THE PROPOSED "SMALL BUSINESS FRANCHISE ACT OF 1999":

THE END OF FRANCHISING AS WE KNOW IT?

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Federal Bar Association Annual Convention

Cleveland, Ohio

September 22, 2000

INTRODUCTION

For the last ten years, legislation to regulate franchising has come before just about every session of Congress. By and large, the proposals have not stirred much excitement either among legislators or the private interests who would be affected. But in November 1999, Rep. Howard Coble (R-NC) and Rep. John Conyers (D-MI) introduced H.R. 3308, the "Small Business Franchise Act of 1999." For a variety of reasons discussed below, H.R. 3308 has passions running high on all sides.

Whether or not H.R. 3308 ever becomes law, it is worthy of study and discussion. The bill serves as a useful list of the principal business and legal issues creating tension in franchise networks today. It also presents a fundamental issue of federalism: the proper roles of the federal and state governments in regulating a distinct type of commercial relationship that represents a major segment of the national economy.

To put H.R. 3308 in context, this paper begins with a brief history of franchise regulation. It then describes the main provisions of H.R. 3308, highlighting in particular the features that would break new ground in franchise regulation. The paper concludes with a section on the published views of the International Franchise Association and the American Franchisee Association concerning H.R. 3308 and the current prospects for the bill.

FRANCHISE REGULATION BEFORE H.R. 3308

Although academic debate continues as to just when franchising was born, there is no debate about when it "grew up" as a business model: the 1950s and 1960s. The explosion in franchising during that period seeded future fortunes, but also offered opportunities for abuse and deception of prospective investors.[1] In response to both the outright con artists and serious franchisors who used irresponsible sales practices, states began to adopt registration and disclosure regimes for franchise sales, starting with the California Franchise Investment Law, which took effect on January 1, 1971.[2] About 14 more states (depending on what one classifies as a "franchise registration" law) followed during the 1970s, but no new states have joined the list since New York in 1979.

The franchise registration laws are loosely modeled on the securities laws and often are administered by the same state authorities who oversee securities law compliance. Though in force in a relatively small number of states, the registration laws have had disproportionate effect, because they cover many of the country's major commercial centers (e.g., California, New York, Illinois, Michigan, Minnesota, Maryland, and Virginia).

After a seven-year rulemaking proceeding, the Federal Trade Commission made pre-sale disclosure a national requirement in the late 1970s by issuing its trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures."[3] The regulation, better known as the "FTC Rule" or "Franchise Rule," took effect in 1979. Unlike the state franchise investment laws (except Oregon), the FTC Rule is purely a disclosure law; no registration or other filing with the FTC is required. In the Statement of Basis and Purpose for the Rule, the FTC expressed its belief that courts should and would hold that individuals have a private right of action for violation of the Franchise Rule.[4] However, based on longstanding Federal Trade Commission Act precedent, courts did just the opposite, holding that no private right of action exists for violations of the Franchise Rule.[5]

During the 1970s, a number of states also enacted franchise relationship laws, which typically govern termination and nonrenewal of franchises. Congress passed similar legislation to regulate franchises in specific industries (the Petroleum Marketing Practices Act and the Automobile Dealers Day in Court Act), but not for franchise relationships generally. The relationship laws generally require notice and/or good cause for termination and nonrenewal, an opportunity to cure in most cases of termination, and sometimes repurchase of inventory upon nonrenewal. Relationship laws usually address other issues as well, but the specific issues covered and the way they are addressed varies greatly from state to state. Other issues covered include requirements to act in good faith, freedom of franchisees to form associations, limitations on discrimination among franchisees, rights of successorship and/or other transfers of ownership of the franchise, purchasing restrictions imposed on franchisees, and "encroachment" on franchisees' territories.

About 18 states ultimately passed franchise relationship statutes of general applicability (again, the exact number depends on the classification system used). The list of states overlaps substantially with, but is not identical to, the list of "registration" states. For example, Connecticut and New Jersey have franchise relationship laws but no franchise investment law.

The adoption of the California Franchise Relationship Act in 1980 marked the end of the legislative wave. Thereafter, specific industries remained popular targets for state legislatures, but no new generally-applicable franchise statutes came on line during the 1980s. In fact, model franchise statutes floated during that period attracted little interest from legislators.[6]

However, the 1980s were significant for two other reasons. First, during that decade, many of the franchise agreements written during the 1960s and 1970s began to expire or come up for renewal, and early franchise investors began to reach retirement age or consider sale of their businesses. Moreover, as their businesses grew, franchisees became more sophisticated, better organized to communicate concerns and to challenge franchisor's policies, and more willing (and better able) to hire good legal counsel.

Second, franchisees perceived trends in the courts as diminishing their legal rights. For example, during the 1980s the courts significantly toughened the standards for proving antitrust violations based on vertical restraints (i.e., restrictions imposed by franchisors and suppliers on franchisees and dealers). Before that period, antitrust claims had been a major legal weapon for franchisees.

The quiet came to an end for franchise companies when the 1990s arrived. The first jolt was the decision by the Small Business Committee of the U.S. House of Representatives to hold hearings on franchising in 1990. But the alarms truly went off when a seemingly unlikely state, Iowa, became the first state in more than a decade to enact a franchise relationship statute of general applicability. In fact, the Iowa statute was by far the most restrictive franchise legislation ever enacted; for example, it included encroachment provisions requiring franchisors to compensate franchisees adversely affected by new outlets. And one month after Iowa's governor approved the law, the chairman of the House Small Business Committee introduced bills to establish a federal franchise disclosure statute and a federal franchise relationship act.

To help stem the momentum of the federal bills and Iowa-style legislation in other states, the International Franchise Association, the oldest and largest association of companies that do business through franchising, took three major actions (in addition to direct lobbying). First, IFA adopted a new Code of Practices that its franchisor members would be expected to follow. Second, IFA developed a National Franchise Mediation Program, administered by an independent mediation agency, to help resolve franchisor-franchisee disputes. Third, and most significant, IFA opened its membership to franchisees for the first time.

IFA's efforts, together with the shift of control of the House of Representatives to the Republicans, nipped the legislative wave in the bud; no additional Iowa-style legislation made it into law. In fact, during the last several years, IFA and its members persuaded Iowa legislators to amend their statute twice to cut back the most offensive provisions. IFA also worked diligently to pass legislation to streamline the registration and disclosure process in Illinois, one of the most difficult states for franchise practitioners to work with.

While IFA fended off additional regulation during the 1990s, two national franchisee organizations gained strength: the American Franchisee Association (AFA) and the American Association of Franchisees and Dealers (AAFD). The head of the AFA was a delegate to the last White House Conference on Small Business and managed to get a number of pro-franchisee items included in the final conference recommendations. The AFA now holds its own annual legal conference and a "legislative day" on Capitol Hill. By contrast with the AFA, the AAFD in the 1990s touted a "marketplace" approach to enhancing franchisees' legal rights, through a certification program for franchisors. However, the AAFD now seems more inclined to support legislation, in light of the limited success of its certification program.

<u>THE PROPOSED NEW WORLD OF H.R. 3308</u>

H.R. 3308 caught the franchising community off guard. Franchisors had justifiably grown complacent about the prospect of federal legislation, because the bills regularly introduced in Congress had only a few Democratic co-sponsors, were assigned to a committee with little authority, and never showed any sign of momentum. By contrast, H.R. 3308 was introduced by a Republican, quickly attracted a long and bipartisan list of co-sponsors, and was assigned to the House Judiciary Committee.

The bill shocked franchise companies not just because of its realistic chances to move forward, but also because of its content. Supporters and opponents of the bill would agree on one thing: if signed into law, the "Small Business Franchise Act of 1999" would dramatically change the face of franchising in the U.S.

The description below covers the main features of H.R. 3308 (but not in the same order as they appear in the bill):

1. <u>Franchise sales</u>.

Section 3(a) of the bill prohibits fraud in the "advertising, offering, sale or promotion" of a franchise. This provision would be unremarkable, except that it also prohibits "making an untrue statement of a material fact" and "failure to state a material fact." The provision seems to create a strict liability standard for an untrue statement or material omission, which would greatly raise the bar above existing law.

Section 3(b) extends this stringent liability standard to franchise offering circulars required by any law (H.R. 3308 does not itself impose disclosure requirements, but refers to the FTC Rule and state laws). Section 3(b) makes it unlawful to make an untrue statement of material fact in an offering circular, to fail to state a material fact, or to make any representation that is "inconsistent" with the disclosure document.

2. <u>Discrimination among franchisees</u>.

Section 4(a) contains an anti-discrimination provision that is structured quite differently from counterparts in state relationship statutes. The provision outlaws requirements that are not imposed on other "similarly situated" franchisees. The section omits specific exceptions that state statutes provide (but the "similarly situated" language perhaps would produce the same net result). Other language in the section appears to limit the anti-discrimination ban to situations of retaliation against a franchisee for involvement in a franchisee association, but the intended scope may be broader.

3. Termination.

Section 4(b) establishes a good cause restriction on termination that closely resembles state relationship laws. There is one critical difference, however. State statutes usually define "good cause" in a non-exhaustive manner, leaving room to argue that good cause for termination exists even in circumstances where the facts do not match any of the examples of good cause in the statute. By contrast, Section 4(b) of H.R. 3308 specifies that good cause exists "only where" the specified events occur. The section borrows from the Petroleum Marketing Practices Act to address an oft-litigated issue under state laws: whether the franchisor's internal economic considerations can constitute good cause. It permits the franchisor to terminate if the franchisor withdraws from the franchisee's "marketing area," but only if the franchisor compensates the franchisee for damages and waives any restriction on the franchisee continuing in business at the same location. Otherwise, "good cause" for termination under H.R. 3308 is limited to material contract breaches and other misconduct by the franchisee.

4. Non-competes.

Section 4(c) provides that a franchisor may not prohibit a franchisee from engaging in business at any location after *expiration* of a franchise agreement. The section seems to distinguish expiration from early termination of the franchise agreement; enforcement of a noncompete would still be allowed in the latter case.

5. Sourcing of Goods and Services.

H.R. 3308 would establish a statutory right for a franchisee to obtain equipment, supplies, etc. "from sources of the franchisee's choosing." The franchisor could require that franchisees purchase from the franchisor or its affiliate only if the equipment, fixtures, supplies, goods, or services are "central to the franchised business" and incorporate a trade secret or other intellectual property of the franchisor. Otherwise, the franchisor may only require that items meet "reasonable established uniform system-wide quality standards."

Section 10(b) recognizes that franchisors may establish "approved vendor" lists. If the franchisor does so, Section 10(b) mandates that the franchisor approve at least two vendors for each item "unless otherwise agreed to by both the franchisor and a majority of the franchisees." Putting aside the implementation questions that obviously arise from this provision, the section is notable for injecting an element of collective bargaining into the proposed law. The AAFD, in particular, has pushed for collective bargaining of franchise agreements for years.

Section 10(c) tracks certain state laws in requiring disclosure of rebates and other benefits received from vendors based on franchisee purchases, as well as requiring distribution of the rebates or benefits directly to franchisees. Under the FTC Rule and state law, disclosure of this information to *prospective* franchisees is already required, but Section 10(c) would establish for the first time a national disclosure requirement to existing franchisees. (Though the section does not specify to whom the franchisor is to "fully disclose," presumably existing franchisees are the intended recipients.)

Similarly, Section 10(d) requires franchisors to "report" their annual revenue from sales of goods and services to franchisees. The FTC Rule and state law require disclosure of this information to prospective franchisees, but there is no obligation to disclose such information to existing franchisees. Section 10(d) does not specify how or to whom the franchisor is to "report"; again, existing franchisees are presumably the intended recipients.

Section 10(d) goes beyond existing law in requiring the franchisor to report, not just the revenue that the franchisor earns from sales to franchisees, but the *profit*. It is not clear whether this competitively sensitive information, once reported, will be deemed to be in the public domain; if so franchisors will find the requirement highly unpalatable.

6. Territorial Encroachment.

H.R. 3308 borrows from the 1992 Iowa law to establish an anti-encroachment provision. Section 11(a) prohibits a franchisor from placing a new outlet "in unreasonable proximity to" an existing outlet if the intent or probable effect is to cause gross sales of the existing outlet to fall more than 5% within 12 months. In the event of an alleged violation of the encroachment provision, the franchisor has the burden of proving that the sales decline was not due to the new outlet. "Outlet" is defined in Section 14 as "a point of sale, temporary or permanent, fixed or mobile, from which goods or services are offered for sale." This definition, while broad, seems to require a physical presence in proximity to the franchisee's outlet. It does not seem to reach Internet, catalog, or other channels for sales from remote locations – although Internet marketing is an intensifying issue in franchise networks.

Section 11(b) provides a way out of the encroachment provision, but few franchisors will be tempted to utilize it. The exception makes Section 11(a) inapplicable if the franchisor commits in advance to pay the existing franchisee 50% of the gross sales (!) of the new outlet for the first 24 months should the existing franchisee's sales decline 5%.

7. Duty of Good Faith.

In most states, the courts have held that franchise agreements, like contracts in general, are subject to an implied covenant of good faith and fair dealing. A few states have codified the duty of good faith in their franchise statutes. H.R. 3308 does the same in Section 5(a). Unlike state statutes, however, Section 5(a) goes on to define "good faith" in terms of two standards – one drawn from the common law and one from the Uniform Commercial Code.

The contours of the implied covenant of good faith and fair dealing vary considerably from state to state. The drafters of H.R. 3308, by incorporating a particular common law standard used in some states, seem to be dictating to the rest of the states what their standard should be. Although H.R. 3308 does not purport to preempt state law, it would provide a national standard that would be enforceable by franchisees in all states. This proposed federalization of an area traditionally governed by state law raises an important policy issue.

Furthermore, Section 5(a) provides that a franchise agreement may not be interpreted or enforced "in such a way as to obfuscate" a party's duty to act reasonably and in good faith, "or otherwise allow a disparate result in the franchise relationship." These concepts have no analog in state statutes, and their meaning is totally open to guesswork. Perhaps the best that can be said of them is that the obligation applies to both franchisor and franchisee.

8. Duty of Due Care.

H.R. 3308 recycles a highly controversial concept from past franchise bills, the duty of due care. Section 5(b) states that a franchise agreement imposes on the franchisor a duty of due care. The franchisor is "required to exercise the skill and knowledge normally possessed by franchisors in good standing in the same or similar types of business," unless the franchisor conspicuously disclaims that it has skill or knowledge (or, conversely, represents that it has a higher level of skill and knowledge, to which it will then be held). Apparently, if the franchisor were deemed not to have the skill and knowledge "normally possessed" in its line of business, the franchisor would be in violation of the statute, with all of the potential consequences discussed below.

Section 5(b) would clearly generate interpretation problems (*e.g.*, what does it mean to say that a franchisor is "in good standing," and who makes that determination?). "Skill and knowledge" is defined in such a way that a company starting a new franchise system – regardless of its experience in the business involved – seemingly could never meet the requirement, and would therefore have to disclaim skill or knowledge. The section prohibits a contractual waiver of the requirement to either possess or disclaim skill and knowledge, but, somewhat paradoxically, also permits a franchisor to limit in writing the "nature and scope" of its skill and knowledge.

9. Fiduciary Duty.

Franchisee plaintiffs have made numerous efforts over the years to hold franchisors to a fiduciary standard. With few exceptions, courts have rejected this theory, holding instead that the franchisor's duties are defined by the franchise contract. In the infamous *Meineke* case, the plaintiff franchisees had won a $390 million judgment in a class action suit based on the franchisor's alleged misappropriation of monies from the franchise system advertising fund, in part based on the theory that a fiduciary relationship existed with respect to administration of the fund. The 4th Circuit reversed the judgment, holding among other things that the franchisees were independent and sophisticated businessmen and women who dealt with Meineke at arm's length.[7]

Section 5(c) of H.R. 3308 may be viewed as a direct response to the *Meineke* decision. Section 5(c) imposes on franchisors a fiduciary duty with respect to any bookkeeping, collection, payroll, or accounting services performed on behalf of the franchisee, as well as with respect to the administration of any marketing fund to which franchisees contribute. It also requires the franchisor to disclose the source and amount of any discount or rebate from persons with whom the marketing fund transacts business, and to deliver such compensation to the fund. The section specifies that the statutory fiduciary duty would not extend to other aspects of a franchise, but it also expressly leaves courts free to find a fiduciary duty in other circumstances.

10. Ownership Transfers.

Like some state laws, H.R. 3308 would restrict the franchisor's discretion to refuse consent to the transfer of an interest in a franchised business – but it would go further than any prior statute. First, subject to certain conditions, Section 8(h) immunizes five types of transfers from any requirement of franchisor consent, regardless of what the contract might provide: succession upon death or disability, incorporation, transfers within an existing ownership group, transfer of less than a controlling interest to a spouse or child, and grant of a security interest in the franchised business. Section 8(h) also provides that a franchisor may not exercise a right of first refusal in these circumstances.

Section 8(d) sets out lists of "permissible" and "impermissible" conditions that a franchisor may impose when the transfer is subject to its consent. Neither list appears to be exhaustive. Section 8(e) overrides a common contractual provision by which franchisors sometimes require the buyer of a franchisee's business to execute the franchisor's then-current form of agreement; the section specifies that the franchisee may assign its existing contract for the remaining term.

Section 8(f) addresses public offerings of securities, a point of contention in mature franchise systems. This section provides that the franchisor may not withhold consent if the ownership group will retain 25% or greater voting power in the franchisee entity.

Section 8(i) prohibits enforcement of a noncompete against a franchisee after he or she transfers his or her "complete interest" in the franchise. Accordingly, the buyer is left to protect itself via the purchase agreement from competition by the former franchisee, and the franchise system is left entirely dependent for protection on what the buyer negotiates and chooses to enforce.

11. Transfer by the Franchisor.

Only a very small number of states currently purport to restrict transfers of interest by the franchisor. H.R. 3308 again breaks new ground in Section 9, requiring the franchisor not only to provide notice to "every franchisee" 30 days in advance, but to include a "complete description of the business and financial terms." Surely the knowledge that the franchisor will have to publish the terms of the deal to its franchisees will affect negotiations between the franchisor and its transaction partner. Section 9 applies to a transfer "by sale or otherwise," leaving unclear whether it reaches to such events as a change of control of the franchisor or a pledge of the royalty stream as security for financing.

12. "Procedural Fairness".

Like most state relationship laws, H.R. 3308 contains a clause prohibiting the franchisor from requiring a franchisee to waive any benefits of the statute or any liability of the franchisor thereunder. But here again, H.R. 3308 would go state law one or two steps better. For instance, Section 6(a) prohibits waiver of liability that a person would incur under the proposed statute "by reason of reckless disregard of obligations and duties under the franchise agreement." The same section prohibits so-called "gag" clauses (i.e., a prohibition on statements about the franchise system or the franchisee's experience) in any agreement relating to the operation of the franchise or the departure of the franchisee from the network.

Section 6(c) takes the extraordinary step of federalizing state venue and choice of law issues. For years, the courts have divided over whether state relationship laws trump contractual forum selection clauses and choice of law clauses. Section 6(c), however, declares that a franchise agreement may not deprive the franchisee of the benefits of the law of the state in which the franchisee's principal business is located. Similarly, it declares that the franchise agreement may not deprive the franchisee of the right to sue or commence arbitration in the franchisee's home state. Section 6(c) also prohibits waiver of the right to participate in a federal or state class action – a provision that has been creeping into franchise agreements with increasing regularity in recent years.

Section 6(d) takes another bold step into a traditional province of state law, decreeing that contractual integration clauses and the parol evidence rule may not be applied to exclude evidence of statutory violations – whether they be violations of the federal statute or of state franchise law.

13. Private Right of Action.

Section 12 of H.R. 3308 embodies one of the Holy Grails of franchisees: a federal private right of action for violation of the FTC Franchise Rule. But Section 12 does not stop there – it provides a federal private right of action for any violation or threatened violation of a *state* disclosure law or of any of the provisions of H.R. 3308. The remedies available include rescission and restitution, damages, injunctive relief, costs of litigation, and reasonable attorneys' fees and expert witness fees.

Section 12(d) sets the statute of limitations as five years from the date of the violation or three years from the date of its discovery. The section doesn't specify whether it is the "longer of" or the "shorter of" these provisions that governs, but in either case the limitations period is generally longer than current laws provide. Section 12(c) preserves arbitration clauses, but with the proviso that the "standards and protections" applied in binding arbitration must not be less than the requirements of H.R. 3308. The standards for officer/director liability in private litigation are consistent with existing law.

14. *Parens Patriae* suits.

Finally, Section 7 of H.R. 3308 empowers state attorneys general to sue as *parens patriae* in a civil action if they have reason to believe that residents of their state are threatened or adversely affected by a "pattern or practice which violates any provision of this Act." Section 7(b) specifies that attorneys general may exercise all of the investigative powers conferred on them by state law as a prelude to a *parens patriae* suit.

CURRENT PROSPECTS FOR H.R. 3308

As might be expected, IFA has gone all out to oppose passage of H.R. 3308. Introduction of the bill may have been a surprise, but the response was swift. IFA beefed up its lobbying staff and developed a Grassroots Action Kit to mobilize its members. The U.S. Chamber of Commerce and the National Association of Manufacturers have also been active in opposing the bill.

IFA presents itself to policymakers as the sole organization that speaks for all major interests in franchising, pointing to its franchisor and franchisee members as well as a third membership category for organizations (including law firms) that provide goods and services to franchisors and franchisees. IFA believes that government intrusion along the lines of H.R. 3308 could decimate the economic incentive to franchise, because companies facing such pervasive regulation will choose to expand through other methods.

IFA's main arguments against H.R. 3308 are that it would open the floodgates of litigation and substitute the judgment of the government for that of sophisticated businesspersons (and do so in a one-size-fits-all manner). But IFA also has articulated ways in which it views H.R. 3308 as harmful to franchisee interests. For example, IFA points out that other franchisees in the network have an interest in the franchisor's flexibility to terminate substandard operators and to enforce noncompetes against former franchisees. IFA also warns that the encroachment provisions are likely to result in the denial of expansion opportunities to existing franchisees, or worse, the surrender of prime locations to competing brands. Franchisee members of IFA have taken an active role in lobbying on these points.

The American Franchisee Association, of course, has a different view. AFA has argued that H.R. 3308 would not inhibit franchising any more than speed limits inhibit driving. In fact, AFA argues that the bill would stimulate growth of franchising by raising the credibility of franchisors as a group. AFA's president has written that "there is nothing in H.R. 3308 that doesn't already exist somewhere in state statute" and that "by setting readily defined standards of conduct, litigation . . . actually will decrease."[8]

All interested parties seem to agree that H.R. 3308 will not move forward in 2000, given the election year and other items on Congress' agenda. However, the bill may still have "legs," as lobbyists like to say. While IFA persuaded some of the original co-sponsors to drop off the bill, others joined to replace them. Moreover, if the Democrats regain control of the House of Representatives, the new chairman of the Judiciary Committee is likely to be Rep. John Conyers, the principal co-sponsor with Rep. Howard Coble. For these reasons, H.R. 3308 remains a serious threat to franchise companies.

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[1] For more information about this period, see the Statement of Basis and Purpose Relating to Disclosures Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,621 (December 21, 1978) ("SBP").

[2] Calif. Corp. Code § 31000 *et seq*.

[3] 16 C.F.R. Part 436.

[4] SBP, 43 Fed. Reg. at 59,723.

[5] *E.g.*, Banek Inc. v. Yogurt Ventures USA, Inc., [1992-1993 New Developments] Bus. Franchise Guide (CCH) ¶10,112, aff'd, 6 F.3d 357 (6th Cir. 1993).

[6] The model statutes were the Uniform Franchise and Business Opportunities Act, issued by the National Conference of Commissioners on Uniform State Laws in 1987, and the Model Franchise Investment Act, issued by the North American Securities Administrators Association in 1989.

[7] Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998).

[8] Susan P. Kezios, "Small Business Franchise Act Eyes Protecting Franchisees, Not Hindering Competition," Nation's Restaurant News, August 14, 2000, at 32.