrated chains. Some franchised outlets, however, may be created at the expense of completely independent businesses. See Elliott, supra note 25, at 18; Ray, supra note 16, at 234.

\(^7\) It has been rather uncertainly hypothesized by Professors Oxenfeldt and Kelly that franchising is but a temporary method of doing business used to raise sufficient capital to form completely integrated corporate chains; according to them, franchise systems will ultimately become vertically integrated chains. Oxenfeldt & Kelly, Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?, J. Retailing 69 (Special Issue on Franchising 1974). Oxenfeldt and Kelly had found that insufficient data then existed to discern reliable trends on company ownership. Id. at 83. Therefore, according to Oxenfeldt and Kelly, the benefits of franchising to society are short term only. Id. This theory gained some support when it became known that several well-known fast food franchisors had begun to repurchase profitable franchised units. See, e.g., Burck, supra note 7, at 121 (McDon-
existed a trend in some industries involved in franchising to expand company-owned units or to repurchase franchised units and operate them as company-owned outlets, this trend peaked in

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ald's); Franchising—A Boom Unabated, FINANCIAL WORLD, Sept. 10, 1969, at 11 (Chock Full O' Nuts); Sherwood, supra, at 32-33 (Howard Johnson and Kentucky Fried Chicken). Proponents of legislation regulating the franchise relationship have contended that franchisor terminations and nonrenewals are largely motivated by a desire to convert their operations from franchises to company-owned units. See Mikva bill Hearings, supra note 5, at 62 (statement of Harold Brown); Brown, Franchising—A Fiduciary Relationship, 49 Tex. L. Rev. 650, 659 (1971). See also Franchising—A Boom Unabated, FINANCIAL WORLD, Sept. 10, 1969, at 11; Ray, supra note 16, at 243. As discussed in note 49, infra, available data demonstrate the invalidity of the Oxenfeldt-Kelly hypothesis.

Company-owned units may be attractive to some franchisors for a number of reasons. In some industries, company-owned units tend to be more profitable and provide a greater return to the franchisor than franchised units. See Burck, supra note 7, at 121; Elliott, More Mouths to Feed, BARRON'S, Sept. 15, 1969, at 25-26; Hunt, The Trend Toward Company-Operated Units in Franchise Chains, J. Retailing, Summer 1973, at 36 [hereinafter cited as Hunt-1973]; Axelrad, supra note 11, at 718 n.57; cf. FRANCHISING-1980, supra note 6, at 81 (comparison of average sales per establishment).

Moreover, company ownership makes possible a greater degree of management control over unit operations than is available over franchised units. See Axelrad, supra note 11, at 718 n.57; Hunt-1973, supra, at 7; Hunt, supra note 45, at 74. Finally, the legal difficulties associated with maintaining a franchise system comprised of semi-autonomous participants may encourage franchisors to establish company-owned units. Hunt, supra note 45, at 74; cf. FRANCHISING-1976, supra note 19, at 24 (costlier and more complicated in franchising due to multitude of state franchising laws).

On the other hand, there exist powerful disincentives to the creation of company-owned units. The capital and administrative requirements for establishing and operating a wholly-owned chain can be prohibitive for even very large franchisors. Hunt-1973, supra, at 4-9; Sherwood, Franchising: Big Business Cashes In On The American Dream, Bus. Management, Aug., 1968, at 33. In many industries, company-owned units are economically feasible only in relatively concentrated markets; often, more isolated marketing areas are not suitable for company-owned outlets. Hunt-1973, supra, at 5, 11. Finally, and most importantly, the otherwise unattainable benefit of local, highly motivated owner-operators strongly favors franchised outlets. Id. at 4; Convenience Store Franchising: How It Works, How (For Some) It Doesn't, PROGRESSIVE GROCER, Nov., 1971, at 90, 93-94 [hereinafter cited as Convenience Store Franchising]; cf. Glaser, The Chain That Makes Managers Partners, Drug Topics, Sept. 1, 1978, at 50.

In the late 1960's-early 1970's a trend existed in fast food franchising toward expanding company-owned units. For example, in 1971, Ozanne and Hunt reported that in fast food franchising, the percentage of company-owned units had risen from 6.6% in 1968 to an estimated 11.3% in 1971. OZANNE & HUNT, supra note 28, at 80. It was estimated that in 1969, 360 franchised units were converted to company ownership by fast food franchisors and 150 company-operated units were converted to franchise operation, yielding a net change from franchised to company-owned units of 210 units. Id. at 81-82. Although considerable attention had been given to franchisor "buy-backs" or repurchases of franchises, Ozanne and Hunt recognized that most of the actual expansion of company-owned units in fast food franchising was by new construction. Repurchases of franchised units accounted for only about 30% of the increase in company owned units in 1969; new construction generated about 70% of the increase. Id.

During the period from 1969 to 1971, in all franchising, the percentage of company-owned units decreased from 17.9% of the total number of units to 17.3%, whereas in fast food
1975, and today the percentage of company-owned outlets has largely stabilized at about nineteen percent for all franchising and twenty-eight percent for fast food franchising.

Franchising, the percentage of company-owned units increased from 13.4% of the total number of units to 18.1%. Franchising-1978, supra note 9, at 34. Commerce Department figures for 1971 also indicated the existence of a shift to company-owned units, predominantly in fast food restaurants and food retailing. In 1971, 1,755 franchised establishments were repurchased for company operations and 602 company-owned establishments were converted to franchise ownership. Franchising-1980, supra note 6, at 9. The Commerce Department noted, however, that such “arrangement” changes—“those converting to franchisee-owned or company-owned operations”—were relatively small, accounting for less than 1% of the number of establishments. U.S. Dep't of Commerce, Franchising in the Economy 1971-1973, at xv (1973).

A trend in fast food franchising toward expanding company-owned units was thus isolated, and was later reaffirmed by Hunt in 1972, Hunt, supra note 25, at 34, in 1973, Hunt-1973, supra, at 11, and, somewhat more guardedly, in 1977, Hunt, supra note 45, at 80. The empirical evidence developed by the 1971 Ozanne-Hunt study of fast food franchising was used by Hunt in 1973 in an attempt to support the Oxenfeld-Kelly hypothesis regarding franchising generally. Hunt-1973, supra, at 3.

Commerce Department data for 1972-1975 indicated a slowing of the shift to company-owned units. During the period from 1972-1975, in all franchising, the percentage of company-owned units increased from 17.4% of the total number of units to 18.5%, whereas in fast food franchising, the percentage of company-owned units increased from 19.4% of the total number of units to 27.2%. Franchising-1978, supra note 9, at 35-36.

The Commerce Department reported that those “outlets repurchased for company ownership were mostly temporary buy-backs for a multitude of reasons, the least of which was the company’s desire to buy these back in order to withdraw from the franchise system.” Franchising-1976, supra note 19, at 17; see Franchising-1980, supra note 6, at 9. Commerce Department data also demonstrated that the shift toward expanding company-owned operations did not occur in franchising generally but was concentrated largely in fast food franchising.

More recent Commerce Department data tend to show that any trend toward expanding company-owned operations has ended, both in all franchising and in fast food franchising. In all franchising in 1976, the percentage of company-owned units increased 0.3% to 18.8%. Franchising-1978, supra note 9, at 36. In 1977, the percentage of company-owned units increased 0.3% to 19.1%. Franchising-1979, supra note 6, at 40. In 1978, the percentage of company-owned units declined slightly to 18.8%. Franchising-1980, supra note 6, at 69. The percentage of company-owned units in all franchising is estimated to have declined in 1979 to 18.5%, and to decline again to 18.2% in 1980. Id. at 70-71.

Similarly, in fast food franchising in 1976, the percentage of company-owned units declined 0.4% to 26.8%. Franchising-1978, supra note 9, at 36. The percentage of company-owned units in fast food franchising increased to 27.9% in 1977, Franchising-1979, supra note 21, at 40, increased slightly to 28% in 1978, is estimated to have remained at 28% in 1979, and to decline slightly to 27.8% in 1980. Franchising-1980, supra note 6, at 69-71 (“restaurants—all types”).

Commerce Department data for all franchising in 1976-1977 also indicate a reversal in the practice of repurchasing franchised units for company operation. In all franchising in 1976-1978, franchisors converted 546, 619 and 612 franchised units, respectively, to company operation, and 956, 899 and 718 company-operated units were converted to franchisee operation, leaving a net change from company-operated to franchised units of 410 units in 1976 and 220 in 1977; and 106 in 1978. Franchising-1980, supra note 6, at 9. The latest figures for fast food franchising confirm that any movement to repurchase franchised outlets seems to
2. The Failure Rate of Franchised Businesses

Business failures sap the vitality of the economy by wasting resources and causing economic disruption. The principal reasons of business failure are proprietor inexperience and lack of sufficient capital. As discussed in Part IV.C.3 below, most franchisors provide initial and continuing training and assistance to their franchisees, thus enabling inexperienced businessmen to compete in the marketplace. Many franchisors also provide capital assistance to franchisees with insufficient capital resources of their own, and to this extent, franchising helps to eliminate one of the principal causes of business failure.\(^{53}\)

have largely run its course, with perhaps a period of uncertainty most recently appearing. In fast food franchising in 1976, 280 franchised units were repurchased for company ownership and 413 units were converted to franchisee ownership, leaving a net change from company-owned units to franchised units of 138 units. \textit{Franchising-1979, supra note 21, at 13.} The trend continued in 1977: 305 units were repurchased for company ownership and 425 units were converted to franchisee ownership, representing a net change from company-owned units to franchised units of 120 units. \textit{id.} The figures for 1978 show that 321 units were repurchased and 312 converted, representing a net change from franchised units to company-owned units of nine. \textit{Franchising-1980, supra note 6, at 14.} High interest rates and the unavailability of capital for expansion appear to influence franchisors' decisions regarding repurchasing. See \textit{Franchising-1976, supra note 19, at 4.}

A 1977 study by the Continental Franchise Review also supports the conclusion that any trend toward expanding company-owned units has ended. See \textit{Franchisor Trends in Terminations and Repurchase, 1977 Continental Franchise Rev. 47-48 [hereinafter cited as Franchisor Trends].} It was reported that the total number of franchises involved in repurchases represented “less than .4% of franchises in this sample of over 18,500, or approximately 74 franchises.” \textit{id.} at 11. Most franchisors indicated that units were repurchased on temporary basis and would be resold to franchisees. \textit{id.} at 30.

Interestingly, the Continental Franchise Review study also noted that in 73.3% of the instances of repurchase, the franchise desired to sell. \textit{id.} at 12. This is not surprising. Ordinarily, repurchases are made by mature, successful franchisors. Hunt-1973, supra note 49, at 9. Many franchisees, nearing the end of 10-, 15- or 20-year agreements with these mature franchisors, have reached retirement age and desire to liquidate their investment. See Elliott, \textit{More Mouths to Feed, Barron's, Sept. 15, 1969, at 5, 25-26.}

A 1977 survey conducted by Hunt confirmed the existence of a new franchisor attitude toward company-owned units, although, based upon the figures contained in the 1971 Ozanne-Hunt report regarding fast food franchising, Hunt continued to believe that the trend was toward company-owned units. Hunt, supra note 45, at 80. The study indicated that in every industry franchisors expected to increase or substantially increase their franchised units and did not expect to expand their company-owned units as fast as their franchised units. \textit{id.} at 79, 81. The study reported that, on the average, 91% of respondents expected either to “substantially increase” or “increase” franchised units, while only 58% expected “substantially [to] increase” or “increase” company-operated units. \textit{id.} at 81.

Data collected by the International Franchise Association (IFA) in states where, as part of their registration statements, franchisors must provide statistics respecting acquisitions also indicate that the trend toward expanding company-owned units has abated. \textit{Mikva bill Hearings, supra note 5, at 344-45 (statement of Philip F. Zeidman).} The IFA's survey in Michigan covered a total of 34,419 franchised outlets and revealed that during the period from 1974 to 1976 only 2,095 or 6.1% of these franchised units were reacquired by franchisors, about 2'c per year. \textit{id.} at 344. In Wisconsin, where the survey covered 12,474 franchised outlets, 696 or 5.6'c of these units were reacquired, about 1.9'c per year. \textit{id.} at 345.

\(^{53}\) See Bernstein, \textit{Does Franchising Create a Secure Outlet for the Small Aspiring Entre-
As a matter of a priori reasoning it would appear that franchised businesses should experience a lower failure rate than completely independent businesses, because an individual franchisee's risk of failure should be reduced by his participation in a well-run franchise system in which the franchisor provides managerial training and a tested marketing and operations plan. The available empirical evidence is, however, inconclusive. The 1971 Ozanne-Hunt study indicated that the actual fast food franchise failure rate was between 1.3% and 7.1% in 1968, and between 1.3% and 6.7% in 1969. Others have estimated that ten percent of all

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Bernstein, supra note 53, at 34; see Hanford, Problems and Financing Trends in Franchising, APPRAISAL J., Apr. 1971, at 222, 224. In 1969, it was reported that while the small business failure rate was 60%, franchisees suffer only a 10% failure rate and franchisors a 1% failure rate. "Caveat Emptor" Keyword of the Franchising Boom, PUBLISHERS' WEEKLY, Aug. 18, 1969, at 49 (citing Dun & Bradstreet statistics). But see OZANNE & HUNT, supra note 28, at 97. The 10% failure rate for franchised businesses was also reported in a study undertaken by students at the Harvard Business School. So You Want to Run a Franchise?, DUN'S REV., Jan., 1969, at 36,37. See also Oxenfeldt & Thompson, Franchising in Perspective, J. RETAILING 3, 6 (Special Issue on Franchising 1974).

Reliable statistics do not exist regarding the failure rate of franchised businesses. Hunt, supra note 25, at 33-34; Hunt, supra note 45, at 75. Commerce Department figures indicate that in 1978, 8,690 establishments or 3.5% of the total number of the 245,694 establishments for which such data were collected experienced a "change in ownership", a category comprised of repurchases for company ownership, conversions to franchisee ownership, and discontinuances of franchised businesses. FRANCHISING-1980, supra note 6, at 69, 84. Data regarding outlets repurchased by franchisors and resold to new franchisees and franchised outlets sold directly by franchisors and resold to new franchisees are not included in the changes in ownership category.

Of the 8,690 changes of ownership in 1978, 7,360 establishments or 3% of the total number of establishments discontinued operations. Id. It may be fair to assume that nearly all discontinued franchised establishments represented failed units. See OZANNE & HUNT, supra note 28, at 94. In fast food franchising, 2,028 establishments or 3.7% of the total number of franchised establishments for which such data were collected experienced a change in ownership in 1978; 1,395 franchised establishments or 2.5% discontinued operation. FRANCHISING-1980, supra note 6, at 69, 84.

However, without knowing the total number of changes in ownership or the percentage of that total representing failed units, calculation of the actual failure rate of franchised businesses is impossible. The 3% and 2.5% establishment franchise discontinuance figures for all franchising and fast food franchising, respectively, represent only the low end of the possible range for franchising's failure rate in 1978.
3. Franchising’s Contribution to Increased Economic Opportunities for Minority Group Members

Many franchised businesses require only minimal entry capital and experience in business and management on the part of the prospective franchisee. Lack of sufficient capital and inexperience are major obstacles facing small entrepreneurs, including minority group members, and thus franchising would appear to provide a medium for assisting minority group members to overcome these deficiencies and own their own businesses.

Beginning in the 1960’s, the federal government, attempting to apply traditional principles to the economic problems of minority group members, sought to foster what became known as “black capitalism.” Franchising, with its relatively low entry barriers, was assigned a major role in this effort to assist minority groups. Many franchise systems developed special programs to aid minority group members to enter franchising. By 1976, at least thirty-six franchisors had developed special programs to encourage minority group ownership of franchises.

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58 See note 54 supra.
59 Especially during the Nixon Administration, the federal government sought to ameliorate poverty problems by encouraging ownership of businesses by minorities. An Office of Minority Business Enterprise was created in the Department of Commerce. In addition, the Small Business Administration fostered the idea that franchising was a means for getting blacks and other minorities into roles as small businessmen. A Business of Your Own?, ECONOMIST, May 2, 1976, at 52.
60 Id.
61 Id. (McDonald's, Kentucky Fried Chicken Corp., and International Industries). See also Hunt, supra note 45, at 75.
62 FRANCHISING-1976, supra note 19, at 19. For example, McDonald's facilitated minority group member's entry into franchising by reducing its usual entry capital requirement. International Industries developed the "Two Plus You" program; the minority group member was required to make a $2.5 downpayment plus an emotional commitment in return for a franchise to be granted after successful completion of a specialized 6 months to 1 year apprenticeship program. OZANNE & HUNT, supra note 28, at 185-86. A joint venture known as "Brady Keys" Kentucky Fried Chicken was begun by All-Pro Chicken, a black-owned franchise system started by Brady Keys and Kentucky Fried Chicken. See Burck, supra note 7, at 150; Blacks Get Boost in Trucking, Fast Food Franchising, COMMERCE TODAY, Sept. 20, 1971, at 22.

The Office of Minority Business Enterprise of the Department of Commerce and the Small Business Administration initiated a project in 1969, popularly known as the "25x25x2" plan, aimed at recruiting minority group members chiefly through the efforts of franchisors. See Washington: Are Controls in the Works?, VOLUME FEEDING MANAGEMENT, Jan., 1970, at 34, 36. The intent of the program was to bring groups of 25 franchisors to eight Washington conferences designed to work out plans whereby each of the participating...
Although many of these programs proved quite successful in recruiting franchisees from minority groups, the percentage of minority franchisees remained relatively low. A 1972 study of black franchise ownership during 1966-1969 reported that less than one percent of all franchises were owned by blacks. The 1971 Ozanne-Hunt study indicated that at the end of 1970, minority businessmen held at most a 2.9% and possibly as low as 1.5% share of the fast food franchises then existing. More recent data indicate that minority participation in business format franchising has expanded. Data collected by the Commerce Department shows that minority group members’ participation in franchising increased by over twenty-three percent in 1978. Of the 1,394 franchisors surveyed, 441 reported a total of 5,859 units owned by minority group members, or approximately four percent of the franchisee-owned establishments in responding franchise systems.

Many minority group members have thus become notably successful franchisees, due primarily to special franchisor recruiting and training programs. Absent these programs, however, increased opportunities for minority group members would seem a difficult goal to attain.

B. The Benefits of Franchising to the Franchisor

Franchising’s continued growth as a way of doing business is perhaps the most eloquent testimony to its benefits to the franchisor. In 1969, there were 315,045 franchisee-owned establishments. By 1978, franchisee-owned establishments rose to 366,923, franchisors would open up at least 25 minority-owned franchises within the succeeding 2 years. The SBA also granted loans to minority franchisees. The Department of Commerce expected to make a portion of up to $301 million in federal grants, loans, and guarantees available to minority franchisees. See also Franchising-1979, supra note 21, at 8.

Swart & Carter, supra note 11, at 104-05. The study also reported a significantly higher failure rate for black operators (23.8%) as compared to white franchise operators (5.1%). Id. at 105-06. The sample size used was admittedly small. Id. The number of minority franchisees is also a function of the low number of minority applicants for franchises. Swart & Carter reported that in 1969, only 1.5% of all franchise applications came from non-whites. Id. at 105.

Ozanne & Hunt, supra note 28, at 192-93. In 1975, Professor Andrew Brimmer concluded that black participation in franchising appeared to be increasing and that it was particularly promising for blacks, as franchisors sought to appeal to black clientele by locating in black neighborhoods. Brimmer, The Outlook for Black Business, Black Enterprise, June, 1975, at 25, 160, col. 2.

Franchising-1980, supra note 6, at 8, 69.

Id. at 69, 75. The Department of Commerce estimates that the total number of establishments (franchise and company owned) will increase from 451,790 in 1978 to an estimated 488,292 in 1980, an increase of 8.1%. Franchise sales of goods and services are expected to rise 18½ between 1978 and 1980. Of the 488,292 establishments estimated for 1980, it is expected that 399,320 (82½) will be franchisee-owned. Id. at 71.
an increase of 16.5%. As franchising has matured, the percentage of franchisor failures has steadily declined.

1. Franchisor Capital Requirements

Low entry barriers make franchising a most attractive way of doing business. Unlike other methods of doing business, huge capital outlays are not required. Moreover, because of franchising's low entry barriers, start-up costs may be quickly recovered. Franchisors are also provided with the human and capital resources necessary for rapid expansion and market penetration.

Unit growth in franchiser-owned fast food establishments has been quite spectacular, up from 24,894 franchised units in 1969 to 39,802 in 1977, id. at 69, 75, a 60% increase. As noted earlier, franchisors report that they plan to expand their franchised operations. See note 52 supra.

The benefits of franchising to the franchisor are also indicated by the number of acquisitions of franchising companies by large, diversified companies. Such well known franchise systems as Kentucky Fried Chicken, Burger King, Pizza Hut, Baskin-Robbins, A&W, and Dunhill Personnel System have been so acquired. See Ozanne & Hunt, supra note 28, at 351-52; Burck, supra note 7, at 118.


See Ozanne & Hunt, supra note 28, at 76-77.

Franchising is also different from other methods of doing business, in that it does not require a nationwide dealer network or access to unique sources of supply or to unique patent rights. Id.

Stephenson & House, supra note 8, at 36.

See, e.g., Ozanne & Hunt, supra note 28, at 32; C. Rosenfield, The Law of Franchis-
pansion enables the franchisor to realize economies of scale earlier in the franchise system's life cycle and allows the risks of operation to be shared among the franchisor and the franchisees.

Despite these obvious advantages, even in the aggregate they do not constitute franchising's chief benefit to the franchisor. Most franchisors believe greater manager motivation to be the most important benefit of franchising.

2. Franchisee Motivation

The single most important benefit of franchising to the franchisor, and the principal reason for franchising's success as a way of doing business, is the participation of local, highly motivated managers committed to their businesses because of their ownership interest.

There is little doubt that franchisees are more highly motivated than company employees. While company employees may have at stake their future advancement and perhaps their compensation or even their present positions, franchisees put at risk their ownership interest in the franchised outlet. In some cases, the superior performance of highly motivated franchisees translates into greater profitability for the franchisor than is obtained from company-owned units.

ING 8 (1970); Oxenfeldt & Thompson, supra note 54, at 9. At least one author rejects the capital market explanation for franchising, arguing that if raising capital were the reason for franchising, the franchisor would do better to create a portfolio of shares of all outlets and sell shares to his managers. Rubin, supra note 14, at 225. But see Hunt-1973, supra note 49, at 12. Rubin theorizes that franchising is an attempt to allocate property rights between franchisor and franchisee in the areas that they can efficiently control. Rubin, supra note 14, at 229.

71 Stephenson & House, supra note 8, at 36, col. 1.

74 Lillis, Narayana & Gilman, Competitive Advantage Variation over the Life Cycle of a Franchise, J. Marketing, Oct., 1976, at 77. In addition to shared risk, the authors list the advantages of franchising as being rapid access to markets, reduced capital costs, highly motivated franchisees, an ability to service marginal locations, growth in independent businesses and reduced economic concentration. Id.

77 See Convenience Store Franchising, supra note 49, at 91, 94: "The franchisee is the equivalent of a partner, and his motivation and drive to succeed are far greater than the corporate store manager." Id. at 91. As stated by Norman D. Axelrad, McDonald's Vice President for Public Affairs: "The reason McDonald's is committed to franchising is simple—the efforts of someone who both owns and manages his or her business provide the McDonald's System with a skilled, involved, innovative management ability which we believe would not be otherwise obtainable." Mikva bill Hearings, supra note 5, at 175, 177.

78 In 1978, the average sales for company-owned establishments were $520,546; for franchisee-owned establishments, sales averaged $862,821. FRANCHISING-1980, supra note 6, at 69, 81. In 1971, it was reported that the average franchised convenience store produced sales 29% greater than company-owned units. Convenience Store Franchising, supra note 49, at
C. The Benefits of Franchising to the Franchisee

Included among the frequently asserted benefits of franchising to the franchisee are the profitability of franchised operations, franchising's low entry barriers, the opportunity to become an independent businessman, the advantages of the franchisor's trademark, goodwill, marketing and operations plan, and initial and continuing assistance, all of which enable the franchisee to compete more effectively with outlets of large, vertically integrated chains.

1. Franchising's Low Entry Barriers

The Commerce Department has published 1978 figures regarding the initial cash required of a franchisee to begin operating "non-traditional" types of franchises. Many types of franchises, such as tax preparation, employment, retailing (non-food), and educational products and services, can be started with as little as $1,000 to $3,000 in cash. While the cash necessary to begin a fast food franchise can run as high as $300,000, some can be started with as little as $5,000. Of course, hotel and motel franchises require considerably more start-up cash.

91. Franchisees are more likely to perform their own maintenance, thereby avoiding the costs of using outside contracting, and adopt sales practices which produce a larger sales volume. Id. at 91. See also Mikva Bill Hearings, supra note 5, at 302 (statement of Philip F. Zeidman); Burck, supra note 7, at 117, col. 1.

To be sure, new franchisees may be more highly motivated than more mature franchisees, and thus greater efforts are required of the franchisor to motivate more established franchisees. The key to franchisee motivation over the life of the franchise agreement is maintenance of the franchisees' confidence in the franchise system through continuous communication. See McGuire, supra note 7, at 55-56.

7 The 1971 Ozanne-Hunt report indicated that in 1969, the median family income for fast food franchisees was $16,000. OzANNE & HUNT, supra note 28, at 141-42. This was $6,000 per year higher before adjustments than the median income for these franchisees in the year just prior to their purchases of their units, id. at 141, and $8,414 higher than the national median for families in 1969. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 409 (1976).

78 Franchising-1980 supra note 6, at 88.

9 Id. Obviously, start-up costs can be significantly higher. For example, the median start-up costs for employment services and educational products and services were $20,000 and $15,000, respectively.

9 Id. The median start-up cost for a fast food establishment was $40,000 in 1978.

11 Id. Start-up costs for such businesses ranged from a low of $10,000 to a high of $700,000, with a median figure of $100,000.
2. The Franchisee as an Independent Businessman

A franchisee’s degree of independence may be measured by the extent to which the franchisee may operate the franchised business according to his or her own desires. Franchisee independence has been said to be limited by the extent of franchisor “operations programming” agreed upon in the franchise contract and the success of this programming in branding the products sold or services rendered by the franchisees. Operations programming is the franchisor’s specification of and supervision over the marketing and operations plan; the extent of operations programming is determined by analyzing the franchisor’s controls over the franchisee’s operation. Branding is the giving of a name or image to a product or service; the extent of branding is measured by gauging the degree of consumer awareness and preference for the franchise system’s products or services within the relevant market.

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Stephenson & House, supra note 8, at 37.

Id. With respect to operations programming, the 1971 Ozanne-Hunt study analyzed the degree of fast food franchisees’ independence by questioning franchisees regarding their perceived degree of control over seven key operating variables: hours of operation, bookkeeping, menu control, content and media of local advertising, retail prices, standards of cleanliness and number of employees. Ozanne & Hunt, supra note 28, at 152-53. A majority of the responding franchisees believed that they had almost complete control over hours of operation, bookkeeping, local advertising, pricing and number of employees. In the remaining areas, franchisees perceived themselves as having significant control. Only in determining the menu did franchisees perceive their franchisors as having almost complete control. Id. The percentages of the responding franchisees who stated that they had almost complete responsibility for the listed areas, in the order listed, were 55.6, 70.4, 61.9, 54.5 and 91.7%, respectively. Thirty-three and seven-tenths per cent of the responding franchisees believed that their franchisors had almost complete control over adding or deleting items from the menu. A majority of the responding franchisors, on the other hand, believed that they had major responsibility for bookkeeping, menu, local advertising and cleanliness, and 47% believed they had almost complete control over two other operating variables, hours of operation and pricing. Id.

Ozanne and Hunt grouped responses into six categories: Categories 1-3 are considered to include responses which perceive the franchisor as having control over an area; 3-6 are franchisee control responses. The data referred to above reflect responses only in category 6—the strongest possible expression of perceived franchisee control. The data referred to with respect to franchisor perceptions reflect an aggregation of responses falling in categories 1-3. Looking only at franchisor responses falling within category 1, the converse of category 6, one sees that in none of the listed areas did a majority of franchisors perceive themselves as having almost complete responsibility. Only in determining the number of employees did franchisors believe franchisees had almost complete control. Id. Fifty-five and two-tenths percent of the responding franchisors believed that their franchisees had almost complete control over determining the number of employees. A majority of the responding franchisors also believed that their franchisees had the greater share of responsibility for determining hours of operation and setting retail prices. Hunt summed up the study’s findings by stating: “The present study concluded that franchisees believe they are independent since they perceive themselves to have primary responsibility for six out of seven key operating areas. . . .” Hunt, supra note 25, at 33.

Stephenson & House, supra note 8, at 37. Successful branding reinforces operations
The notion that franchisees are totally independent businessmen has clearly been oversold. Indeed, no businessman is totally independent and free of controls, since all businesses are subject to controls imposed by the government, suppliers, creditors, and accounting rules. The most significant controls are imposed by the businessman's customers, who demand uniformly high quality in the products sold and services rendered. In no other method of doing business are controls more necessary than in franchising. Successful franchising depends upon the development and maintenance of standardized, centralized controls over the franchisee's business practices to ensure uniform quality throughout the franchise system. As a consequence, to ensure the success of

programming by establishing clear customer expectations from which it difficult for the franchisee to deviate. Thus, to the degree that branding is successful, the franchisor may obtain greater control over the franchisee because of the franchised outlet's increased profit potential, reduced risk and attractiveness as an investment opportunity. See id. at 37. Consequently, to the extent that branding efforts are successful, the franchisee's independence may be correspondingly decreased.

See Axelrad, supra note 11, at 697; Ray, supra note 16, at 238. One commentator has stated this proposition as follows: "Franchisees must agree to restrictions, or else the bedrock of the concept—uniformity—is undermined." Washington: Are Controls in the Works?, Volume Feeding Management, Jan., 1970, at 34, 35. See 1 G. Glickman, supra note 1, at §§ 2-2.1 (quoting FTC memo to the Small Bus. Ass'n, March 10, 1966). Uniform quality is especially important when products are sold or services rendered under the franchisor's trademark, for, as discussed above, successful branding leads to clear customer expectations. See Stephenson & House, supra note 8, at 37. Once customer expectations have been established by successful branding, they can be preserved only through franchisor controls. Id. Favorable perceptions fostered by successful branding would be lost if they were permitted to be altered by condoning franchise mismanagement or allowing total independence of operation. See also Hewitt, Good Faith or Unconscionability—Franchise Remedies for Termination, 29 Bus. Law. 227, 230 (1973). Thus, to the extent that uniform standards of quality are undermined by a lack of franchisor controls or by a franchisee's disregard of the franchisor's restrictions, both the franchisor and the other franchisees in the system inevitably will suffer.

Moreover, there appears to be a trend in the law in the direction of imposing greater liability upon franchisors for the quality of their products and services and for policing their trademarks. See Hewitt, supra, at 230-31; Mikva Bill Hearings, supra note 5, at 590, 619 (statement of E. Bruce Butler); id. at 619 (statement of Rep. Krueger). See generally 1 G. Glickman, supra note 1 at §§ 4.03, 4.06. In recent years, franchisors increasingly have been held liable for the torts and contracts of their franchisees. See, e.g., Wood v. Holiday Inns, Inc., 508 F.2d 167, 175-76 (5th Cir. 1975) (negligence); Kuchta v. Allied Builders Corp., 21 Cal. App. 3d 541, 546-47, 98 Cal. Rptr. 588, 590-91 (1971) (breach of contract); Billops v. Magness Constr. Co., 391 A.2d 196, 198 (Del. 1978) (false imprisonment, intentional and negligent infliction of emotional distress, battery, assault); Singleton v. International Dairy Queen, Inc., 332 A.2d 160, 161-62 (Super. Ct. Del. 1975) (personal injuries resulting from negligent design of franchisee's establishment); Sapp v. City of Tallahassee, 348 So. 2d 363, 367 (Fla. Ct. App. 1977) (failure to provide adequate security); Buchanan v. Canada Dry
the franchise system and of the individual franchisees, franchisors are required to maintain sufficient controls over their franchisees to ensure efficiency and quality throughout the system. Franchisor controls, however, tend to lessen the degree of independence of the franchisee.

Nevertheless, despite necessary franchisor controls, the franchisee still operates his or her own business, and ultimately determines its success or failure. Profits from franchising can be large, and the growth of the franchisee’s realizable equity in the business substantial. In most cases, these would seem to be more significant benefits to the franchisee than complete independence.

3. Franchisor Assistance to the Franchisee

While not without cost to the franchisee in the form of decreased independence, franchising enables the franchisee to compete more effectively with outlets of large, vertically integrated chain outlets. Through franchising, the franchisee obtains the benefits of the franchisor’s marketing and operations plan and assistance in setting up and operating the franchise. As discussed above, franchising enables business risks to be spread among the franchisor and the franchisees.

Upon joining an established franchise system, the new franchisee begins its operation with a pre-sold trade name and proven goodwill in addition to the marketing and operations plan. Most


Some prospective franchisees might as a matter of temperament be unwilling to accept necessary franchisor controls. Accordingly, instead of promoting franchising as affording prospective franchisees with an opportunity to become totally independent businessmen, franchisors should emphasize through initial disclosure and continuous communication the critical importance of maintaining uniform quality throughout the franchise system and franchisee conformity to franchisor restrictions necessary to achieve this end.

See Mikva Bill Hearings, supra note 5, at 86; id. at 303 (statement of Philip F. Zeidman).

This fact stems from successful branding and operations programming designed to maintain the integrity of the branded products. See Bernstein, supra note 53, at 26. Those franchisees who enter franchise systems at earlier stages in their development and before imitators are on the scene usually invest less to join and achieve greater results than later participants who may pay increased fees, face stiffer competition in the market and obtain less choice sites. Id.

The pre-opening package varies among franchisors. The franchisor supplies the particular franchise concept, including the trademark and the marketing and operations plan. Wattel, Are Franchisors Realistic and Successful in Their Selection of Franchisees?, J. Retailing 54, 65
franchisors also provide guidance and direct assistance in such capital matters as site selection, design and engineering of the franchisee's facility, choice of interior configuration, necessary operating equipment, furniture, and general contractor services.\textsuperscript{99}

Another form of franchisor aid frequently offered is direct loans or assistance in arranging financing from other sources.\textsuperscript{90} Moreover, some franchisors aid their franchisees by constructing the facilities and then leasing them to the franchisee.\textsuperscript{91} Additionally, many franchisors assist franchisees in securing the equipment necessary to commence operations.\textsuperscript{92}

Franchisor training programs enable many prospective franchisees with little or no prior business experience to enter a field that they would otherwise be unable to enter.\textsuperscript{93} Most franchisors provide franchisees with formal training programs and on-the-job training. The 1971 Ozanne-Hunt study found that 78.2\% of all responding fast food franchisors provided a formal training program at a central location, with the median length of this training being

(Special Issue on Franchising 1974). See also Brown, Benefits of Franchising, N.Y.L.J., June 8, 1971, at 1, col. 1, quoted in Mikua Bill Hearings, supra note 2, at 86-87.

\textsuperscript{99} See Ozanne & Hunt, supra note 28, at 125-32; Bernstein, supra note 54, at 28-30. Site selection is critical in many types of franchised businesses, especially fast food restaurants. As shown by the 1971 Ozanne-Hunt study, the majority of fast food franchisors pre-select locations and offer them to franchisees, although many franchisees have significant input in site selection. Ozanne & Hunt, supra note 28, at 126-28. The "normal procedure" of 54.1\% of the responding franchisors was to make this preselection and offer, according to the study. \textit{Id.} However, only 38\% of the responding franchisees reported that their franchisors selected their locations. "Well-operated [franchisors] will issue a franchise only for a location or area where the franchisee has good prospects for success." Bernstein, supra note 53, at 30. Most responding franchisees were generally satisfied with the quality of franchisor site selection, and the better the franchisee rated the franchisor's site selection, the higher was the income earned. Ozanne & Hunt, supra note 28, at 126-28.

\textsuperscript{90} Franchising-1978, supra note 9, at 10.

\textsuperscript{91} Ozanne & Hunt, supra note 28, at 129-30; see Bernstein, supra note 53, at 29-30. However, Ozanne and Hunt found that most franchisees owned or held the master lease on the land (nearly 60\%) and owned or held the master lease on the building (more than 60\%). Ozanne & Hunt, supra note 28 at 129-30. Also, 96.7\% of the responding franchisors retained the right to approve the physical layout of the establishment, according to Ozanne and Hunt. \textit{Id.} at 130-31. Where a distinctive building or physical layout is part of a branding effort the franchisor must ensure that all franchisees support that effort. Franchisor controls over the physical layout aid the franchisee, as indicated by Ozanne and Hunt's finding that franchisees in specially-designed buildings were more financially successful than others. \textit{Id.} at 131. Despite some franchisee's complaints that franchisors impose ruinously expensive layout changes, layout changes such as in-store seating have been responsible for substantial volume increases. See Institutions/Volume Feeding, Oct. 15, 1977, at 112.

\textsuperscript{92} Ozanne & Hunt, supra note 28, at 132. Only 23.3\% of the fast food franchisors responding to the Ozanne and Hunt survey reported that they required franchisees to purchase equipment from them. Nevertheless, 89.7\% of the franchisees did purchase equipment from the franchisor, and the majority of those who did rated it "above average" or "excellent." Only 10.7\% rated the equipment "below average" or "poor." \textit{Id.}

\textsuperscript{93} See Wattel, supra note 63, at 66; Bernstein, supra note 53, at 30.
two weeks. Participation in a quality training program increases the franchisee's probability of success; those franchisees who had attended had higher incomes than those who did not. Almost all franchisors provide on-the-job training as well. The Ozanne-Hunt study found that over ninety percent of the responding franchisors provided on-the-job training; the median length was also two weeks. Similar to those participating in the formal training programs, franchisees who attended on-the-job training had higher incomes than those who did not. In addition to pre-opening assistance, almost all franchisors provide continuing assistance to their franchisees. The Better Business Bureau has stated that the franchisor's continuing assistance to the franchisees is "one of the best justifications for the whole franchise system.'"
4. Franchisee Satisfaction

Despite significant franchisor-franchisee differences of opinion regarding various aspects of the franchise relationship, Ozanne and Hunt found that over sixty-five percent of the responding franchisees were sufficiently satisfied with their franchised businesses and that "if they had it to do over again," they would still choose to be franchisees with their present systems. Only 6.7% would prefer to change systems, and 68.8% desired to renew their franchise agreements upon expiration. Recent Commerce Department data show that in 1978, 15,373 franchise arrangements came up for renewal; only 1,074, or 6.9% of the agreements up for renewal, were not renewed because the franchisee alone did not want to renew.

D. Conclusions

The available evidence demonstrates that franchising significantly benefits society, the franchisor, and the franchisee. Franchising contributes to economic deconcentration by encouraging the creation of relatively small, independently owned businesses. Although the available evidence is inconclusive, it would appear that franchised businesses have a significantly greater chance for success than other types of businesses. Franchising has greatly benefited franchisors in that it requires low initial and expansion capital. But most important is franchising's unique provision of local, highly motivated owner-operators not otherwise available.

Franchising, supra note 49, at 91. Professor Rubin argues that basing franchisor revenue on sales instead of profits gives the franchisor the correct incentives to police franchisee performance. Rubin, supra note 14, at 229. As discussed above, franchisor policing to ensure the maintenance of uniform quality standards is essential to the success of a franchise system.

The quality of the franchisor's continuing assistance appears to be related to franchisee success. Ozanne and Hunt found that as the perceived quality of franchisor assistance improves, franchisee income rises. Ozanne & Hunt, supra note 28, at 159.

100 Id. A more recent study conducted in 1977 by the Continental Franchise Review indicates that only 3.9% of the franchisees actually chose not to renew their franchise agreements when they expired. Franchisor Trends, supra note 52, at 14. Statistics gathered by the International Franchise Association indicate the annual rate of franchise nonrenewal to be 0.03%. Mikva Bill Hearings, supra note 5, at 344 (statement of Philip F. Ziedman). This rate is based on data furnished by the Michigan Securities Commission for 1974-1976. Information for Wisconsin from the same period indicated a 0.00% annual rate of franchise nonrenewal.

101 Franchising-1980, supra note 6, at 11.
Finally, franchising's low entry barriers allow the franchisee to own his or her own business with good chances for success. Through franchising, the franchisee gains the important benefits of the franchisor's trademark, goodwill, and assistance in setting up and operating the franchise. Franchisees are not totally independent businessmen, of course, nor can they be if successful franchising, which depends in large measure upon the maintenance of uniform quality throughout the system and therefore upon franchisor controls, is to be preserved.

It may be seen, therefore, that franchising, while by no means a sure road to success or a way of doing business without substantial difficulties, significantly benefits society, the franchisor and the franchisee. The foregoing analysis of these benefits has sought to provide a realistic appraisal of franchising, without any of the over-promotion once associated with franchising. Unfortunately, over-promotion by some franchisors did exist, however, and it not unnaturally engendered unrealistic franchisee expectations. When these expectations went unfulfilled, some franchisees turned to the legislatures and the courts for assistance, citing a number of franchisor abuses allegedly existing in franchising and claiming that these abuses stemmed from an imbalance of bargaining power between franchisor and franchisee.

V. BARGAINING POWER IN FRANCHISING

The principle abuses associated with franchising are claimed to be misrepresentation, nondisclosure and other forms of franchisor overpromotion, unreasonable franchisor requirements, and arbitrary and capricious termination by franchisors. Proponents of legislation regulating the franchise relationship claim that these abuses arise from a disparity of bargaining power between franchisor and franchisee and assert that they are widespread.

102 See Kamenshine, *Competition Versus Fairness in Franchising*, 40 Geo. Wash. L. Rev. 197, 199 (1971); Hunt & Nevin, supra note 11, at 54.

103 See Howard & Dickinson, *Legal-Economic Aspects of Franchising*, 13 J. Small Bus. Management 21, 21 (1975). Howard and Dickinson claim that disparity of bargaining power is due to the relative sizes of the franchisor and the franchisee, control by the franchisor over a branded product's supply source or license, franchisor power over agreement renewal or termination and franchisor control over certain operating decisions. Id.

Former Representative Abner J. Mikva, until his recent appointment to the federal bench the principal sponsor of federal legislation that would regulate the franchise relationship, has remarked:
throughout the franchising "industry." It is contended that existing legal remedies are inadequate to correct these abuses and therefore that legislation regulating the franchise relationship is needed.

With the exception of abuses associated with the overpromotion of franchising, however, which may be cured by full and fair disclosure by franchisors, proponents of legislation regulating the franchise relationship have been unable to document any such widespread abuses. Moreover, the isolated abuses other than those associated with overpromotion that do occur are susceptible to correction through the enforcement of existing legal remedies. Accordingly, the existing and proposed legislation regulating the franchise relationship can only be seen as the product of an overreaction to the overpromotion of franchising.

A. Bargaining Power Between Franchisor and Prospective Franchisee

It must be kept in mind that while franchising is no doubt attractive, participation in franchising is not a necessity for an aspirant businessman. To be sure, in some industries, such as automobile dealerships or gasoline service stations, a franchise is a virtual prerequisite to entry into the marketplace. In most

In most states, the franchise relationship continues to be governed by traditional contract law even though it lacks the principle upon which contract law is based — equal bargaining power between the contracting parties. The underlying notion of a "buy-sell" contract is a willing buyer and a willing seller, each free to go elsewhere, or not buy at all.

Similarly, the Ozanne-Hunt report lists the principal indicators of imbalance of bargaining power as secrecy of the franchise agreement, economic and information inferiority of the franchisees, and greater and more detailed obligations placed upon the franchisee by the franchise agreement. Ozanne & Hunt, supra note 28, at 55, 56. Ozanne and Hunt reported that while 57.7% of the responding franchisors and 76.3% of the responding franchisees believed that the franchise agreement favors the franchisor, nearly 25% of the responding franchisees believed that the franchise agreement favors the franchisor, nearly 25% of the responding franchisees believed that the agreement favored themselves.

See, e.g., Hunt & Nevin, supra note 11, at 54; Regulation of Franchising, supra note 11, at 1027-28. See also Ozanne & Hunt, supra note 28, at 55, 72.


cases, though, there are alternatives to franchising, particularly in industries where business format franchising has been most successful. No one is forced to become a franchisee to enter the marketplace. Moreover, within franchising there are a multitude of businesses available from which prospective franchisees can choose. Thus, before entering into a franchise relationship, most prospective franchisees are, in the words of former Congressman Abner J. Mikva, "free to go elsewhere, or not buy at all."  

Moreover, it cannot be assumed that franchisor size and experience always results in disparity of bargaining power between franchisor and prospective franchisee. Of the 1,394 franchisors identified by the most recent Commerce Department survey, 243 companies accounted for approximately eighty-five percent of the establishments and sales. The remaining 1,151 franchise companies, the overwhelming majority of franchisors, would thus appear to be relatively small business enterprises, without the substantially greater bargaining power over prospective franchisees ascribed to franchisors generally by proponents of legislation regulating the franchise relationship.  

Although the popular impression of prospective franchisees may be that they are all individual businessmen, this is not always the case. Many partnerships, limited partnerships, and investor syndicates have become franchisees. Indeed, many large, multimillion dollar corporations have entered franchising as franchisees. Almost all franchisors permit multi-unit ownership by fran-

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107 Ungar v. Dunkin' Donuts, Inc., 531 F.2d 1211, 1223 (3rd Cir.), cert. denied, 429 U.S. 823 (1976). Competition for high caliber franchisees is intense, for good franchisees are difficult to find. See Bernstein, supra note 53, at 28; McGuire, supra note 7, at 55; Rubin, supra note 14, at 232.  

108 See note 103 supra.  

109 See also Mikva Bill Hearings, supra note 5, at 421, 429-24 (statement of John Hatch). Indeed, in infant industries it is not uncommon for a franchisee to be in a much stronger bargaining position than the franchisor.  

110 See Gellhorn, supra note 24, at 472 n.23.  

chisees, and the Commerce Department has reported a trend toward multi-unit ownership by franchisees. Some franchisees are publicly held and listed on the New York Stock Exchange. Indeed, some franchisees are larger than their franchisors.

Obviously, large business enterprises are less susceptible to franchisor pressure than individual businessmen and thus cannot credibly claim a significant disparity of bargaining power with their franchisors. In fact, legislation regulating the franchise relationship might actually unbalance rather than balance the bargaining power between these franchisees and their franchisors.

Nor, as some would have it, are prospective franchisees mere naifs, ripe for exploitation by experienced franchisors. The 1971 Ozanne-Hunt report is quite revealing about the prior experience of fast food franchisees. Thirty-two percent of the responding franchisees were self-employed before purchasing their franchises; some had even owned franchises in other systems. Twenty-seven percent of the franchisees previously were business managers or corporate professionals, and seventeen and one-half percent were white-collar workers or skilled blue-collar workers or foremen.

It had been asserted that most prospective franchisees do not consult lawyers before signing the franchise agreement. The 1971 Ozanne-Hunt study showed, however, that over sixty percent of the responding franchisees consulted lawyers before entering into the franchise agreement. Of those franchisees who did not consult lawyers, 35.9% consulted existing franchisees and 32.2% consulted lawyers.

See Fast-Food Franchisors Squeeze Out the Little Guy, BUS. WEEK, May 31, 1976, at 46, 48; The Fast-Food Stars, BUS. WEEK July 11, 1977, at 56, 59. Ozanne and Hunt reported that of the responding franchisees, 27.8% operated from 2 to 35 units. OZANNE & HUNT, supra note 28, at 102-03.

FRANCHISING-1979, supra note 21, at 4.

See Mikva Bill Hearings, supra note 5, at 248 (testimony of Edward Kushell). Examples of publicly held corporations include Gino's Inc. and Collins Food Int'l.

Id. See Kohn, The Importance of Franchise Class Actions, 47 ANTITRUST L.J. 915, 919 (1979). Large corporations which have operated franchised establishments as one small facet of their business include Standard Oil of Ohio (Dutch Pantry), American Broadcasting Co. (Holiday Inn), and Great Lakes Carbon Corp. (Holiday Inn). See Bernstein, supra note 53, at 35.

See Axelrad, supra note 11, at 713 n.43; Mikva Bill Hearings, supra note 5, at 48, 54 (testimony of then Deputy Assistant Attorney General Joe Sims).

OZANNE & HUNT, supra note 28, at 110-12. See Regulation of Franchising, supra note 11, at 1028 n.7. It has been reported that Wendy's has concentrated on selling franchise territories rather than single-unit franchises, and on selling primarily to experienced fast food operators. BUS. WEEK, Sept. 20, 1976, at 101.

accountants. Today, the percentage of prospective franchisees who consult lawyers is undoubtedly greater.

The balance of bargaining power between franchisor and prospective franchisee may be affected by the terms of the franchise agreement. In many franchise systems, franchisees must invest upwards of $500,000 for their franchises; it is quite unlikely that such franchisees enter franchising with their eyes closed. It stands to reason that the larger the required investment, the more likely it is that the prospective franchisee will exercise due care when entering into the franchise agreement.

The duration of the franchise relationship may also affect the balance of bargaining power between franchisor and prospective franchisee. Recent data collected by the International Franchise Association shows that approximately sixty-three percent of the franchise agreements analyzed were for at least 10 years, and about thirty-one percent were for at least 20 years. Commerce Department figures show that about seventy-eight percent of the agreements issued in 1978 were for 10 years or more and that nearly half were for 20 years or more. Prospective franchisees would naturally be more careful when signing agreements of long duration. Thus, it would appear that the longer the duration of the agreement, the more likely it is that the prospective franchisee has carefully evaluated the terms of the agreement and knowingly agreed to the terms.

120 See Mikva Bill Hearings, supra note 5, at 162 (statement of Thomas W. Power); FRANCHISING-1980, supra note 6, at 88 (table showing total investment and start-up cash required for franchised businesses).
121 See Mikva Bill Hearings, supra note 5, at 344-46 (testimony of Philip F. Zeidman). The IFA examined statistics from three large industrial states, Michigan, Wisconsin and Illinois, as gleaned from franchisors' 1977 Uniform Franchise Offering Circular filings. Presumably, these filings included those of "traditional" franchisors, and thus the figures may not be strictly comparable to the Commerce Department's figures discussed in the text accompanying note 120 infra.
122 FRANCHISING-1980, supra note 6, at 11.
123 Decision Criteria, supra note 53, at 88; see ABA FORUM COMM. ON FRANCHISING, FIRST ANN. FORUM, Outline of Jules L. Garel 1 (1978). Mr. Garel notes:

The modern franchisee is no longer a no-experience novice. The typical new franchisee, in many industries, is a professional franchisee—compared with the amateur franchisee of the late 1950's, and the 1960's.

Franchisors now seek out and contract with well financed, well organized persons and companies with experience in the business of the franchise. Franchisees are often well represented by highly-qualified counselors—lawyers, CPA's and business consultants.

The time of total futility in negotiating from the franchisee's side of the table
B. Full Disclosure: The Effective Equalizer of Bargaining Power

While in many cases the bargaining power of the franchisor and the prospective franchisee may be substantially equal, in others it may not because of the particular prospective franchisee's inexperience and lack of information. Any such disparity of bargaining power can effectively be equalized by full disclosure by the franchisor. While not without costs, including the tendency of disclosure systems to become regulatory systems through internal pressure, full disclosure enables prospective franchisees to make a reasoned evaluation of the potential risks and benefits of franchising.

To date, fourteen states have enacted legislation of the full disclosure variety, and bills which would require full disclosure have been proposed in a number of other states. Designed to protect prospective franchisees from misrepresentation and nondisclosure by franchisors, full disclosure laws require franchisors to provide prospective franchisees with objective information sufficient to enable them to make a considered and informed decision.

Many of the disclosure provisions of proposed and enacted state legislation are patterned on the California Franchise Investment Law. The Franchise Investment Law requires a new franchisor to register the offer of a franchise with the office of securities. The Commissioner of Securities has the authority to stop the registration process if he finds that the franchisor has violated any provisions of the law. The Commissioner may also require the franchisor to provide additional information to the prospective franchisee.

is over. Franchisors, particularly in sophisticated industries, expect and suggest negotiations between the parties. Franchisors do not want franchisees to avail themselves of the defense of unconscionability by franchisors saying "this is the agreement, take it or leave it."

See generally Hunt, supra note 25, at 37.


sale of a franchise if the franchisor has failed to comply with the requirements of the disclosure law if the sale would operate as a fraud on prospective franchisees. Large franchisors, generally those with a consolidated net worth of at least $5 million and with at least twenty-five franchisees conducting business at all times during the 5-year period immediately preceding the offer, are exempt from the registration requirement but must nonetheless provide comparable information to prospective franchisees.126

The statute mandates disclosure in the registration application of such information as the identity and background of the franchisor and its principals; a recent financial statement; a sample franchise contract; the franchisor’s policies with respect to franchise fees, royalties, supplies, and franchise termination, renewal and repurchase provisions; available financing arrangements; substantiation of profit projections; details of any celebrity participation; and territorial protection given to the franchisee. The registration application must be accompanied by a proposed offering prospectus.127

Franchisors subject to the registration requirement must provide the prospectus to all potential franchisees before the franchisor receives any consideration or 48 hours before the execution of a franchise agreement. Moreover, all advertisements soliciting prospective franchisees must be filed with the Commissioner at least 3 business days before publication. As with the registration requirement, large franchisors are exempt from filing their advertisements.128

The statute gives the franchisee a private right of action against the franchisor for damages caused by the franchisor’s violation of the disclosure provisions and, if the violation is willful, the franchisee may seek rescission of the franchise agreement.129

126 Id. § 31101. Even for exempt franchisors, the California statute requires them to provide a history of the franchisor, a copy of a typical franchise agreement, the amount of the franchise fee normally charged and a list of other fees, if any, a listing of conditions under which the agreement may be terminated or not renewed, a description of operating restraints on the franchisee, a description of any financing arrangements, the basis for any profit projections, and similar information. Id.

127 Id. §§ 31111-31114. The requirements and format of the California law are similar to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976).

128 CAL. CORP. CODE § 31156 (Deering 1979).

129 Id. § 31300. Again paralleling the federal securities laws, the California statute imposes liability upon the franchisor for failing to comply with the registration requirements and for making material misstatements or omissions in its communications or in its filing with the state.
Over the past few years, bills have been introduced in Congress that would require full disclosure,¹³² but to date no such legislation has passed. In December 1978, the Federal Trade Commission promulgated a Trade Regulation Rule, “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures” (FTC Rule), requiring full disclosure, which took effect on October 21, 1979.¹³³

The FTC Rule provides that it is an unfair or deceptive act or practice within the meaning of section 5 of the Federal Trade Commission Act for a franchisor to fail to provide, within at least 10 days prior to the execution of a franchise agreement, a prospective franchisee with a prospectus containing information similar to that required by the California statute.¹³⁴ In addition, a franchisor must

¹³³ FTC Rule, supra note 11. The Rule was originally scheduled to take effect on July 21, 1979, but the effective date was extended to allow the FTC more time to consider the numerous public comments received. According to the FTC, the Rule was “promulgated in response to widespread evidence of deceptive and unfair practices in connection with the sale of franchises and business opportunity ventures.” 43 Fed. Reg. 59,614, 59,614 (1978). By requiring full disclosure, the FTC is attempting to redress what it believes is a serious “informational imbalance” existing between prospective franchisees and their franchisors. Id.

The FTC Rule defines the term “franchise” quite broadly, based on the FTC’s finding that the franchise relationship has three distinct conceptual characteristics distinguishing it from conventional commercial relationships: “increased potential for success, loss of [franchisee] independence, and a payment of capital to the franchisor by the franchisee.” Id. at 59,699. Two types of commercial relationships are defined as “franchises”: (i) an arrangement where the franchisee sells goods or services meeting the franchisor’s quality standards, the franchisor exercises significant control or gives significant assistance to the franchisee, and the franchisee pays more than $500 to the franchisor within 6 months after the franchised business begins operation; and (ii) an arrangement where the franchisee sells goods or services supplied by the franchisor, the franchisor secures accounts for the franchisee or provides a location for the franchised business, and the franchisee pays $500 to the franchisor within 6 months after the franchised business begins operations. Id. at 59,619-59,620 (16 C.F.R. § 436.2(a) (1980)). The FTC’s Statement of Basis and Purpose specifies that an arrangement which is initially represented as a franchise (as the term is defined) is subject to the rule even if subsequent events result in its failure to qualify as a franchise, e.g., where the franchisor originally promised assistance but subsequently failed to provide it. Id. at 59,699-59,700. The Rule applies to product and trade name franchising, called “product” franchising, to business format or enterprise franchising, called “package” franchising, and to such non-franchising commercial arrangements as rack jobbing and vending machine distributorships, called “business opportunity ventures.” Id. at 59,697-59,698. The inclusion of “business opportunity ventures” in rules dealing with franchising is unusual and confusing. The Commerce Department in its analysis of franchising has never taken such an expansive view of franchising, nor have most commentators on franchising. See, e.g., Hunt, supra note 25, at 34.

¹³⁴ FTC Rule, supra note 11, at 59,614 (16 C.F.R. § 436.1(a) (1980)). The required statement may be provided to the franchisee in either a document prepared according to interpretive guides issued by the franchise staff of the FTC, see 44 Fed. Reg. 49,866, Aug. 24, 1979, or in conformity with the Uniform Franchise Offering Circular (UFOC) Guidelines, which a number of states have adopted for registration and disclosure of franchise offerings.
disclose detailed information about franchise terminations, nonrenewals and repurchases, and franchisee training. The Rule permits franchisors to include statements of projected or forecasted earnings, income, or sales for a prospective franchisee, provided they are supported by a reasonable basis and presented in a format disclosing their underlying material assumptions.

The Rule does not preempt state law giving equal or greater protection to prospective franchisees. The FTC may seek civil penalties of up to $10,000 per day for violations of the Rule and may also seek to enjoin continued violations. In the “Statement of Basis and Purpose” accompanying the Rule, the FTC declared its belief that “the courts should and would hold that any person injured by a violation of this rule has a private right of action against the violator.” It is quite doubtful, however, that the

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135 FTC Rule, supra note 11, at 59,616 (16 C.F.R. § 436.1(a)(15)(1980)). The FTC concedes that franchisors do not omit from the franchise agreement provisions dealing with renewals, terminations, and repurchases. The FTC’s concern seems to be that these provisions may be buried in the agreements. Id. at 59,664. Given the amount of information required in the FTC’s prospectus, the FTC’s concern may well go unsatisfied.

136 Id. at 59,617 (C.F.R. § 436.1(24)(b)(1980)). The FTC Rule prohibits inclusion of these projections in the prospectus itself. The franchisor, however, may provide a prospective franchisee with a separate written statement containing projections and the required supporting information. Id.

137 Id. at 59,719-59,723. But see FRanchising-1979, supra note 21, at 26-27. By not preemitting state law, the FTC rejected the requests of those who sought some semblance of uniformity as a meritorious consequence of federal regulation in this area. The FTC justifies its action by suggesting that the end result will be one standard, which will be an amalgam of federal, state, and local laws. The problem with this argument is that it holds true only if franchisors are willing to apply the most stringent “amalgam” in all locales. Even then, the need to make state filings and comply with required state formatting rules creates the potential for an almost nightmarish situation. For example, by regulations effective January 1, 1980, California permits only the UFOC format with modification as provided in the regulation; the FTC format will not satisfy the Commissioner of Corporations, who administers the California Franchise Investment Law. The FTC also argues that in most situations, all state and local laws and, “in large part,” the FTC Rule can be complied with by using the Uniform Franchise Offering Circular. Certain provisions of the Rule will still control, however, even if the UFOC format is used in lieu of the Rule’s disclosure document. Such provisions include (1) the persons required to make disclosure, (2) the transactions requiring disclosure, (3) the timing of the disclosure, and (4) the types of documents to be given to prospective franchisees.

138 The FTC Rule purports to impose these penalties by labelling a violation of the Rules as an “unfair or deceptive act or practice within the meaning of section 5 of [the Federal Trade Commission Act].” Id. at 59,614 (16 C.F.R. § 436.1 (1980)). Assuming arguendo that the FTC by mere assertion can make a violation of the Rule illegal under the FTC Act, the penalties are provided by statute. See 15 U.S.C. § 54 (1976). Following promulgation of the FTC Rule, many franchisors filed petitions for judicial review. Trade Reg. Rep. (CCH), March 12, 1979, at 9. These proceedings have been consolidated in the Ninth Circuit. In re FTC Franchise Rule Review, No. 78-3680 (9th Cir. 1979).

139 FTC Rule, supra note 11, at 59,723.
courts will agree with the FTC's position on the existence of a private right of action under the Rule.\textsuperscript{140}

The International Franchise Association (IFA) has gone on record in support of uniform national legislation or regulation which would require full disclosure of all information material to the purchase and continuing operation of the franchise,\textsuperscript{141} although a representative of the IFA has criticized the FTC Rule for not preempting state laws.\textsuperscript{142} To simplify the task of conforming with the requirements of the various state disclosure laws, the IFA and the Uniform Franchise Regulation Committee of the Midwest Securities Commissioners Association have produced the Uniform Franchise Offering Circular and Registration Application (UFOC).\textsuperscript{143} The "Statement of Basis and Purpose" accompanying the FTC Rule provides that the FTC "will accept compliance with the UFOC as compliance in large part with [the FTC] Rule."\textsuperscript{144}

Full disclosure as mandated by the FTC Rule and state legislation should prove sufficient to correct any informational imbalance between franchisor and prospective franchisee. Indeed, according to a 1976 study by Hunt,\textsuperscript{145} state full disclosure laws have greatly reduced the incidence of franchisor misrepresentation to prospective franchisees regarding the potential profitability of their franchises.\textsuperscript{146}

Other principal abuses associated with the overpromotion of franchising seem to have been largely corrected as well. Headline stories reporting on franchisees achieving "instant success" have been replaced by sober analyses of franchising.\textsuperscript{147} More conservative accounting standards have largely eliminated the reporting of


\textsuperscript{141} Mikva Bill Hearings, supra note 5, at 310-12 (testimony of Philip F. Zeidman). The International Franchise Association argues that disclosure laws are clearly preferable to statutes that attempt to regulate the franchise relationship. Id.


\textsuperscript{143} Franchising-1979, supra note 21, at 21; Mikva Bill Hearings, supra note 5, at 353-56.

\textsuperscript{144} FTC Rule, supra note 11, at 59,721. See note 133 supra.

\textsuperscript{145} Hunt & Nevin, supra note 11.

\textsuperscript{146} Id. at 61. The study was limited to a survey of franchisors and franchisees in Wisconsin. Id. The study found that only 15% of the responding franchisees claimed that their franchisors had overestimated profitability during negotiations. A pre-disclosure law study had put the same percentage at 37%. Id. at 56. Hunt and Nevin assumed that the disclosure law was the cause of this drop. While acknowledging that the costs of complying with full disclosure laws may tend to cause small franchisors to abandon franchising, Hunt and Nevin concluded that overall benefits of these laws outweighed their costs. Id.

\textsuperscript{147} See generally Coyle, supra note 42; Burck, supra note 7; Murray, supra note 24.
franchising fees as current income,\textsuperscript{148} and as a result, the pressure on franchisors to increase their sales of franchises in order to report earnings growth has been reduced.\textsuperscript{149} Many franchisors who relied upon celebrity allure alone failed to weather the economic downturn of the 1970's and its attendant effects on franchising. Consequently, the belief that a celebrity name automatically attracts customers seems largely to have disappeared.\textsuperscript{150}

C. Bargaining Power During the Course of the Franchise Relationship

While acknowledging that, with full disclosure, franchisors and prospective franchisees possess equal bargaining power, former Congressman Mikva has argued that as the relationship matures, the balance of bargaining power becomes substantially unequal, principally due to the franchisor's controls over the franchisee's sources of operating supplies and the franchisor's power over termination and renewal.\textsuperscript{5} While it may be true that some franchisors have greater bargaining power than their franchisees, there is no evidence that franchisor abuses of their bargaining power are widespread throughout franchising. As discussed above, upon entering franchising, the franchisee forgoes certain elements of independence in operating the franchised business in return for the right to operate under the franchisor's trademark and its marketing and operations plan. Most franchisors also agree to provide their franchisees with continuing assistance. Of course, depending upon the franchisee's satisfaction with the franchise relationship, the benefits of a strong trademark resulting from successful branding, an effective marketing and operations plan, and desirable franchisor assistance can also be viewed as contributing to "undesirable" franchisor controls. This difference in franchisee perception, and not franchisor abuses of their bargaining power, would appear to account for most of the conflicts between franchisor and franchisee.


\textsuperscript{149} See Franchisors: Out of the Frying Pan?, Financial World, Nov. 10, 1971, at 10; Ray, supra note 16, at 235. The FTC Rule requires franchisors to provide audited financials prepared in accordance with generally accepted accounting standards. FTC Rule, supra note 11, at 59,616-59,617 (16 C.F.R. § 436.1(a)(20) (1980)).

\textsuperscript{150} See Axelrad, supra note 11, at 705-06.

\textsuperscript{5} See, e.g., Mikva Bill Hearings, supra note 5, at 34-35, 41, 44 (testimony of Rep. Mikva).
1. Franchisor Controls Over Franchisee Sources of Operating Supplies

The principal justification for franchisor controls over franchisee sources of operating supplies is the need to maintain uniform standards of quality in the products sold and services rendered throughout the franchise system. Moreover, franchisors are obligated by federal trademark law to ensure that the products or services identified by the mark meet all owner quality standards at the risk of loss of their trademark rights.

Except for isolated instances not shown to be widespread, there is no evidence that as a matter of general practice, franchisors abuse their controls over franchisee sources of operating supplies to increase revenue or obtain kickbacks from approved suppliers. Abuses of that nature, when they do occur, usually involve tying arrangements, which raise questions under the antitrust laws.

A tying arrangement is the conditioning of the sale of a desired product (the tying product) upon the purchase of another less desired product (the tied product). The principal anticompetitive effects of tying arrangements are said to be that the purchaser of the tied product is forced to forego his or her free choice between competing sellers of the tied product and that others who sell the tied product are foreclosed from selling to purchasers of the tied product.

A tying arrangement is illegal per se under section 1 of the Sherman Act whenever the seller has sufficient power over the ty-
Many states have "little Sherman Acts" also making tying arrangements illegal, and tie-ins by franchisors may run afoul of section 3 of the Clayton Act and section 5 of the Federal Trade Commission Act.

It has been asserted without convincing supporting data that tie-ins are widespread in franchising. Some franchisors are said to tie the franchisee's initial equipment of operating supplies to the franchisor's trademark or other aspects of the relationship. The controversy continues whether the franchise itself, the licensed trademark or other aspects of the franchise relationship are sufficiently separate and distinct "products" to form the basis of a tying arrangement.

Moreover, in light of the Supreme Court's decision in United States Steel Corp. v. Fortner Enterprises, Inc., it is doubtful whether sufficient economic power can be presumed solely from the fact that the alleged tying product is a trademark.

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2 In Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972), the court held that a trademark was "unique," thus giving rise to the presumption of sufficient economic power. Id. at 49. This decision was based on rather ambiguous language in Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 502-05
Finally, the per se tying rule does not apply if the franchisor does not sell, or have an equivalent economic interest in, both the tying and the tied product.\footnote{107} Hence, the mere fact that franchisees,


In Fortner II, the Supreme Court clarified and in several respects modified the reasoning of Fortner I. United States Steel Corp. v. Fortner Enterprises, Inc., 429 U.S. 610 (1977) (Fortner II). Perhaps most significant, the Court, while reiterating the concept of uniqueness, stated the controlling test in terms of "power . . . within the market for the tying product" and "whether the seller has some advantage not shared by his competitors in the market for the tying product.” Id. at 620.

One difficulty in applying the Fortner II standards to franchising is defining the “market for the tying product.” It cannot be the market for the franchisor's trademark or license, for the franchisor has no competitor in the market for its own trademark, and only licensees of the franchisor can use its trademark legally. On the other hand, if the "market for the tying product" is the market for the product sold by the franchisees, it is difficult to identify any significant "advantage not shared by [the franchisor's] competitors" in that market. As noted by the second circuit in the Capital Temporaries case, a trademark, unlike a patent, does not prevent a competitor from copying the products sold by the franchisees. 506 F.2d at 663. And while in some industries the trademark may be a prerequisite to market entry, cf. text accompanying note 106 supra (automobile dealerships and gasoline stations), in many others it is not. In those cases in which it is not, the franchisor's competitors are free to develop their own distinctive trademarks. Following Fortner II and noting the harsh criticism which has been leveled against Chicken Delight, the court in Cash v. Arctic Circle, Inc., [1979] 1 TRADE CASES (CCH) ¶ 63,095 (E.D. Wash. 1980), declined to recognize a presumption of economic power inherent in a trademark. But cf. Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 725 (7th Cir. 1979) (sole national franchisor of drive-through photo processing possessed sufficient power with regard to the tying product, the trademark/franchise).

\footnote{107} See Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977); Venzie Corp. v. United States Mineral Prods. Co., 521 F.2d 1309 (3d Cir. 1975).

agreements may provide that franchisees must purchase initial equipment or operating supplies from their franchisors or from franchisor-approved sources does not mean franchisees are coerced by their franchisors into making such purchases. To be sure, most franchisees who understand the critical importance of maintaining uniform standards of quality throughout the franchise system willingly—indeed, enthusiastically—accept franchisor purchase restrictions.

Some critics claim that the antitrust laws are inadequate to deter illegal tying arrangements and other anticompetitive practices by franchisors. It is said that antitrust litigation is not pursued by wronged franchisees because of the high costs in time and money and the complexity of the antitrust laws. The laws themselves, however, provide strong incentives for litigation: recovery of attorneys' fees and treble damages. Moreover, in appropriate cases, injunctive relief may be obtained and illegal clauses stricken from the franchise agreement, and costs of maintaining antitrust litigation may be spread through use of the class action device.

In order to obviate possible antitrust claims, prudent franchisors should require their franchisees to purchase operating supplies from them only when these supplies are not duplicable by competing manufacturers. Franchisors who derive a significant amount of revenue from sales of operating supplies would be well advised to consider royalties as an alternative method of obtaining

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See Regulation of Franchising, supra note 11, at 1033-34. It is claimed that antitrust suits are prohibitively expensive and time-consuming. Furthermore, they are said to be ineffective by always being after-the-fact. It is claimed that the franchisor may itself be insolvent by the time of the lawsuit and that the franchisee may, as a result of the antitrust law violation, be unable to bear the cost of litigation. See also Mikva Bill Hearings, supra note 5, at 35 (testimony of Rep. Mikva).

See Mikva Bill Hearings, supra note 5, at 511 (testimony of Samuel Bernstein).

Id. at 267 (statement of Philip F. Zeidman).

Id. at 298.

See, e.g., Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972). Most of the franchisor tying arrangements cited by proponents of legislation regulating franchising have come to light as a result of franchisee-prosecuted litigation or complaints to the FTC. See Mikva Bill Hearings, supra note 5, at 587 (statement of Bruce Butler). Franchisor controls over franchisee sources of operating supplies not reached by the antitrust laws are those that are not illegal because of quality control considerations or lack of franchisor coercion.
regulate franchises. Moreover, franchisors should set reasonable standards for attaining approved supplier status and must not accept kickbacks or rebates from approved suppliers.

2. Franchisor Control Over Termination and Nonrenewal of the Franchise Agreement

According to proponents of legislation regulating the franchise relationship, the root cause of the alleged bargaining power disparity between franchisor and franchisee during the course of the franchise relationship is franchisor control over termination and nonrenewal of the franchise agreement. The proponents have contended that franchises have been terminated on arbitrary grounds and that franchisors use the threat of termination or nonrenewal to force franchisees to accept onerous and often illegal requirements. These abuses are asserted to be widespread throughout franchising and not susceptible of correction by existing legal remedies.

Although termination and nonrenewal problems have been identified in some industries, such as beer distributing, petroleum marketing and automobile retailing, the available evidence simply does not support claims that franchisor abuses regarding termination and nonrenewal are widespread in all industries.

The Ozanne-Hunt study did not collect data regarding termination and nonrenewal rates. Instead, Ozanne and Hunt analyzed the provisions of fast food franchise agreements, regarding renewal, the right to sell, inheritance, and termination. Eighty-two and one-half percent of the franchisors responding to the survey indicated that their franchise agreements were renewable at the franchisee's option; the median length of the renewal term was 5

171 Mikva Bill Hearings, supra note 5, at 33-34 (testimony of Rep. Mikva); id. at 440 (statement of Jerome R. Waldie); Brown, The Mikva bill, N.Y.L.J., April 13, 1976, at 1, col. 1, quoted in Mikva Bill Hearings, supra note 5, at 80-82; Brown, supra note 48, at 662-63. See also Hunt, supra note 45, at 76-77.

172 See Mikva Bill Hearings, supra note 5, at 138-40 (statement of Cathleen H. Douglas); Brown, supra note 100, at 110; Burck, supra note 7, at 148.

173 See Mikva Bill Hearings, supra note 5, at 33-35 (testimony of Rep. Mikva). In 1971, Ozanne and Hunt found that almost 77% of the fast food franchisees surveyed believed that federal legislation restricting the franchisor's right to terminate the franchise agreement was necessary. Ozanne & Hunt, supra note 28, at 276-77.

174 See Mikva Bill Hearings, supra note 5, at 291-92 (statement of Philip F. Zeidman); FRANCHISING-1978, supra note 9, at 24; FRANCHISING-1977, supra note 65, at 2; Bennison, supra note 8, at 157.

175 Ozanne & Hunt, supra note 28, at 269-83.
years. Most of the fast food franchise agreements provided that the franchisee could sell the franchise to third parties, subject to franchisor approval. Sixty-four percent of the franchise agreements studied contained a right of inheritance clause assuring the passage of the franchisee's franchise rights to his or her heirs, provided their successors agreed to assume the deceased's obligations.

Discussing termination and nonrenewal, Ozanne and Hunt listed three general causes of termination: franchisee bankruptcy, expiration of the agreement, and default in the franchisee's performance. Default was regarded as "sensitive" because of the wide range of grounds for termination and the possibility of unequal enforcement of default clauses. Franchisors indicated that they gave franchisees a median of 30 days to correct violations of default provisions.

The report noted that many critics of franchising implied that franchisors held "the threat of termination over the heads of franchisees." Ozanne and Hunt reported no statistics regarding the actual termination rate of franchisees, but the data they did develop indicated that the critics incorrectly perceived franchisor threats of termination. Although Ozanne and Hunt speculated that

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179 Only 13.6% of the franchisors reported that they charged a renewal fee. Nearly 69% of the franchisees indicated that they planned to renew their agreements, although some expressed serious concern about renewal negotiations. Significantly, their strongest concern centered about their franchisors' institution of a royalty fee for the first time in the new franchise agreement. Id. at 270-71.

180 Id. at 271-73. Approximately 48% of the agreements gave the franchisor the right of first refusal. An identical percentage of the responding franchisees were allowed to sell to any franchisor-approved third-party. The first-refusal arrangement may be more beneficial to the franchisee in that it places the burden on the franchisor either to buy or agree. Several franchisees reported that their franchisors had used their right of approval to introduce a new, more stringent contract. Id. at 272. Ozanne and Hunt presented no evidence on how prevalent this alleged practice was. While the report was sympathetic to franchisee desires to sell the franchise as an on-going business including good will, Ozanne and Hunt recognized that franchisors owed a duty to themselves and to the other franchises in the system to prevent poor prospects from buying franchised units. They questioned whether any legislation could protect the franchisee's right to sell and at the same time force the franchisor to deal in good faith in approving the sale of the franchise. Id. at 273.

181 Id. at 273-74. The majority of franchisors responded that their franchisee's heirs inherited the franchise; 41.2% indicated that they did so with franchisor approval. Id. at 274. Ozanne and Hunt commented that the right to inherit only with the franchisor's approval is really "no right at all." Id. However, the same factors that necessitate franchisor approval of potential buyers argue for franchisor approval of heirs.

182 Id. at 274.

183 Id. at 275-76.

184 Id. at 276.
some franchisees may feel an implied threat of termination because of the way franchise agreements "dwell on the franchisor's right to terminate," the study revealed that only 12.9% of the franchisees reported that their franchisors had "ever threatened to revoke their franchise." It was not reported whether these threatened terminations were for cause or how many franchisees actually were terminated following such threats.

A 1977 study conducted by the Continental Franchise Review attempted to gauge the prevalence of and reasons for nonrenewal. It was found that approximately ninety-one percent of all expired franchise agreements were renewed. Of those agreements not renewed, 3.9% were not renewed at the choice of the franchisee, 2.9% represented franchisee failure to meet contract provisions, and 1.9% resulted from poor franchisee performance.

Statistics reported in 1977 by the International Franchise Association also indicate the absence of widespread termination or nonrenewal problems. In Michigan, the annual rate of termination by franchisors was shown to be 1.4% of the total number of franchised outlets of registered franchisors; 0.01% were not renewed by franchisors. In Wisconsin, the annual rate of termination by franchisors was shown to be 2.6% of the total number of franchised outlets of registered franchisors; 0.18% were not renewed by franchisors.

According to the Commerce Department, in 1978, ninety-three percent of the 15,373 non-traditional franchise arrangements which came up for renewal were renewed. Of those not renewed, twenty-three percent resulted from objections by the franchisor, forty-five percent from the franchisee not wanting to renew, and thirty-two percent from mutual agreement.

There were 5,969 terminations of non-traditional franchise agreements in 1978, of which 1,748 were terminated by franchisors. This was only 0.09% of the franchisee-owned establishments existing in 1978. One-thousand two-hundred and twelve were terminated

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185 Id. Every franchise agreement examined by Ozanne and Hunt contained a termination clause.
186 Id.
187 Franchiser Trends, supra note 52, at 3.
188 Id. at 14. The industries in which poor performance resulted in nonrenewal were predominantly automotive parts and service and campgrounds.
189 See Mikva bill Hearings, supra note 5, at 344-46 (testimony of Philip F. Zeidman).
190 Id. at 344-45.
191 FRANCHISING-1980, supra note 6, at 10-11.
for non-payment of royalties or other financial obligations, 107 for the franchisee's failure to comply with quality control standards, and 429 for other reasons not identified. Franchisees terminated 3,069 franchise agreements while an additional 1,152 were terminated by mutual consent. A total of 2,786 franchisees in 1978 asked permission from their franchisors to sell their franchises to others; all but 56 transfers were approved.192

In sum, while some franchisees may believe that widespread termination and nonrenewal problems exist, there is no evidence to support the claim that franchisor abuses of termination and nonrenewal powers are prevalent throughout franchising. Indeed, the available evidence shows that franchise terminations are exceedingly uncommon, which should not be surprising. Terminations are expensive and time-consuming and almost inevitably result in costly litigation. Few franchisors are able to afford indulgence in arbitrary or capricious termination or non-renewal.193 Moreover, any arbitrary, capricious, or illegal terminations or nonrenewals which might occur may be redressed by existing remedies. Legislation has been passed to correct abuses in industries where abuses have been shown to be widespread.194 As discussed above, the antitrust laws provide strong incentives to encourage litigation of antitrust violations.195

192 Id. at 11. The Commerce Department did not give the number of franchise agreements existing in 1978. It is assumed that for each franchised establishment there is a separate franchise agreement. To the extent that franchise agreements govern more than one establishment, the termination rate would be correspondingly higher.

193 As stated in a 1971 Conference Board report on franchising, the evidence does suggest that most franchisors could not afford to unreasonably terminate very many of their franchise contracts. When a termination does occur, it usually comes as the culmination of a series of attempts by the franchisor to get the franchisee to operate in conformance with a contract stipulation. Mikva Bill Hearings, supra note 5, at 261 (testimony of Edward Kushell) (quoting Franchise Distribution, Conf. Bd. Rep. No. 523 (1971)). See also id. at 431-32 (statement of John Hatch). As stated by Congressman Krueger: "Whim and caprice are seldom profitable, and I suspect [franchisors] are more interested in profit than whimsy." Mikva Bill Hearings, supra note 5, at 497.

194 See note 22 supra.

195 See notes 169-173 and accompanying text supra. Accordingly, terminations and nonrenewals that are shown to have resulted from franchisee resistance to illegal franchisor activities such as price fixing, see, e.g., Simpson v. Union Oil Co., 377 U.S. 13 (1964), unreasonable territorial or customer restrictions, see, e.g., Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977), tying arrangements, see, e.g., Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972), unreasonable restrictive covenants, see, e.g., American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3d Cir. 1975), monopolization or attempts to monopolize, see., e.g. Photovest Corp. v. Fotomat Corp,
Additionally, the common law of contracts protects franchisees against termination or refusals to renew in retaliation for noncompliance with illegally imposed obligations. Some courts have gone so far as to restrict the franchisor's right to terminate by using other common-law principles or the Uniform Commercial Code. Thus, for example, in *Arnott v. American Oil Co.*, the eighth circuit held that a "fiduciary relationship" existed between an oil company (which the court held to be a franchisor) and its lessee service station dealer (which it held to be a franchisee), and that the oil company breached its duty of good faith and fair dealing in terminating its lease agreement with the dealer without good cause. In *Shell Oil Co. v. Marinello*, the Supreme Court of New Jersey held that public policy prohibited a petroleum company franchisor from terminating its service station franchisee except for good cause, which the court defined as failure by the franchisee substantially to comply with its obligations under the franchise agreement. Similarly, in *Ashland Oil, Inc. v. Donahue*, the West Virginia Supreme Court of Appeals held that section 2-302 of the Uniform Commercial Code prohibited as "unconscionable" on its face a contract provision that granted a franchisor the unilateral right to terminate upon 10 days' notice following a determination by the franchisor that the franchisee has impaired the quality or reputation of the franchise product. While many of the difficulties discussed later in this paper about the ability of the courts successfully to interfere with commercial contractual relationships may arise by resort to common-law or UCC principles, at least the courts would do so presumably only after a thorough analysis of the particular fact situation presented.

[1977] 1 TRADE CASES (CCH) ¶ 61,529 (S.D. Ind. 1977), aff'd in part and rev'd in part, 606 F.2d 704 (7th Cir. 1979), can be redressed under the antitrust laws, which permit the recovery of treble damages and attorney fees.

See Mikva Bill Hearings, supra note 5, at 284-85 (testimony of Philip F. Zeidman).

609 F.2d 873 (8th Cir. 1979). Judge Bright strongly dissented from the holding that the relationship between the parties was one between franchisor and franchisee rather than between commercial lessor and lessee, and from the court's dictum that "[i]nherent in a franchise relationship is a fiduciary duty." Id. at 890 (Bright, J., dissenting).


63 N.J. at 410-11, 307 A.2d at 603.


Id. at 440.
D. Conclusions

A disparity of bargaining power between franchisor and franchisee, while not always as great as claimed by proponents of legislation regulating the franchise relationship, nonetheless may exist in some cases. The disparity may result from the franchisor's greater experience and its controls over the franchisee's operations. But these controls are necessary to ensure the maintenance of uniform standards of quality throughout the franchise system, to protect the franchisor's trademark, and to enable the franchisor effectively to assist the franchisee in opening and operating the franchised unit. These, of course, are the very benefits franchisees seek and pay for when purchasing a franchise. Full and fair disclosure would permit prospective franchisees to understand and accept or reject the necessity of franchisor controls and would result in fewer unrealistic franchisee expectations.

VI. THE OVERREACTION TO THE OVERPROMOTION OF FRANCHISING

Despite the lack of evidence supporting claims of widespread franchisor abuses other than those associated with the overpromotion of franchising, fifteen states have passed legislation regulating the franchise relationship. The statutes generally prohibit a franchisor from requiring "unreasonable" standards of franchise performance and require the franchisor to demonstrate "good cause" for termination or nonrenewal. At the national level, the "Franchise Reform Act," introduced by former Congressman Mikva, would seek to substitute government regulation of termi-

202 See notes 3-4 supra. In 1978, the California Department of Corporations, the agency that administers the California Franchise Investment Law, promoted legislation instituting a new form of regulation to tie in with its disclosure law. This new form of regulation is derived from state "blue sky" laws and employs what is commonly referred to as the "fair, just and equitable" standard. This legislation would extend significantly the reach of the state's regulatory arm into the substantive provisions of the franchise agreement. The legislation failed to emerge from committee. See FRANCHISING-1979, supra note 6, at 21-24.

203 Mikva Bill, supra note 2.
nation and nonrenewal for private agreement between franchisor and franchisee.

The Mikva Bill would prohibit the franchisor from terminating the franchise agreement unless the franchisor has "good cause" for terminating or effects a "marketing area withdrawal." To demonstrate good cause, a franchisor would be required to prove that the termination was based upon the "continued" failure by the franchisee, without "reasonable" excuse or justification, to comply "substantially" with an "essential" and "reasonable" franchisor requirement imposed "under the terms of the franchise." Good cause could also be shown if the franchisor proves that the termination was based upon the franchisee's continued "bad faith" conduct or "unjustified" and "unreasonable" failure to carry out the terms of the franchise agreement.

At the expiration of the franchise agreement, the franchisor would be required to enter into a new agreement with the franchisee, unless the franchisor is able to prove one of several items: that it was effecting a "marketing area withdrawal," that it had permitted the sale of the franchise to a franchisor-approved third party, or that it had paid the franchisee "reasonable" compensation for the loss of value, including goodwill, of the franchisee's business attributable to the franchisor's failure to renew. In the event no agreement is reached, "reasonable" compensation is to be determined by binding arbitration. Finally, before terminating the agreement or refusing to renew, the franchisor must provide the franchisee with at least a 90-day notice of its intention, unless shorter notice is required to protect against an imminent danger to public health or safety, or in the cases of franchisee bankruptcy, insolvency, or voluntary abandonment.

Legislation regulating franchising has not fared well in Congress; to date, the Mikva Bill has not even been reported out of committee. The failure of broad franchising legislation to become

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263 Id. § 5(2).
264 Id. § 5(1).
265 Id. § 3(3)(A).
266 Id. § 3(3)(B).
267 Id. § 6(a).
268 Id. § 6(a)(1).
269 Id. § 6(a)(2)(A).
270 Id. § 6(a)(2)(B).
271 Id. § 6(b).
272 Id. § 4(b).
law at the national level is largely attributable to its proponents' inability to demonstrate that the legislation is necessary or wise.

The real impetus for legislation regulating the franchise relationship is apparent. When some franchisees mature and become successful, they tend to attribute their success not to the franchisor's efforts but almost solely to their own. At this point, they may begin to tinker with the franchise operation, believing they can do it better their way. Moreover, as time passes, the original value of the franchise and the franchisor's services may become less appreciated, especially when the franchisor has provided only initial expertise and the trademark. Some franchisees may therefore begrudge the franchisor's continuing controls and financial return. This attitude, of course, often results in violations of the franchise agreement and consequent termination or non-renewal.

It is not surprising, therefore, that some franchisees have attempted to insulate themselves from the consequences of their deviations from the agreed upon terms of the franchise agreement by seeking legislation regulating the franchise relationship. While perhaps understandable, these efforts should be recognized for what they are: attempts to foster personal economic interests.

VII. THE CONSEQUENCES OF OVERKILL

The consequences of overkill in the form of overly restrictive governmental regulation of franchising could well be quite serious: it could set the franchisor against the franchisee, thus undermining the mutuality of effort necessary to the franchise operation; cause a further overburdening of the legal system; and interfere with the successful allocation of goods and services in the American economy through the means of the private commercial contract.

A. The Undermining of the Franchise Relationship

Successful franchising depends upon continued cooperation between franchisor and franchisees to maintain uniform standards of quality throughout the franchise system. While deceptively simple and superficially appealing, legislation prohibiting "unreasona-
ble” standards of performance and permitting termination of the franchise agreement only for “good cause” introduces undesirable elements of uncertainty and subjectivity into the franchise relationship. For example, a court interpreting the terms “unreasonable” and “good cause” could adopt general community standards instead of the franchisor’s higher standards of quality deemed essential to customer satisfaction.219 As discussed earlier, when customer expectations regarding uniform quality go unfulfilled, the value of the trademark is eroded and consequently the entire franchise system will suffer.220

Moreover, vague terms such as “unreasonable” and “good cause” invite litigation to determine their content, for the franchisee will be left with no univocal standards upon which to rely. To the extent that franchisees believe termination to be overly difficult regardless of performance, they would have less of an incentive to be conscientious. The net effect of legislation regulating the franchise relationship will be to substitute an adversary relationship for one of mutual cooperation, thus undermining franchising as a successful method of doing business.221

The “good cause” requirement is perhaps even more objectionable when applied to nonrenewal. It is clearly anticompetitive to force a franchisor to renew an undesirable franchisee at the end of the franchise term.222 Ultimately, consumers would have to pay the price for poor franchisee performance. Moreover, the proposed legislation might have significant inflationary effects, in that it would protect subpar franchisees from the competition that brings lower prices.223

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219 See Regulation of Franchising, supra note 11, at 1046-47; Mikva Bill Hearings, supra note 5, at 172-74 (statement of Norman D. Axelrad).
220 See note 167 and accompanying text supra.
221 As stated by then Deputy Assistant Attorney General Joe Sims on behalf of the Antitrust Division of the Department of Justice:

[W]e have some doubts as to the likely effectiveness of the [Mikva] bill in redressing problems of unequal bargaining power between franchisors and franchisees. These problems are exacerbated by the vague standards employed by the legislation which would encourage litigation whenever a franchise is terminated or not renewed.

... [T]he bill would undoubtedly foster extensive litigation and undermine the certainty necessary for informed bargaining between franchisors and franchisees.

Mikva Bill Hearings, supra note 5, at 47. See also id. at 215 (statement of Donald J. Loss); id. at 532-33 (statement of James D. McKevitt).
222 Id. at 47-49 (statement of Joe Sims); id. at 301-08 (statement of Philip F. Zeidman).
223 Id. at 104-05, 300 (statement of Philip F. Zeidman); id. at 593 (statement of E. Bruce Butler).
Legislation making the franchise relationship virtually perpetual inevitably would encourage some franchisors to repurchase franchised outlets, look more favorably at other forms of doing business including vertical integration, or limit franchisees to large, well-established businessmen. The legislation would also deter small prospective franchisors from using the franchise method of doing business. The Supreme Court has recognized this effect:

To the extent that [a legal restriction] prevents a firm from using the franchise system to achieve efficiencies that it perceives as important to its successful operation, [it] creates an incentive for vertical integration into the distribution system, thereby eliminating to that extent the role of independent businessmen.

In sum, the overregulation of franchising might well unduly burden existing franchisors and deter prospective franchisors, thereby reducing and perhaps destroying the real benefits of franchising to society, the franchisor, and the franchisee. Former Securities and Exchange Commissioner Roberta S. Karmel’s comments are particularly apt:

Much regulatory legislation was intended to provide the public, and especially consumers, with protection against perceived ills. In many instances we must reassess not only the efficiency of that protection, but also whether the economic, legal and social burdens of maintaining the legislative insurance are worth such protection. All regulation is costly, not only because it is paid for by taxation, but also because it interferes with market forces, increases the size and complexity of government, and favors one group of people in our society over another. In many instances the favored group needs special consideration or protection. But often, the claims of the protected are no better than the claims of the regulated.

B. The Overburdening of the Legal System

As discussed above, vague, overbroad legislation regulating the

211 See, e.g., Hunt-1973, supra note 49, at 26; Kamenshine, supra note 98, at 219-20; Axelrad, supra note 11, at 718; Mikva Bill Hearings, supra note 5, at 222 (statement of Donald J. Loss).
212 See Mikva Bill Hearings, supra note 5, at 56 (statement of Joe Sims); id. at 197-98 (letter from Norman D. Axelrad); Hunt supra note 45, at 82.
franchise relationship would inevitably engender a large volume of litigation, thus further burdening an already overburdened judicial system. Courts would become enmeshed in reviewing routine business decisions. Under the terms of proposed legislation, franchisees would have everything to gain and very little to lose through litigation. This is unfortunate, for legal rights should bear at least some relationship to legal resources. Most unfortunate of all, though, is that franchisees and, ultimately, consumers will be burdened with the costs of litigation generated by legislation regulating the franchise relationship.

Legislation regulating the franchise relationship is most

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226 See Mikva Bill Hearings, supra note 5, at 49, 51 (statement of Joe Sims); id. at 333 (statement of Philip F. Zeidman).

227 The implications of the proposed legislation for our judicial system may be illustrated by a hypothetical case. Assume that a fast food franchisor, recognizing the dramatic increases in consumer demand for frozen yogurt, decides to expand its existing menus to meet this new demand under a franchise agreement that gives complete menu control to the franchisor. An individual franchisee who has been successful selling the old menu unilaterally decides that frozen yogurt would not be successful in his market and refuses to go along with the change. After repeated warnings from the franchisor and following extensive discussions, this franchisee is terminated for failing to institute the required menu change. Under the proposed legislation, the franchisor will be required to show that this franchisee was terminated for "good cause." Mikva Bill, supra note 2, § 5. "Good cause" is defined to mean:

a termination by a franchisor which is based upon (a) continued failure by the franchisee, without reasonable excuse or justification, to comply substantially with an essential and reasonable requirement imposed by the franchisor under the terms of the franchise; or (b) continued bad-faith conduct or unjustified and unreasonable failure to act by the franchisee with respect to the carrying out of the terms of such franchise.

Id. § 3(3).

Suppose the franchisee can show that the expected increase in profit from adding frozen yogurt would be minimal (but still important from the viewpoint of the franchisor), and claims that he did not want to incur the costs of instituting the menu change. Or suppose the franchisee subsequently can show that the franchisor was mistaken, that frozen yogurt turned out to be a fad and that the profits of both the franchisor and the other franchisees did not increase as a result of the change. Or suppose the franchisee can show that for some reason his customers did not want frozen yogurt, while admitting that the system's franchisees as a whole will realize increased profits as a result of the change. Or, finally, suppose the franchisee decided to discontinue frozen yogurt, and it was the franchisee who insisted upon selling the product.

On any of these assumptions has the franchisor established "good cause" within the meaning of the Mikva Bill? The Mikva Bill's partial definition of "good cause" as a franchisee's continued failure, without justification, to comply substantially with an essential and reasonable requirement imposed by the franchisor merely restates the problem in new words, leaving unanswered two questions: whether the complained-of requirement must be essential and reasonable to the interests of the franchisor, the franchisees in toto, or the individual, terminated franchisee; and whether an individual franchisee would be excused or justified in failing to comply with a provision of a franchise agreement merely because compliance would not benefit the franchisees in toto or him individually.
seriously defective when it contains no meaningful definition of "good cause" and is silent on the question of whose "good cause" must be established before a franchisor may terminate a franchise. In any event, it would appear to be beyond the ordinary institutional competence of a court to "balance" (if this is what the "good cause" standard requires) the long- and short-term interests of one franchisee (or group of franchisees) against the long- and short-term interests of the other franchisees and the franchisor, including the franchisor's shareholders. Put most generally, a court may not always know how to go about allocating the risk that the benefits of any necessarily uniform change in the franchised product or format will be unevenly distributed among the various interests. But the court would be obligated to try to do so, and the Bar would scramble to assist it, and ultimately—undoubtedly after considerable delay—the quasi-feudal "status" of "franchisee" might be determined, however at variance with the terms of the franchise contract.

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221 Recent experience under the California Automobile Franchise Act, cal. veh. code Ann. §§ 3000-3010 (West Supp. 1979), suggests that, if enacted, the Mikva Bill is likely to be used by franchisees principally as a means of delaying the termination of their franchise, allowing them, in the interim, to obtain the benefits of continued participation in the franchise system without having to conform to the uniform practices observed by the other franchisees. See text following notes 14 supra and 256 infra. The California Automobile Franchise Act affords existing automobile franchisees a right to a hearing to determine whether there is "good cause" to distribute like-make cars within an existing market area. The filing of a protest by an existing franchisee automatically enjoins the franchisor from establishing a new franchise. In a recent case upholding certain procedural provisions of the Act, New Motor Vehicle Bd. v. Orrin W. Fox Co., 439 U.S. 96 (1978), appellants asserted, apparently without challenge, that of the 117 protests filed by existing franchisees since the effective date of the Act (July 1, 1974), only 42 had gone on to a hearing on the merits, and of those only one had ultimately been sustained. Id. at 103. These facts led Justice Stevens, in dissent, to observe that the real effect, and perhaps purpose, of the statute was to give existing franchisees "the unqualified entitlement to an order that is tantamount to a preliminary injunction absolutely prohibiting the opening of the new dealership until after the relatively meaningless hearing has been completed." Id. at 121 (Stevens, J., dissenting).

C. The Impairment of Freedom to Contract

Freedom to contract is the concept by which the state has acknowledged its limited institutional competence to resolve all the affairs of everyday commercial life.\(^2\) Today, more than ever, there is widespread agreement that the government ought to refrain, as much as possible, from regulating the private affairs of merchants and others.\(^4\) Freedom to contract, which includes the right of private citizens to invoke the sanction of the law to enforce their private agreements,\(^2\) represents an important source of our economic strength and perhaps an essential safeguard of our political freedom.\(^6\) Of course, it is recognized that freedom to contract is not absolute and that legislative protection might be appropriate within a particular industry where conditions are such that one of the contracting parties has no freedom of choice in deciding whether to enter into the contract.

Freedom to contract has also been one means by which competing merchants have satisfied the constantly changing desires of independent consumers.\(^2\) Subject to the binding obligations of existing contracts and the antitrust laws, freedom to contract traditionally has protected the right of merchants and others to enter and leave the marketplace at will.\(^2\) As noted, franchising's success is dependent upon consumer identification of the franchisor's trademark with uniform goods or services, and this identification may be assured only by the franchisees' voluntary agreement to relinquish a certain amount of freedom of action to the franchisor in accepting the franchisor's controls.\(^2\) In view of the availability of a


\(^3\) See note 229 supra.

\(^4\) On the political implications of the freedom to contract, see F. Hayek, The Road to Serfdom 72-87 (1944).

\(^5\) For example, if the demand for natural fibers declines, clothing suppliers have been free not to renew their existing contracts with cotton growers and free to enter into new contracts with manufacturers of synthetic fibers.

\(^6\) See, e.g., Hurley v. Edgingfield, 156 Ind. 416, 59 N.E. 1058 (1901); Constitutional Obstacles, supra note 13, at 1499.

\(^7\) See text following note 14 supra.
great number of related marketing opportunities and given full disclosure, the willingness of an independent merchant to enter into a franchise agreement is a good indication that, at least initially, he understands that his acceptance of the franchisor's controls is the price of obtaining the benefits of uniformity.\textsuperscript{240}

With time, however, the franchisee may believe that he can increase the profitability of his own individual franchise by deviating from the franchisor's product line or by failing to adhere to the franchisor's marketing and operations plan. It may be true that the success of a franchise system might not be affected greatly by any individual franchisee's "immaterial" or "unsubstantial" deviations from the product line or the marketing and operations plan, just as the solidarity of a union might not be affected greatly by the refusal of any one union member to pay his dues. Unfortunately, the very reason that leads the first franchisee to attempt to increase his individual profits eventually tempts the remaining franchisees to deviate from the product line or the marketing and operations plan. The result in franchising, like the result in the field of labor relations, is the destruction of uniformity throughout the franchise system and therefore of the system's accumulated goodwill and of the centralized decisionmaking capacity that gives franchising significant advantages over other ways of doing business.\textsuperscript{241}

The proposed legislation would deny to the franchisor and to the other franchisees, the right to enforce the bargained-for uniformity of the franchised products or services and the right to terminate franchisees who refuse to abide by the terms of the same franchise agreement they expect to be enforced against others.\textsuperscript{242} In

\textsuperscript{240} The U.C.C. recognizes that a contract is not unconscionable merely because one party restricts his future action in the expectation of short-term gain. See generally U.C.C. § 2-302 (1978) (unconscionability). "The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract . . . . The principle is one of the prevention of oppression and unfair surprise . . . . and not of disturbance of allocation of risks because of superior bargaining power." Id., Official Comment 1 (emphasis added); see Sinkoff Beverage Co. v. Joseph Schlitz Brewing Co., 51 Misc. 2d 446, 273 N.Y.S.2d 364 (Sup. Ct. Suffolk County 1966).

\textsuperscript{241} At present, a franchisor may terminate a franchisee who fails to comply fully (and not merely substantially) with the terms of the franchise agreement. See Buyers & Traders Service, Inc. v. Car Maintenance Specialists, Inc., 290 S.2d 753, 757 (Ct. App. La. 1974); Cycleway, Inc. v. Kawasaki Motors Corp., 77 Misc. 2d 829, 832, 354 N.Y.S.2d 812, 816 (Sup. Ct. Oneida County 1974) ("the law of this state [is] that where the parties have agreed to a termination clause, it must be enforced as written"). But see Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973), cert. denied, 415 U.S. 920 (1974) (implied covenant in
doing so, the proposed legislation would, ironically, also deny the individual franchisee the freedom to contract for the uniformity throughout the franchise system upon which the long-term success of his own franchise depends.\textsuperscript{243}

The proposed legislation would have a far reaching effect upon the underlying principles of freedom to contract and upon the salutary effect this freedom has had upon our political system. Two essential principles may be said to underlie freedom to contract. First, freedom to contract necessarily implies freedom to restrict one's future actions and the right to restrict others' future actions.\textsuperscript{241} Presumably, franchisees, like other merchants, enter into contracts that limit their future actions with the expectation that this loss of freedom will more than be made up for by the right they have gained to restrict the future actions of the franchisor and the other franchisees.\textsuperscript{245}

Second, freedom to contract is based upon the fundamental assumption that the ongoing distribution of goods and services in the marketplace ordinarily involves a network of complex interests and claims that cannot be resolved adequately by either legislative command or judicial decision.\textsuperscript{246} Accordingly, the state has traditionally authorized merchants and others to resolve their differences privately,\textsuperscript{247} and courts have long refused to rewrite the terms of a contract in which the parties have themselves allocated the risk of changed circumstances.\textsuperscript{248}

To insist upon freedom to contract in the mercantile setting of a franchise system is not to ignore the existence of so-called contracts of adhesion.\textsuperscript{249} The uniformity imposed by the franchise agreement bars termination where there has been substantial compliance). The Mikva bill would substitute a regime of "substantial compliance," "reasonable excuse" and "justification" for the principle of full compliance. Mikva Bill, supra note 2, § 3(3)(A), (B). See note 229 supra.

\textsuperscript{243} See note 86 supra.

\textsuperscript{241} Hale, Bargaining, Duress and Economic Liberty, 43 Colum. L. Rev. 603 (1943). Hale provides an interesting and provocative discussion of the role of forbearance in contract law.

\textsuperscript{246} See text accompanying note 235 supra. See also Hewitt, supra note 85, at 233-34.


\textsuperscript{249} See 3 A. Corbin, Contracts § 541 (1960), and cases cited therein.

\textsuperscript{250} Typical of contracts of adhesion are insurance policies, which have long been recognized as departing from the principle of freedom to contract because insurers seek to obtain uniform agreements from a wide range of persons whose life-chances may differ greatly, and because the only alternative to one insurer's uniform terms is the uniform terms of another insurer. See Kessler, Contracts of Adhesion—Some Thoughts about Freedom of Contract, 43 Colum. L. Rev. 629, 631-35 (1943).
agreement differs in important ways from the uniformity imposed by the typical contract of adhesion. First, uniformity is the essence of franchising, not simply an administrative convenience. Second, in virtually every market there are actively competing alternatives to franchising. Most franchisees who do not want to bear the costs (and reap the related benefits) of uniformity are free to enter the market on their own.

Nor does insistence upon freedom to contract in a commercial setting argue against the now widely accepted restrictions upon the freedom of workers, tenants, and consumers to contract in a marketplace in which they are prevented by market forces from independent decisionmaking. That society now protects people from having the necessities of life exploited does not mean that freedom to contract has been rendered irrelevant. In contrast to the restrictions upon freedom to contract regarding necessities of life, freedom to contract among merchants has not been thought to require the law’s intrusive solicitude. So long as there was in fact an informed “meeting of the minds,” commercial agreements have been enforced according to their terms. The doctrines of adhesion, mistake, duress, unconscionability, waiver, estoppel and plain old-fashioned fraud have served to police the actual freedom of the parties to contract or not contract on agreed-upon terms.


253 See, e.g., U.C.C. § 2-201(2) (1978) (exception to statute of frauds applicable to agreements between merchants); id. § 2-205 (written offer by merchant to buy or sell goods not revocable, for up to 3 months, for lack of consideration); id. § 2-207 (special rules govern construction of additional terms in acceptance or confirmation between merchants); id. § 2-209 (except as between merchants, agreement excluding modification or rescission of contract must be separately signed by other party); id. § 2-719 (limitation of consequential damages for personal injury in the case of consumer goods is prima facie unconscionable, but limitation of damages where loss is commercial is not).

254 See, e.g., Campbell Soup Co. v. Wentz, 172 F.2d 80 (3d Cir. 1948) (refusal to enforce contract determined to be unconscionably one-sided); Goodman v. Dicker, 169 F.2d 684 (D.C. Cir. 1948) (damages awarded where one party had, in bad faith, induced other party to expend money in expectation of a contract with unconscionable price); Helene Curtis Indus., Inc. v. United States, 312 F.2d 774 (Ct. Cl. 1963) (damages awarded due to failure of
On this view of contracts, a merchant has the right to refuse to enter into a contract unless the other party enforceably agrees to perform his part of the bargain (not just most of the bargain or the part of the bargain that a future court finds "reasonable")\(^{235}\) and the right to bargain for termination of the agreement if the other party is in breach of the contract. Of course, both parties must be fully informed of the possibility of termination and must have had a fair opportunity to choose among competing contractors. But assuming that these conditions have been met, freedom to contract traditionally has protected the right of a merchant to refuse to enter into a contract and to enforce the contract he does enter into according to its terms.\(^{236}\)

Legislation regulating the franchise relationship would do away with both of these rights, introducing long-abandoned, quasi-feudal status relations into the commercial world. Freedom to contract, in which is subsumed freedom to terminate a contract if the other party refuses to abide by its agreed-upon terms, would be transformed into a status relation of indefinite duration. Commercial relations entered into in order to take advantage of temporary market conditions would ripen by prescription into a unilateral right to enjoy the benefits of a contract only so long as the contract remained profitable. This trend might be accelerated by our legal system's inability meaningfully to define "good cause" and the system's ability to create status relationships. While the constantly changing desires of independent consumers move in new directions, the franchisor and the franchisee, the manufacturer and the wholesaler, and more generally, the buyer and the seller, would be frozen in place, unable to terminate existing agreements except for some undefined "good cause," and unable to meet the new demands of consumers.

Recent years have seen the introduction of judicial and legislative measures to protect consumers from the disproportionate information and market power that some merchants may enjoy in cer-

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\(^{235}\) See note 238 supra. See also Jacobs & Youngs, Inc. v. Kent, 230 N.Y. 239, 241, 129 N.E. 889, 890 (1921) (per Cardozo, J.) ("The courts never say that one who makes a contract fills the measure of his duty by less than full performance.").

\(^{236}\) Id.; see Rubin, supra note 14, at 232.
taint situations. In attacking the central core of freedom to contract, however, legislation regulating the franchise relationship fatefully signals the introduction into our legal order the revolutionary and ominously paternalistic notion that even merchants do not know, and cannot be trusted to determine, what is in their own best economic interests.

VIII. The Balanced Approach

Full and fair disclosure, together with the enforcement of existing remedies and remedial legislation where necessary to correct specific, proven abuses in those industries in which they might occur, is sufficient to eliminate franchising's principal problems. A more fundamental solution to franchising's problems, however, is the development and preservation of a healthy franchise relationship evincing mutual respect and interdependence between franchisor and franchisee. In a healthy relationship, franchisor and franchisee alike strive to attain a common goal: the success of the franchise system and the resultant benefits to both.

There are many paths to a healthy franchise relationship. In many franchise systems, both franchisor and franchisee make a significant financial commitment bonding their mutuality of interest. As discussed earlier, franchise agreements in most industries are for 10 years or longer, allowing both franchisor and franchisee an ample opportunity to recoup their investments. But the single most important way to achieve a healthy franchise relationship is through continuous communication between franchisor and franchisee to ensure high franchisee motivation—the key to successful franchising. Achievement of a healthy franchise relationship eliminates the need to use the highly undesirable business practice of termination. If problems do arise during the franchise relationship, and in almost every human relationship problems do arise, they are most effectively resolved by the mutual efforts of a franchisor and a franchisee seeking a common goal.


As stated by one commentator:

[It is difficult to see why the courts would want to interfere at all in the franchise-franchisor relationship. Arguments which rely on the ignorance of the franchisee or the bargaining power of the franchisor are as valid here as in any other context (which is to say, not very valid).]

Rubin, supra note 14, at 232 (footnote omitted).
Legislation that would upset the delicate balance of the franchise relationship of course strikes at the very heart of franchising. When a problem arises, instead of seeking the cooperation of a highly motivated franchisee, the franchisor may be forced by this legislation to give a formal notice of default, lest legal rights be lost. At this point, a healthy relationship is destroyed and an adversary relationship substituted for it. The parties are thus forced to concentrate on preserving legal rights rather than resolving mutual problems.

If efforts at franchise motivation fail and termination is necessary, in ordinary circumstances the franchisor should not repurchase the franchise for company operation. Repurchasing at this point only invites franchisee claims that termination was effected in order to take over the franchise. Instead, the franchisor should attempt to arrange for the sale of the business to a mutually acceptable third party.

Although terminations are relatively infrequent, the power to terminate is essential to enable the franchisor to maintain uniform standards of quality throughout the franchise system and to protect its reputation and trademark. Moreover, a substandard franchisee harms not only its own reputation but also the reputations of all other franchisees within the system. A successful franchise system's customers expect to find uniformly high levels of quality in any franchised establishment they patronize. Franchisors need the ability to protect the system by terminating those who fail to meet these expectations.

Legislation which assumes, in direct contradiction of the facts, that all franchisors seek to exploit their business relationships with their franchisees is a discredit to the vast majority of franchisors who operate ethically and in the mutual interest of their franchisees and themselves. More important, this legislation threatens the ability of most franchisors to conduct their business with the flexibility necessary to deal promptly with the small percentage of misguided or unmotivated franchisees.

Given a sufficiently long duration of the franchise agreement to enable franchisees to recoup their investment, nonrenewal problems can largely be resolved through early notice. In cases where franchisees do not qualify for renewal because of failure to meet the franchisor's standards of performance, franchisors should notify them well in advance, the exact time depending upon the
nature of the business and the reasons for nonrenewal.259

Legislation that would force franchisors to renew a franchise would deprive a franchisor of the ability to choose the people who will operate within its system. More significant, however, it would encourage present and prospective users of the franchise method of doing business to look more favorably at other methods of doing business. Some prospective franchisors desirous of issuing long-term franchises will be most hesitant to enter franchising at all if the franchise, once issued, becomes perpetual.

Legislation regulating the franchise relationship should be limited to addressing specific, proven abuses within a particular industry. Legislation that would regulate the franchise relationship without taking into account such critical factors as the nature and practices of the industry to be regulated, the length of the franchise agreement, the capital investments of both franchisor and franchisee, and the extent of franchisor controls necessary to preserve uniform quality standards is legislative overkill.260

Despite its very real problems, franchising is a strong and growing way of doing business. The fundamental problem in franchising—overpromotion by some franchisors—reflects more on some of the promoters rather than on the franchising concept. When franchising failed to live up to the unreasonable standards set for it by the overpromoters, its problems became magnified through the microscope of franchisee disappointment. Disclosure rules and practices can be improved, and franchisees in certain industries may need additional legislative protection. But legislation regulating the franchise relationship in all industries is neither necessary nor wise. It would be most unfortunate if franchising as a way of doing business were crippled or destroyed and its benefits lost because of an overreaction to the overpromotion of franchising.

259 McDonald's policy with respect to renewal or "rewrites" of franchise agreements is set forth in Mikva Bill Hearings, supra note 5, at 194-96 (exhibit C to statement of Norman D. Axelrad). In instances where franchisees do not qualify for rewritten agreements, it is McDonald's policy to notify the franchisee 3 years in advance so that they can have ample time to locate a buyer for the business. In all situations where a franchisee is deemed not qualified for a rewrite, he or she will be given the opportunity to sell the franchise at fair market value to a new qualified buyer acceptable to McDonald's, and McDonald's will immediately agree to grant a new term franchise to this buyer. Under no circumstances will McDonald's operate any McDonald's restaurants that are not rewritten.

260 See Mikva Bill Hearings, supra note 5, at 54 (statement of Joe Sims).