Mr. Chairman, I am J. Howard Beales, III, the Director of the Federal Trade Commission's Bureau of Consumer Protection. On behalf of the Commission, I appreciate this opportunity to provide information to the Subcommittee on franchising and the Commission's enforcement of the Franchise Rule.

As you know, the Commission promulgated the Franchise Rule in the late 1970s, and since that time has rigorously enforced its provisions. Since the Franchise Rule was enacted, the Commission has brought over 200 franchise and business opportunity cases against over 640 entities and individuals. Indeed, just last week, the Commission announced its seventh joint law enforcement sweep in this field. Together with the Department of Justice and our state partners, we have filed over 70 cases against business opportunities and related schemes, the most prevalent and persistent problem in Franchise Rule enforcement.

The FTC's mission is to protect American consumers by taking action against unfair or deceptive acts or practices and by promoting vigorous competition. To that end, the Commission enforces the Federal Trade Commission Act ("FTC Act"), which prohibits unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. The FTC Act also empowers the Commission to prescribe rules that define with specificity acts or practices that are unfair or deceptive. One such rule is the Commission's Franchise Rule. Today, I will describe the Franchise Rule and the Commission's enforcement history. I will then discuss franchise relationship issues and the Commission's ongoing rule amendment proceeding.

I. BACKGROUND

A. The Franchise Rule Provides Important Information And Prohibits Deceptive Practices

When the Commission promulgated the Franchise Rule in the 1970s, the Commission determined that prospective franchisees needed certain critical information from franchisors. Without adequate information, prospective franchisees risked serious economic injury as a result of misrepresentations or omissions of material facts about the franchise business under consideration. Prevalent deceptive practices included the misrepresentation of: (1) the nature of the franchise; (2) the range of goods and services, such as supplies, equipment, and training, to be provided as part of the franchise package; (3) the value and profitability of the franchise; and (4) the franchisor's financial stability and prior experience.

The Franchise Rule seeks to facilitate informed decisions and to prevent deception in the sale of
franchises by requiring franchisors to provide prospective franchisees with material information prior to the sale. Specifically, the Franchise Rule requires franchisors to make material disclosures in five categories: (1) the nature of the franchisor and the franchise system; (2) the franchisor's financial viability; (3) the costs involved in purchasing and operating a franchised outlet; (4) the terms and conditions that govern the franchise relationship; and (5) the names and addresses of current franchisees who can share their experiences within the franchise system, thus helping the prospective franchisee to verify independently the franchisor's claims. In addition, franchisors must have a reasonable basis and substantiation for any earnings claims made to prospective franchisees, as well as disclose the basis and assumptions underlying any such earnings claims.

B. The Franchise Rule Covers Sales Of Franchises And Business Opportunity Ventures

The Franchise Rule generally covers two different types of business arrangements: franchises and business opportunity ventures. Franchises typically involve retail outlets that bear the franchisor's trademark and follow the franchisor's business operations model, such as fast-food restaurants, hotels, and automotive repair shops. These are commonly known as "business-format" franchises. Business opportunities, on the other hand, often do not entail a trademark or detailed business plan. In a business opportunity, the promoter typically promises to provide the buyer with equipment that is used to sell products or services to the public, such as vending machines, rack displays, pay phones, or medical billing software. The business opportunity promoter also frequently promises to find the buyer a market for the products or services sold by securing locations or accounts for the equipment used in the business, such as placing vending machines or rack displays in airports or bowling alleys, or providing the names of doctors seeking medical billing assistance.

C. Fifteen States Also Have Franchise Disclosure Laws

The FTC is not the only governmental entity to address pre-sale disclosure of franchise information. In addition to the FTC, 15 states require pre-sale disclosure in franchise sales in the form of a Uniform Franchise Offering Circular ("UFOC"). In many respects, the UFOC Guidelines' required disclosures are substantially similar to those of the Franchise Rule. Both formats, for example, require a description of: (1) the franchisor and its business; (2) prior litigation and bankruptcies; (3) initial and ongoing fees; (4) franchisor and franchisee obligations and other terms of the franchise contract; (5) restrictions on sales; and (6) rights to renew and terminate the franchise. In addition, both formats require substantiation of any earnings claims, statistics on existing franchisees, a list of franchisee references, and audited financial statements.

Because a UFOC is accepted by both the states and the FTC, the UFOC Guidelines have effectively become the national franchise disclosure standard.

II. FRANCHISE RULE ENFORCEMENT

The Franchise Rule has the force and effect of law, and it may be enforced through civil penalty actions in federal courts. The FTC Act authorizes courts to impose civil penalties of not more than $11,000 per compliance violation. In addition, the Commission may seek to obtain preliminary and permanent injunctive relief (including the full range of equitable remedies) in federal court. Such actions often result in monetary redress made to injured consumers.

To date the Commission has brought over 200 law enforcement actions under the Franchise Rule and Section 5 of the FTC Act against franchisors and business opportunity ventures, involving over 640 entities and individuals. Many of those actions have been against well-known franchise systems. For example, the Commission brought suit against Minuteman Press, a national printing franchisor. That case, which involved a six-month trial, resulted in a settlement in which the
defendants paid over $3 million in consumer redress.

A. Distinctions Between Business-Format Franchisors And Business Opportunity Sellers

Our law enforcement experience shows that business-format franchising has matured since the promulgation of the Franchise Rule in the 1970s. Many franchise systems today are established, well-respected, household names. While there is no question that fraud may occur in the sale of some franchises, the Franchise Rule's pre-sale disclosure requirements provide valuable information to help protect against fraud. Where Rule violations occur, it is mostly among small, start-up franchisors who may not be well-versed in the Franchise Rule's disclosure requirements. As a result, the Commission receives few franchisee complaints alleging fraud, deception, or substantive Rule violations by business-format franchisors.

Unfortunately, the same cannot be said of business opportunity sellers. Many business opportunities are outright scams that disappear shortly after taking consumers' money. Compliance with the Franchise Rule by business opportunity sellers is low. A 2001 Staff Review of the Commission's Franchise Program reported that the Commission brought 170 franchise or business opportunity cases against 330 entities and 305 individuals between 1993 and 2001. Of the 170 cases, 148 were against business opportunity schemes. Commission actions have involved, for example, the deceptive sale of vending machine and rack display opportunities; pay telephones, fax, and Internet access ventures; 900-number telephone schemes; and medical billing opportunities. Almost all of these cases involved the making of false or unsubstantiated earnings representations in violation of the Rule and most alleged that the promoter failed to provide prospects with any disclosures whatsoever.

In addition to violating the Franchise Rule, business opportunity sellers also frequently engage in a myriad of deceptive acts and practices in violation of Section 5 of the FTC Act in order to lure unsuspecting consumers to invest. For example, business opportunity sellers often disseminate false earnings projections and make false promises of exclusive market territories. In addition, they often use shill references or false testimonials to create the impression that their opportunity is safe and profitable. Typically, they also misrepresent the availability or profitability of locations for vending machines or other equipment used in the business; misrepresent their prior success; misrepresent assistance to be provided to the purchaser; and misrepresent the nature of their products or services.

B. The Commission's Law Enforcement Efforts Track Consumer Complaint Data

The Commission's law enforcement efforts described above track the breakdown of complaints the FTC receives. Overwhelmingly, the complaints the Commission receives involve the sale of business opportunities. The Commission's staff analyzed 4,512 franchise and business opportunity complaints in the Commission's Consumer Information System ("CIS") database between 1993 and June 1999. Of the 4,512 complaints, 3,392 complaints - more than 75% - clearly involved business opportunities. An additional 832 complaints were against companies that did not appear on known lists of franchisors and most likely were business opportunities as well. Only 6% of the complaints pertained to traditional franchise arrangements. Complaints were lodged against 949 business opportunity sellers, but against only 197 franchisors.

Injury to individual consumers resulting from business opportunity fraud is also among the highest levels of injury we see in consumer protection. The staff's analysis of complaint data between 1993 and June 1999 shows that more than 650 consumers each reported losses of at least $10,001. An additional 631 consumers each reported losses of between $5,001 and $10,000, and 621 between $1,001 and $5,000. Indeed, injury from business opportunity fraud consistently ranks among the top 10 product/service categories in the Commission's database based upon...
amount paid, often resulting in consumer losses of over $1 million each month.

For these reasons, the Commission continues to focus much of its Franchise Rule enforcement and consumer educational resources on combating business opportunity fraud. Indeed, since 1995, the Commission has joined with the Department of Justice and state consumer protection agencies to bring seven joint law enforcement sweeps covering a variety of business opportunity ventures. The most recent of these sweeps occurred just last week - Operation Busted Opportunity, which targeted over 70 business opportunity and related schemes.

The Commission will continue to work with its law enforcement partners to protect consumers from such frauds.

III. FRANCHISE "RELATIONSHIP" ISSUES

One area of franchising that has received widespread attention in recent years is the nature of franchise relationships. The Franchise Rule requires the disclosure of material information concerning the sale of a franchise. It does not, however, regulate the substance of the terms that control the relationship between franchisors and franchisees. The Commission believes that the market is the best regulator of franchise sales, provided that prospective franchisees have full and complete disclosure of material information with which to conduct a due diligence investigation of the franchise offering.

Nonetheless, we are aware that some franchisees, franchisee trade associations, and franchisee advocates have raised concerns about franchise relationships. Their concerns do not involve allegations of deception or fraud in the sale of franchises. Rather, they assert that the underlying relationship between franchisor and franchisee is often unfair, with the franchisor dictating the terms under which the franchisee will conduct business, often allegedly resulting in significant financial losses. Among other issues, franchisees have complained about: (1) lack of protected territories and encroachment by franchisors into their market location; (2) obligations to purchase supplies or inventory from specified providers, even if comparable items are available at cheaper prices from alternative suppliers; and (3) renewal of franchise agreements on restrictive or more onerous terms.

A. The Commission Lacks Complaint Data that Would Indicate Franchise Relationship Disputes Are a Prevalent Problem

Although the Commission does not doubt that individual franchisees may have experienced abuses in their relationships with franchisors, the Commission is unaware of any evidence that relationship issues are prevalent throughout franchising. As a preliminary matter, we do not know the exact number of franchisees in the United States. In its 2001 report on the Franchise Rule, the GAO stated that there are more than 320,000 franchised units in the United States. Accordingly, we can reasonably assume that there are hundreds of thousands of franchisees. Yet, FTC complaint data for the period 1993 through June 1999 show that only 288 franchisees filed complaints with the Commission. Of these, 134 contained insufficient information to determine any specific allegation. Of the remaining 154 complaints, 141 raised post-sale issues involving 102 companies. It appears that franchisees in about 95% of the approximate 2,500 franchise systems operating in North America did not file a single relationship complaint with the Commission during nearly seven years. Moreover, the vast majority of companies that were the subject of a franchise complaint generated only a single complaint. For example, 91 companies generated only one complaint each, while only one company generated more than five complaints. In short, complaints to the Commission rarely present a pattern of law violations by business-format franchise systems.

The lack of relationship complaints in business-format franchising is consistent with the findings of
the GAO. After conducting an inquiry into the scope of franchise relationship issues, the GAO concluded:

The extent and nature of franchise relationship problems are unknown because of a lack of readily available, statistically reliable data - that is, the data available are not systematically gathered or generalizable. According to FTC staff, data FTC has collected, while limited, suggest that franchise relationship problems are isolated occurrences rather than prevalent practices. Franchise trade association officials pointed to indicators or anecdotal information to support their views regarding franchise relationship problems, but they were not aware of any statistically reliable data on the extent and nature of these problems. Likewise, none of the nine states we contacted - eight of which have franchise relationship laws - had readily available, statistically reliable data on the extent and nature of franchise relationship problems.\(^{(35)}\)

**B. Franchise Relationship Issues Are Determined by State Contract Law**

Franchise relationship issues are generally governed by the private contractual relationship between the franchisor and franchisee. To the extent that there are contract disputes, these are appropriately resolved under applicable state law. As noted above, the Franchise Rule is designed to ensure that franchisees have time to review all material terms and conditions of the franchise relationship, and an opportunity to seek legal, accounting, and marketing advice as well as the opportunity to speak to both former and current system franchisees before entering into a franchise agreement.

It has been suggested by some that the Commission could use its unfairness authority to address franchise relationship issues. However, the Commission's unfairness authority is limited. Economic injury to franchisees alone is insufficient. Section 5 of the FTC Act provides that the Commission does not have the authority to declare an act or practice unfair unless it meets three specific criteria: (1) the act or practice causes or is likely to cause substantial injury; (2) that is not outweighed by countervailing benefits to consumers or to competition; and (3) is not reasonably avoidable.\(^{(36)}\)

Even where there is substantial injury to franchisees, the second and third criteria must be met. Franchise systems, like all businesses, are influenced by ordinary market forces, and franchisors may want franchise agreements that maximize their ability to respond quickly to market changes. Therefore, a franchisor's choice of contract terms and conditions is often based upon some economic rationale that is designed to benefit consumers and/or the system's existing franchisees. The benefits flowing from these contractual terms may outweigh complaints or allegations of "oppression" by individual complainant-franchisees.

Further, the Commission would be required to establish that contractual provisions that prospective franchisees voluntarily read, agreed to, and signed are not reasonably avoidable. This would be difficult because, under the Franchise Rule, prospective franchisees receive a disclosure document at least 10 business days before they are required to sign the franchise agreement. Presumably, every prospective franchisee also has the opportunity to review the franchise agreement before signing, seek legal, accounting, and marketing advice, as well as to speak to both former and current system franchisees. In short, it would not be appropriate for the Commission to second-guess a prospective franchisee's wisdom in signing a particular franchise agreement, as long as the prospective franchisee is forewarned about the legal consequences of his or her actions.

**IV. RULEMAKING**

As the Subcommittee is probably aware, the Commission is in the process of updating the Franchise Rule.\(^{(37)}\) In 1999, the Commission published a Notice of Proposed Rulemaking ("NPR"),
which set forth the text of a proposed revised Rule. Among other things, the proposal would revise the Rule in four material respects. First, it would focus exclusively on franchise issues. In the NPR, the Commission proposed that business opportunities be addressed in a separate rulemaking procedure that would focus narrowly on appropriate disclosures and, more importantly, on prohibitions necessary to prevent persistent fraud in that area. Second, the proposal would revise the Franchise Rule along the UFOC Guidelines model. This would reduce inconsistencies between federal and state disclosure laws and reduce compliance burdens. Third, the proposal would update the Rule to address new technologies, in particular the sale of franchises through the Internet. Fourth, the proposal would provide prospective franchisees with more information about the state of the franchise relationship. While specific complaints by franchisees are relatively few, as noted above, there remains considerable support among franchisee associations and franchisee advocates for greater disclosure of information from which a prospective franchisee can assess the quality of the relationship he or she will be entering.

The next step in the rule amendment process is the publication of a staff report that analyzes the record to date and offers specific recommendations for further fine-tuning of the NPR proposal. Because the rulemaking is ongoing, we cannot, at this time, comment on any substantive aspect of the proposed rule or its implementation. Nonetheless, we note that several NPR proposals, if ultimately adopted by the Commission, would give prospective franchisees expanded information with which to assess the franchise offering and the relationship between the franchisor and franchisee. For example, these proposals would: (1) alert prospective franchisees about the availability of the Commission's Consumer Guide to Buying a Franchise, which contains advice on how to read a disclosure document; (2) increase franchisors' disclosures about prior litigation with franchisees; (3) warn prospective franchisees about the consequences of purchasing an unprotected territory and not to rely on unauthorized financial performance information; and (4) make available information about franchisor-sponsored and independent franchisee associations.

V. CONCLUSION

Based upon the Commission's two decades of experience in enforcing the Franchise Rule, it is clear to us that deceptive business opportunity sales, rather than business-format franchise sales, remains a persistent cause of significant injury to American consumers. The Commission will continue to dedicate significant law enforcement resources to targeting this problem, as well as consider promulgating a separate business opportunity trade regulation rule that will prohibit specific practices that often underlie fraudulent business opportunity schemes.

Thank you for this opportunity to describe for the Committee the Commission's Franchise Rule program. I will be pleased to respond to your questions.

Endnotes:

1. The views expressed in this statement represent the views of the Commission. My oral statement and responses to any questions you may have are my own and are not necessarily those of the Commission or any Commissioner.

2. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. Part 436. The Commission also enforces over 30 rules governing specific industries and practices, for example: the Funeral Rule, 16 C.F.R. Part 453, which requires funeral providers to give consumers accurate price lists that itemize goods and services offered; and the Telemarketing Sales Rule, 16 C.F.R. Part 310, which defines and prohibits deceptive telemarketing practices and other abusive telemarketing practices.


5. In many respects, franchisees are not ordinary consumers. For example, the Magnuson-Moss Warranty Act defines "consumer" as "a buyer . . . of any consumer product." In turn, it defines "consumer product" in relevant part as "any tangible personal property which is distributed in commerce and which is normally used for personal, family, or household purposes." 15 U.S.C. § 2301.
Similarly, the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7001 et seq., defines "consumer" as "an individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes . . . ." Id. § 7006. Franchisees, in contrast, do not just buy products, but invest in a business system. Indeed, several states have held that franchisees are not "consumers" entitled to protection under state general consumer protection statutes. E.g., West Coast Franchising Co. v. WCV Corp., 30 F. Supp. 2d 49 (E.D. Pa. 1998); Sparks Tune Up Centers v. Addison, Civ. No. 89-1355, 1989 U.S. Dist. LEXIS 7413 (E.D. Pa. 1989)(applying Ohio law). This view, however, is not universal. See, e.g., Hofsettler v. Fletcher, 905 F.2d 897 (6th Cir. 1988); Deerman v. Fed. Home Loan Mortg. Corp., 955 F. Supp. 1393 (N.D. Ala. 1997); LJS Co. v. Marks, 480 F. Supp. 241 (S.D. Fla. 1979).


7. The Franchise Rule also covers "product franchisees," in which the franchisee typically distributes products manufactured by the franchisor, such as automobile dealerships. See Franchise Rule, Final Interpretive Guides, 44 Fed. Reg. 49,966, 49,966-967 (Aug. 24, 1979).

8. These states are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, Michigan, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Twelve of these states review and approve franchisors' UFOCs before they can be used in the state. In order to reduce franchisors' compliance burdens, the Commission will accept a UFOC in lieu of a franchise disclosure document.

9. The UFOC Guidelines, however, focus exclusively on franchise sales; business opportunities are regulated to varying degrees in 22 states. The UFOC Guidelines also contain more expansive disclosures than the Franchise Rule. For example, the UFOC Guidelines require the disclosure of: (1) regulations specific to the industry in which the franchisee will conduct business; (2) litigation or a bankruptcy involving a franchisor's predecessor; (3) computer system requirements; and (4) the names and addresses of former as well as current franchisees.


13. Since the promulgation of the Franchise Rule and the UFOC Guidelines in the 1970s, no additional state has sought to adopt franchise disclosure regulation. Indeed, several states, including Michigan, Wisconsin, and Indiana, have eliminated routine review of UFOC filings.

14. The franchise legal community is also well-organized. For example, the American Bar Association's Forum on Franchising has nearly 600 members. Franchisors are also represented by the International Franchise Association ("IFA") and the National Franchise Council. Franchisees are represented by various groups including the IFA, American Franchisee Association, and American Association of Franchisees and Dealers. In addition, we have recently seen the growth of franchisee councils and independent franchisee associations that represent franchisee interests, such as the National Franchise Association (the association of Burger King franchisees).

15. In such instances, the FTC staff may recommend that the alleged violation be addressed through a referral to the National Franchise Council ("NFC"), a private industry group comprised of a limited number of select franchise systems, mostly in the hotel and food industries. Franchisors who agree to be referred to the NFC's Alternative Law Enforcement Program receive Franchise Rule compliance training, compliance monitoring, and in, some instances, participate in mediation of franchisee complaints. This approach to addressing minor, non-fraudulent violations of the Franchise Rule is consistent with the goals of the Small Business Regulatory Fairness Enforcement Act, 5 U.S.C. § 601, et seq., which, among other things, requires agencies to consider reducing or waiving civil penalties in appropriate circumstances.


17. Similarly, in its 2001 audit of the Commission's Franchise Program, the General Accounting Office ("GAO") found that, between 1993 and 2000, the Commission staff opened 332 franchise and business opportunity investigations, the overwhelming majority of which involved business opportunities. GAO, Federal Trade Commission Enforcement of the Franchise Rule (July 2001)("GAO Report") at 13-15. See also Appendix V: Information on Business Opportunity and Franchise Court Cases Filed by FTC During 1993-2000, id. at 49-64.


26. Id. at 4-9.

27. Id. at 17 (Chart C.5). The level of actual injury is probably much greater. Our review found that 727 business opportunity purchasers did not disclose how much they believed was lost through their investment. See Id. (Chart C.6).

28. In addition to law enforcement, the Commission has engaged in numerous consumer educational efforts to spread the word about business opportunity and related frauds. For example, the Commission's Office of Consumer and Business Education ("OCBE") has generated nearly 20 brochures and alerts on various business opportunities and related schemes (multi-level marketing, pyramids, work-at-home schemes). In fiscal year 2000 alone, OCBE distributed 169,120 printed copies of these materials and received 374,787 hits on its online versions. Staff Review at 61.

29. The Franchise Rule (as well as the UFOC Guidelines) addresses each of these issues through pre-sale disclosure. See 16 C.F.R. § 436.1(a)(13) (territorial protections); § 436.1(a)(10) (required suppliers); § 436.1(a)(11) (revenue received by franchisor from required suppliers); § 436.1(a)(15) (renewal and termination conditions).

30. GAO Report at 5.

31. See Id. at 22.

32. See Bond's Franchise Guide (1998 ed.) at 9, 25 (estimating there are 2,500 American and Canadian franchisors).

33. The complaint data noted above do not necessarily represent an exact accounting of all correspondence that was submitted to the Commission during the relevant time period. As noted in the Staff Review, complaint data prior to 1997, especially telephone calls, were not routinely captured in a centralized database. This changed in 1997, when the Commission created the Consumer Response Center, which standardized Commission complaint handling. For these reasons, data submitted to the Commission after 1996 is the most complete. Nonetheless, the CIS data analyzed in the Staff Review are the single best source of complaint information available to the Commission both before and after 1997. See Staff Review at 4.

34. It is possible that franchisees may have complained to state agencies. However, as noted below, the GAO found that the states contacted during its audit did not have readily available and statistically reliable data on the extent and nature of franchise relationship problems. Also, to the extent that states contribute data to the Commission's Consumer Sentinel database, franchisee complaint information to the states would have been included in the complaint data analyzed by the Commission's staff.
