Federal Trade Commission

THE FRANCHISE RULE: THEORY AND ENFORCEMENT

Prepared Remarks of

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I am very pleased to be invited to share with you some of my thoughts about the Commission's role in the franchise industry, an important and integral part of our economy.

In my remarks, I will first provide an economic perspective on franchising as an organizational form and how this perspective informs the nature of franchise law. I will then discuss the Commission's Franchise Rule enforcement program, stressing in particular the need for federal-state cooperation. Finally, I will share some of my thoughts with you concerning the newly revised Guidelines for preparing the Uniform Franchise Offering Circular (UFOC).[1]

An Economic Perspective on Franchising

Franchising first came into use in the late nineteenth century and has become widespread in the last forty years, now accounting for a tremendous one-third of all retail sales.[2] The conventional organizational form of franchising lies between independent contracting and centralized intra-firm employment, and has elements in common with both extremes. On the one hand, the franchisor often exercises a great deal of control over the

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[1] The views I express here are, of course, my own and are not necessarily shared by any other Commissioner or Commission staff. Also, I would like to acknowledge the help of Thomas N. Dahdouh, Richard Quaresima and Kathryn Fahnline.

[2] U.S. Department of Commerce, Franchising in the Economy 1985-87, at 14 (1987).

operations of the franchisee. On the other hand, the franchisee typically owns the bulk of the assets of the franchise.

Both parties contribute to this unique business relationship. The franchisor brings a unique way of doing business, which is embodied by the trade name. The franchisor's continuing role is to preserve the value of the trade name and assist in starting up and maintaining the franchises.[3] The franchisee, on the other hand, brings to the relationship capital and managerial skills.

Other than these basic components, the term "franchising" encompasses a wide range of control by the franchisor. As even a brief look at the Franchise Rule's definition of the term "franchise" reveals,[4] franchising encompasses situations as diverse as a McDonald's -- with a valuable trademark, stiff requirements for quality controls for franchisees and substantial assistance to franchisees -- to a business opportunity offer with less control over purchasers -- for example a company that sells vending machines along with a continuing supply of products to be stocked in those machines and a promise to secure sites for the machines.

Franchising, it has been argued, solves various problems encountered in alternative organizational forms such as company-owned stores or contracts to use brand names without any

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[3] The franchisee has an incentive to cut quality since he will not bear the full costs of his actions.

[4] 16 CFR § 436.2(a).

controls. The first problem is known in economics as the "principal-agent" problem. In a nut shell, it is difficult for the principal to devise incentive schemes that encourage the agent to provide the optimal amount of effort. In this setting, the owner of a brand-name might find it difficult to motivate the managers of company-owned stores to provide the optimal level of effort and, consequently, may be forced to engage in costly monitoring of company-store managers.

This is a particular problem when the environment (demand) is variable, since this characteristic of the environment makes it more difficult to distinguish shirking from low demand. This principal-agent concern suggests that a businessperson might be better off just selling the brand name and accompanying knowledge rather than creating company-owned stores. At least in theory the right to use a brand name could be sold; however, such a sale could lead to debasement of the brand name through lower quality -- effectively the buyer could "free ride" on the franchisor's brand name reputation. Franchising attempts to address both these problems because the franchisee is the residual claimant, i.e. she keeps the profit remaining after expenses have been paid. Therefore, franchisees have a greater incentive to both expend effort and minimize costs.[5] They may also have better information regarding local conditions, such as local labor markets. Based on this explanation, some researchers argue that

[5] The debasement problem can also be attenuated if the manager is an owner who posts a bond in the form of a franchisee fee and site-specific investments.

franchising will be more prevalent in those markets where the operations are physically dispersed,[6] and where they are more labor intensive.[7] This may explain the prevalence of franchising in the fast food industry.

A second problem that some have argued motivates business people to use the franchising form is that the franchisor faces a capital constraint and is able via franchising to obtain capital at lower cost than other arrangements would allow. This explanation, however, is controversial. It has been criticized by some, for example Professor Paul Rubin, who has argued that this theory is not consistent with economic theories of finance.[8]

Despite such criticisms, many established franchisors indicate that they entered franchising precisely to expand the business quickly.[9] Thus, some have suggested that a combination

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[6] As the operations become more physically dispersed, the costs of monitoring increase.

[7] Machines do not shirk; people do.

[8] Paul Rubin, "The Theory of the Firm and the Structure of the Franchise Contract," 21 J. of Law & Econ. 223 (1978). He suggests that a pure capital constraint theory will not successfully explain franchising because, under such a model, a franchisor would do better to create a portfolio of shares of all outlets and sell those shares to his managers, thus reducing the risk for purchasing managers, with no effect on the amount of capital raised. Empirical research also has not supported the capital constraint hypothesis. One might expect, based on this theory, that the franchisor would reduce its reliance on franchising as the franchising chain matures. Empirical research, however, has not found this to be the case.

[9] See Carrie Shook & Robert L. Shook, Franchising: The Business Strategy that Changed the World (1993) and Stan Luxemberg, Roadside Empire: How the Chains Franchised America (1985), for case studies of successful franchise operations.

of the capital constraint theory and the principal-agent theory noted above may provide the best economic explanation for franchising's explosive growth.[10]

Structure of the Franchise Contract

So, where does the Franchise Rule fit into all of this? As you all know, the Franchise Rule requires franchisors and certain other sellers of business opportunity ventures to provide potential investors with information essential to an assessment of the potential risks and benefits of an offer: for example, material civil litigation in which the seller has been involved, certain financial information about the seller, and a non-selective list of the names, addresses and telephone number of at least 10 nearby franchisees.

In an ideal world, it would be possible for the franchisor and the prospective franchisee to negotiate a contract that completely specifies the contractual obligations of both parties under all possible situations. However -- as I am sure you realize -- this is impossible for two major reasons. First,

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[10] See Francine Lafontaine, "Agency Theory and Franchising: Some Empirical Results," 23 Rand J. Econ. 263 (1992). While the capital constraint theory might not explain the use of franchising by itself, it has more intuitive appeal when it is noted that a franchisor selling a portfolio of shares in all her stores to shareholding managers faces the same principal-agent incentive problems with those shareholding managers as she would if she kept all her stores company-owned and retained salaried managers instead. Consequently, Professor Rubin's alternative of the franchisor selling a portfolio of shares in all her stores to shareholding managers might not be so attractive after all.

uncertainty regarding the future implies that it will be difficult to anticipate and specify, a priori, all possible outcomes. Second, contractual performance may be difficult to observe or very costly to measure: this is the principal-agent problem discussed earlier. For example, it might be difficult to specify in advance all of the specific situations that will justify the termination of the franchisee.

The fact that franchise contracts are necessarily incomplete leaves an opening for both the franchisee and the franchisor to engage in behavior that harms the other party. Franchise disclosure laws help to mitigate the effects of opportunistic behavior by the franchisor, given the incompleteness of the contract.

For example, one method franchisors use to maintain the quality of the franchise system is to terminate franchisees offering a low-quality product or service.[11] However, as mentioned already, it is difficult to specify contractually all of the different types of franchisee behavior that might degrade the trade name and thereby justify termination. One contract provision that is sometimes used by franchisors to address this

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[11] Although the franchisee has an incentive to maintain the quality of the product in order to increase sales, the franchisee also has an incentive to lower quality in order to reduce costs. The incentive to lower costs by offering a lower quality product may be especially great for outlets that receive little, if any, repeat business. A restaurant franchisee that has an outlet located adjacent to a major highway might use lower quality meat to make hamburgers or might not maintain the appearance of the outlet. The provision of a lower quality product by this franchisee reduces the value of the trade name, harming both the franchisor and other franchisees.

problem is a termination-at-will clause. While this clause will allow the franchisor to maintain the value of the trade name by terminating problem franchisees, the franchisor may opportunistically terminate or fail to renew the franchise (or possibly change terms for renewal), possibly enabling the franchisor to take over the franchise at a "fire-sale" price.[12] In order to indirectly prevent such behavior, franchise law mandates that franchisors disclose to franchisees accurate information regarding terminations and nonrenewals before the franchisor signs up. Franchise law also requires the franchisors to disclose the names and addresses of some franchisees, thereby potentially allowing the franchisee to find out more about the franchisor's previous history in dealing with her franchisees. These disclosures to future potential buyers increase the costs to a franchisor of arbitrarily terminating a current franchisee.

Of course, a very few franchisors are simply frauds, fly-by-night operators who take the upfront fee and then just walk. Frauds seem to occur mostly in the business opportunity sector. These operations have attracted a significant portion of the Commission's enforcement activity with respect to the Rule, although the Commission is committed to enforcing vigorously the Rule against <u>all</u> violators, not just fraudulent operators.

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[12] Franchisors may also be concerned with the possibility that the franchisee might learn the system, walk and then compete directly with the franchisor's other franchisees. At the same time, franchisees have encroachment concerns relating to franchisor's opening company-owned stores (or allowing a new franchise) in close geographic proximity.

Other aspects of disclosure requirements at the state and federal level are rooted not in the economics of franchising discussed above, but in the economics of information. There is an asymmetry of information between the franchisor and the potential franchisee regarding the true value of a franchise. Furthermore, it would be difficult for franchisees to get certain types of accurate information -- for example, a franchisor's litigation history -- unless it is provided by the franchisor. Of course, along with the requirement that the franchisor disclose certain information, is the mandate that, when the franchisor discloses anything, she only discloses truthful information. Thus, franchisors must provide timely and accurate information regarding the finances of the franchisor and indicate the amount of capital necessary to start up the franchise as well as documenting any earnings claims that are made. All these requirements are designed to provide basic information necessary for the franchisee to make an informed decision. Without these disclosure requirements and enforcement of truthful disclosures, it would be difficult in many cases for the good franchisors to distinguish themselves from the bad franchisors.[13]

While the Franchise Rule requires that earnings claims be accurate if made, the Rule does not require that franchisors provide financial earnings of current or past franchisees or forecast future financial earnings. Such a voluntary disclosure

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[13] Of course, this is less of a problem for established franchisors with reputations, such as McDonald's, than it is for new franchise operations.

regime, in order to be effective in preventing harm to potential franchisees, requires that potential franchisees in fact will take the absence of earnings claims as a bad signal -- that is, as an indication that current franchisees are not in fact doing well.

Federal-State Cooperative Efforts

Disclosure laws mean nothing if they are not vigorously enforced. I and my colleagues on the Commission are acutely aware of the injury that Franchise Rule violations can cause to franchisees. We are committed to aggressive enforcement of the Franchise Rule. But we cannot do it alone. As you all know, one of the Commission's top priorities has been to increase the cooperation between the Commission and other law enforcement agencies, particularly state and local law enforcement. In the past few years, federal-state enforcement agency relations have greatly improved. A strong foundation has been laid for joint law enforcement projects. In an era when government resources are being cut, it is critical to strengthen this cooperation so that scarce law enforcement resources can be used most efficiently.

One of the most productive examples of federal-state cooperation in the recent past has been in enforcing the Commission's Used Car Rule. The Used Car Rule requires used car dealers to provide certain pertinent information including warranty information in a "Buyers Guide" sticker on the window of each car. During the last several years, the Commission and the states have conducted joint "sweeps" of used car lots to determine violators of the Used Car Rule. Sweeps, as opposed to a single inspection, enhance the Rule's visibility, which, in turn, leads to greater deterrence. However, since sweeps require larger numbers of staff, federal-state cooperation is needed to make the sweeps work. During the past two years, Commission-State joint actions involving the Used Car Rule have resulted in hundreds of settlements.

The Commission staff and the states have recently begun to use sweeps in Franchise Rule enforcement. The targets of these sweeps are the used car lots of the Franchise industry: franchise and business opportunity trade shows. Over the past year, the Commission staff, with the support of numerous state Attorneys General, have visited 12 trade shows in an effort to enforce the timing requirements for disclosures under the Rule. During a sweep, staff act as interested investors willing to purchase a franchise. Numerous non-public investigations have sprung from this effort and I am certain you will hear more about the fruits of this project in the upcoming months.

We intend to increase our joint efforts in the trade show sweeps during the next year. While many franchisors use trade shows as a forum for preliminary discussions with potential investors, others use it as a vehicle to entice investors with false or inflated earnings claims. We are specifically targeting those franchisors who make earnings claims on the floor of the shows but do not give out disclosure documents.

We are also looking at holding the promoters of the shows liable as "brokers." Although show promoters may be considered to be brokers and brokers are covered by the Rule, show promoters are exempt from liability under the Rule if and only if they give consumer education notices to those attending informing them of their rights under the Franchise Rule.[14] All too often promoters fail to give out this notice while franchisors on the floors of these shows are making inflated earnings claims.

The FTC and NAAG have also published a joint rule enforcement handbook that discusses methods of federal-state cooperation in enforcing five Commission Trade Regulation Rules, including the Franchise Rule. Because many states have business opportunity or franchise laws that require registration of franchisors and/or prior approval of disclosure documents for franchise offerings or otherwise regulate franchisor conduct, coordination of federal and state efforts can lead to a qualitatively greater aggregate enforcement effect. This type of cooperation is essential for effective Rule enforcement in an era when resources are so limited.

Apart from the sweeps project, federal-state cooperation continues during investigations of individual franchisors. On June 21, for example, the Commission filed a law suit in the

[14] 46 Fed. Reg. 52327, 52329.

Southern District of Florida against six individuals who were deceptively selling franchises in violation of the Rule through twenty corporations.[15] All the individual defendants used aliases. As you can imagine, it would have been impossible for Commission staff to identify all the companies and individuals and decipher the full scope of the scheme without the help of the local authorities. I understand that the Florida authorities helping the Commission ranged from the state business opportunity registration office right down to the local town police department. It is this type of cooperation that you can expect to see in the future.

Another law enforcement area where I hope to see greater federal-state cooperation is in the area of auto repair fraud. FTC staff has been participating in several of the activities undertaken by the Auto Repair Task Force created by the National Association of Attorneys General ("NAAG"). The NAAG Auto Repair Fraud Task Force plans to conduct a forum for discussing the issues raised in the auto repair industry and the FTC staff will be closely involved, ultimately making a recommendation to the Commission on what role the FTC might play in resolving this serious problem.

While franchise problems are not the root of the auto repair problem, franchise Rule enforcement in the auto repair area is important because of the presence of nationally and locally

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[15] FTC v. William O'Rourke, No. 93-6511-Civ-Gonzales (S.D. Fla. 1993).

franchised repair outlets. Here, greater enforcement of the Franchise Rule can not only prevent injury to franchisees, but injury also to consumers. Nationally-franchised auto repair outlets held about 13% of the automotive repair market in 1990[16] and had annual sales of about $13.8 billion.[17] The Commission is concerned that some franchisors may misrepresent the availability of training and assistance that will be provided to franchisees, or the degree of technical expertise required to operate a franchise, or the cost of equipment necessary to run the franchise. These franchisor misrepresentations can result in inadequate or incompetent auto repair to the general public because the franchisee has not been properly trained or given the assistance necessary to operate the business.

While some of these franchise auto repair operations are national in scope, most are local in nature. Consequently, the Commission is working in cooperation with state and local law enforcement agencies in order to ensure that the significant problem of auto repair fraud is stemmed. Recently, the Commission acted against one such franchising operation.[18] The Commission's complaint alleged, among other things, that the company falsely represented to franchisees who had no technical experience that they could still perform a sufficient number of

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[16] MVMA Motor Vehicle Fact & Figures '92 at 66.

[17] "Bumper to Bumper Auto Car," Nation's Business (October 1991), at 70.

[18] FTC v. Car Checkers of America, Inc., Civ. No. 93-623 (MLP), (D.N.J. 1993).

car inspection services to turn a profit. The complaint also alleged that the company represented that it provided all the tools necessary to conduct car inspections, but failed to disclose that their system was incompatible with some car models.

I am hopeful that these examples of coordinated efforts between the FTC and the states will result in new and expanded enforcement actions, which are, after all, the only effective way to deter violations of the Rule.

Federal Legislative Initiatives

In addition to states and other local law enforcement agencies, another way to strengthen enforcement may be to afford aggrieved franchisees a private right of action against franchisors who violate the Franchise Rule. In the past, the Commission has supported a private right of action under the Rule for franchisees. The courts, however, have uniformly held that there is no such private right of action under the current Rule.

New UFOC Guidelines

One other area of federal-state cooperation deserves mention, because it is a topic of interest to you and one that the Commission is currently considering: namely, the new Uniform Franchise Offering Circular (UFOC) Guidelines. As you all know, the UFOC is an effort by a number of states to attain some uniformity with respect to disclosure requirements applicable to franchisors. When the Commission issued the Franchise Rule in 1978, it authorized franchisors to use the already-existing UFOC for compliance. This authorization for Rule compliance avoided two undesirable consequences. First, it avoided imposing on the franchisor the costs and burdens of providing franchisees with both a UFOC and a Rule disclosure document in those states requiring a UFOC-style document. This also reduced confusion for investors who would then have to wade through two disclosure documents. Second, adopting the UFOC avoided any need to consider preemption of the five state statutes that failed to give state officials the statutory authority to accept the Rule's disclosure format for the disclosure filings they required. In this way, the Commission sought to harmonize its Rule with already-existing state regulation.

Work began on broad new revisions to the UFOC in November 1990. This past summer, North American Securities Administrators Association (NASAA), the organization of public officials responsible for the UFOC, submitted a formal request to the Commission that it approve the revised version of the UFOC. Commission staff participated by invitation in the entire process, both in the meeting of the full Franchise Committee, and the separate closed meetings of the state regulators on the Committee who made the final decisions and recommendations to NASAA.

The Commission approved the original version of the UFOC because it provided "equal or greater protection than the Rule" to investors. The Commission is now considering whether the revised version of the UFOC provides that same protection and whether it should authorize franchisors to use the new format to comply with the Rule. Although I must therefore keep my remarks brief, I did want to give you some general thoughts on the revisions.

Perhaps the aspect of the revisions that most struck me was that it encourages the use of concise "plain English" and discourages verbose "legalese." Many disclosure documents prepared under the old UFOC Guidelines are so massive and use such intricate legalese that many prospective franchisees are deterred from reading them, much less using them as a tool for investigating the franchise offer.

The "plain English" requirement in the new UFOC provides prospective franchisees with more easily understood disclosures to assist them in making informed decisions. As attorneys drafting disclosure documents, whether in the UFOC format or FTC format, by drafting more user-friendly disclosure documents, you will be doing your part to help smooth out some of the perceived problems in the industry.

Next, I would note that the drafters of the revised guidelines sought to reduce the impact various state laws have on the basic disclosure document. Regulatory uniformity is advantageous both to the business community and to the consumer.

An example of the move to greater uniformity in the UFOC is in the financial disclosure requirements for start-up franchisors who do not have the required three years of audited financial statements. The old UFOC had no uniform standard for financial disclosures in registration states for offerings by these start-up franchisors and, consequently, different states had different requirements for the discretionary approval of offerings by start-up franchisors. The financial disclosure requirements of the revised UFOC now set a uniform standard for such start-up franchisors. It is my understanding that it was the hope of the drafters that this uniform standard for new franchisors would be a significant advance in reducing any inconsistencies among the states in this area.

CONCLUSION

The Commission's duty to consumers requires it to vigorously enforce its regulations, and the Franchise Rule is one of its most important. Both the franchisor and the franchisee benefit when the franchisee fully understands the nature of the relationship. The Commission's job, along with state and local law enforcement agencies, is to prosecute those franchisors who do not live up to the disclose requirements mandated by law. Your job as attorneys for franchisors and franchisees is to make sure the disclosure is complete because, whether you represent a franchisor or franchisee, your client will benefit by full disclosure.

Thank you very much for your interest and attention today. I appreciate the assistance and cooperation your organization has given to the Commission over the years and I hope we can continue to work together in the future.