



FRANCHISING AND FRANCHISE LAW

An Introduction

By Howard Yale Lederman

Fast Facts

- Franchising involves an agreement. The franchisor licenses a franchisee the right to use the franchisor's business model and intellectual property in running a business in exchange for the franchisee's franchise fee, royalty, and other payments.
- Modern franchising laws and regulations, like the Michigan Franchise Investment Law and the Federal Trade Commission Rule, have replaced the old laissez-faire regime with a pre-contract disclosure regime.

Franchising is a Growing and Important Part of Our Economy

Franchising is a national and international strategy for growing a business. Franchising involves an agreement. The franchisor licenses to the franchisee, for a defined period, the right to use the franchisor's business model and intellectual property—such as signs and logos, trademarks and service marks, business plans, and operations manuals—necessary to operate the business. The franchisor also provides marketing and sales assistance, training, and other support to promote and grow the brand. In return, the franchisee pays an initial franchise fee, makes regular royalty payments, and sometimes pays other amounts to the franchisor. Although the word franchise originated from the French word for freedom from feudalism,¹ franchising has become synonymous with tight franchisor control and rigid uniformity.² Typically, franchisor control is almost 100 percent. For example, a McDonald's franchise agreement reads:

“The McDonald's System is a comprehensive restaurant system for the retailing of a limited menu of uniform and quality food

products, emphasizing prompt and courteous service in a clean, wholesome atmosphere....The foundation of the McDonald's System and the essence of this License is adherence by Licensee to standards and policies of Licensor providing for the uniform operation of all McDonald's restaurants...including, but not limited to, serving only designated food and beverage products; the use of only prescribed equipment and building layout and designs; strict adherence to designated food and beverage specifications and to Licensor's prescribed standards of Quality, Service, and Cleanliness...."³

Nevertheless, since franchisors often offer proven successful business models, numerous entrepreneurs choose franchising over more independent alternatives.

Why has franchising prevailed over other products and services distribution systems? "Through franchising, a franchisor is able to maintain a large number of consumer outlets to distribute his products without having to invest his own money in the retail end of the operation. This is perhaps the prime advantage of franchising as an alternative to company-owned sales outlets. A vast distribution system can be quickly accomplished with a relatively [low investment] in sales outlets."⁴

Since 1945, franchising has emerged as a growing part of our economy. According to International Franchising Association (IFA) estimates, despite the severe recession, the number of franchising establishments and direct franchise-based employees has remained substantial and franchising's gross domestic product contribution has remained considerable, as shown in the following table:

Year	No. of Franchising Establishments	No. of Direct Franchise-Based Employees	Franchising's Gross Domestic Product Contribution
2007	770,835	7,994,000	\$403 billion
2008	774,016	8,028,000	\$410 billion
2009	746,646	7,800,000	\$405 billion
2010	740,335	7,786,000	\$418 billion
2011	735,571	7,934,000	\$439 billion
2012	749,499 (estimated)	8,102,000 (estimated)	\$460 billion (estimated) ⁵

Franchising "exists in more than 160 countries and is used in more than 70 different business sectors. U.S. franchisors are expanding internationally," and this growth is "ever-increasing."⁶

The Jungle Law Period

As Justice Holmes wrote, "[t]he life of the law...has been experience," including "[t]he felt necessities of the time," and "intuitions of public policy."⁷ Like federal and state securities laws, the Federal Trade Commission (FTC) Rule and state franchise laws emerged from experience with a nearly laissez-faire franchising regime. This regime featured almost complete freedom of contract with ineffective common-law remedies and little FTC involvement.⁸

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Franchising became a jungle, where jungle law ruled. Franchise fraud prevailed. "In the 1960s, franchising entered its 'Wild West' era...new franchisors rode into town almost daily, and many of them were operated by opportunists looking to make a quick buck."⁹ Franchisor representatives were often "renegade stock and insurance salesmen with shady records."¹⁰ They had strong incentives to sell as many franchises as possible to reap high earnings and franchise fees. They were selling to "suckers." Franchisors and the media had created "a general public belief that franchising is the wave of the future."¹¹ Franchisors used entertainment and sports celebrities to head and publicize franchise schemes and high-pressure sales tactics to pressure franchisees to sign franchise agreements.¹² Many people bought franchises, went broke, and lost their life savings.¹³

After investigating franchise sales practices, the New York attorney general concluded that "in almost every instance, the franchise offering literature was either inaccurate, misleading, wholly lacking, or blatantly false as to material facts necessary to making an intelligent investment decision."¹⁴ Robert M. Dias, president, National Association of Franchised Businessmen, named "outright fraud" as the problem and offered numerous franchisor fraud examples.¹⁵ The FTC "found widespread deception in the sale of franchises...through both material misrepresentations and non-disclosure of material facts."¹⁶ Even franchisor representatives

admitted that the whole franchise marketplace was out of control. One fast-food franchisor's general counsel recognized that his industry "grossly oversold itself with promotions that were designed to work on the unrealistic hopes and daydreams of the naïve[,] and that this activity led to a 'boom (that) was built on the desire for a fast buck, slick promotion, and the myth of Horatio Alger.'"¹⁷ Freedom of contract meant freedom to defraud.

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The Advent of State Franchise Laws and the FTC Rule

By 1970, California Commissioner of Corporations Anthony Pierno was receiving "so many complaints about fraudulent franchises...that Pierno turned to his state's governor, Ronald Reagan, for help. Governor Reagan allowed Pierno to call in representatives from the IFA and the country's few franchise law practices to write the first law regulating franchising."¹⁸ The legislative aim

was to protect franchisees from losing their franchise investments because of franchisor fraud. From their efforts emerged the nation's first franchisee protection law, the California Franchise Investment Law (CFIL).¹⁹

Because of the huge franchisor-franchisee imbalance of power and massive franchise fraud, 18 states²⁰ have passed franchise investment or similar laws. These laws' main purposes were to prevent franchise fraud and to address this imbalance. In 1974, the Michigan legislature passed the Michigan Franchise Investment Law (MFIL),²¹ a CFIL mirror image. MFIL's main purpose was to remedy perceived abuses by franchisors manipulating, coercing, or lying to unsophisticated potential franchisees.²²

State laws soon mandated substantial pre-contract disclosures. In 1979, the FTC also mandated such disclosures. The FTC Rule required franchisors to provide prospective franchisees with a Uniform Franchise Offering Circular (UFOC), including 23 informational items on the offered franchise, its officers, and other franchisees.²³ These items include the franchisor's litigation history, past and present franchisees' contact information, any exclusive territory accompanying the franchise, franchisor assistance, franchise purchasing and start-up costs, and franchisor financial performance representations. The franchisor had to disclose these items at its first face-to-face meeting with the franchisee, or at least 10 days before the franchise agreement signing date. From the 1970s until 2007, franchisors did so with UFOCs. On January 23, 2007, the FTC modified its rule to make it more like state disclosure laws to permit electronic disclosure.²⁴ Since 2007, franchisors have disclosed pre-contract information with franchise disclosure documents.

MFIL Franchise Definition

For the FTC Rule and state franchise laws to apply, the franchisor-franchisee agreement must be a franchise. Thus, it must meet the FTC Rule's and applicable state franchise laws' franchise



definition. To be a franchise under MFIL, an agreement must meet three requirements:

- (a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor.
- (b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate.
- (c) The franchisee is required to pay, directly or indirectly, a franchise fee.²⁵

Only if an agreement meets these requirements do federal and state mandatory disclosure, franchise termination, and other protections apply. But other laws, like dealership and distributorship, business opportunity, and sales laws, might also apply.²⁶

In addition, the federal and state governments have franchise and similar laws covering specific industries. For instance, the federal government passed what became known as the Automobile Dealer Day in Court Act in 1956²⁷ and the Federal Petroleum Marketing Practices Act in 1978.²⁸ Some states have similar acts.²⁹ Some states also have similar laws covering other industries, like alcoholic beverages,³⁰ construction and farm equipment and machinery,³¹ and other vehicles.³²

Therefore, franchising has become a growing and important part of the national and international economy. In response to the old laissez-faire regime, where freedom of contract meant freedom to defraud, the FTC and many states have enacted franchise laws and regulations. These have established a new disclosure regime featuring more disclosure and less withholding of essential information. ■



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FOOTNOTES

1. *Webster's Third New International Dictionary* (1993), p 902.
2. See, e.g., *Husain v McDonald's Corp*, 205 Cal App 4th 860, 869; 140 Cal Rptr 3d 370 (2012); McCarthy, *Trademark franchising and antitrust: The trouble with tie-ins*, 58 Cal L R 1085, 1090 (1970); Chisum, *State regulation of franchising: The Washington experience*, 48 Wash L R 291, 297 (1973).
3. *Husain*, n 2 *supra* at 869.
4. McCarthy, n 2 *supra* at p 1087.
5. International Franchise Association, *2012 Franchise Business Economic Outlook*, p 1, available at <http://www.franchise.org/UploadedFiles/Fact_Sheet_EconOutlookFactSheet.pdf>. All websites cited in this article were accessed November 17, 2012.
6. M. L. Herman, *International Franchising* (2009), available at <<http://www.franchise-law.com/PracticeAreas/International-Franchising.asp>>.
7. Oliver Wendell Holmes, *The Common Law* (Boston: Little, Brown, and Company, 1881), p 1.
8. Robert M. Dias, President, Nat'l Ass'n of Franchise Businessmen, Statement at the Hearings on the Impact of Franchising on Small Businesses before the Subcommittee on Urban and Rural Economic Development of the Senate Select Committee on Small Business, 91st Cong (1970).
9. Bennett & Babcock, *Franchise Times Guide to Selecting, Buying, and Owning a Franchise* (New York: Sterling Publishing Co, Inc, 2008), p 136.
10. Brown, *Franchising: Trap for the Trusting* (Little, Brown, and Company, 1969), p 3.
11. Chisum, n 2 *supra* at 299.
12. See Brown, n 10 *supra* at 3; Dias Statement, n 8 *supra*.
13. See, e.g., Bennett, n 9 *supra* at 136; *US v Bessesen*, 433 F2d 861 (CA 8, 1970).
14. Chisum, n 2 *supra* at 297.
15. Dias Statement, n 8 *supra*.
16. Grueneberg & Hurwitz, *The FTC Franchise Rule: Analysis and Commentary* (American Bar Association, 2008).
17. Brown, *The Realities of Franchising* (Faneuil Press, 1970), p 122.
18. Bennett, n 9 *supra* at 136.
19. Cal Corp Code § 31000 through § 31516.
20. E.g., California Franchise Investment Law, Cal Corp Code § 31000 *et seq.*; Connecticut Franchise Law, Conn Gen Stat § 42-133e through § 42-133h; Hawaii Franchise Investment Law, Hawaii Rev Stat § 482E-1 *et seq.*; Illinois Franchise Disclosure Act, 815 Ill Comp Stat 705/1 *et seq.*; Indiana Deceptive Franchise Practices Act, Ind Code § 23-2-2.7-1 through § 23-2-2.7-7; Maryland Franchise Registration and Disclosure Law, Md Code Ann Bus Reg § 14-201 *et seq.*; Michigan Franchise Investment Law, MCL 445.1501 *et seq.*; Minnesota Franchise Act, Minn Stat § 80C.01 *et seq.*; New York Franchise Law, NY Gen Bus Law § 680 through § 695; New Jersey Franchise Practices Act, NJ Stat Ann § 56:10-1 *et seq.*; Oregon Franchise Law, Or Rev Stats § 650.005 through § 650.100; Virginia Retail Franchising Act, Va Code Ann § 13.1-557 *et seq.*; Washington Franchise Investment Protection Law, Wash Rev Code § 19.100.010 through § 19.100.019; Wisconsin Franchise Investment Law, Wis Stat § 553.01 *et seq.*
21. MCL 445.1501 through MCL 445.1538.
22. *Jerome-Duncan, Inc v Auto-By-Tel*, 989 F Supp 838, 842 (ED Mich, 1997); see House Legislative Analysis, HB 4203, August 2, 1974.
23. Federal Trade Commission, *FTC Issues Updated Franchise Rule*, available at <<http://www.ftc.gov/opa/2007/01/franchiserule.shtml>>; see 16 CFR 436.5.
24. *Id.*
25. MCL 445.1502(3).
26. Schneider & Nye, *Business Franchise Law: Cases and Materials* (Durham: Carolina Academic Press, 2003), p 4.
27. 15 USC 1221 *et seq.*
28. 15 USC 2801 *et seq.*
29. E.g., Michigan Motor Vehicle Dealer Franchise Act, MCL 445.1561 *et seq.*; Illinois Motor Vehicle Franchise Act, 815 Ill Comp Stat 710/1 through 710/14; Maine Motor Vehicle Dealer's Act, Me Rev Stat Ann tit 10, § 1171 *et seq.*; Virginia Petroleum Products Franchise Act, Va Code Ann § 59.1-21.8 *et seq.*; Michigan Motor Fuel Distribution Act, MCL 445.1801 *et seq.*
30. E.g., Maryland Beer Franchise Fair Dealing Act, Md Code Ann § 17-101 *et seq.*; Maine Malt Liquors and Wine Wholesaler Act, Me Rev Stat tit 28A § 1451 through § 1465.
31. E.g., Illinois Equipment Fair Dealership Law, 815 Ill Comp Stat 715/1 *et seq.*; Iowa Equipment Dealership Agreements Law, Iowa Code § 322F.1 *et seq.*; Michigan Farm and Utility Equipment Act, MCL 445.1451 *et seq.*; Missouri Farm Machinery Dealership Agreements Law, Mo Rev Stat § 407.838 through § 407.848 and § 407.850 through § 407.885.
32. E.g., Iowa Farm Implement, Motorcycle, Snowmobile, and All-Terrain Vehicle Franchises Law, Iowa Code § 322D.1 through § 322D.10; Maryland Equipment Dealer Contract Act, Md Code § 19-101 through § 19-505; Michigan Watercraft and Outboard Motor Manufacturers, Distributors, and Dealers Law, MCL 445.54 through 445.547; Missouri Motorcycle and All-Terrain Vehicle Franchise Practices Law, Mo Rev Stat § 407.1025 through § 407.1049.