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 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 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."

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.”

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:

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

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.”

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.” 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.

Franchisors used entertainment and sports celebrities to head and publicize franchise schemes.

Many people bought franchises, went broke, and lost their life savings.

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.” Franchisor representatives were often “renegade stock and insurance salesmen with shady records.” 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.”

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.” Robert M. Dias, president, National Association of Franchised Businessmen, named “outright fraud” as the problem and offered numerous franchisor fraud examples. The FTC “found widespread deception in the sale of franchises…through both material misrepresentations and non-disclosure of material facts.” 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.’” Freedom of contract meant freedom to defraud.

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.” 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).

Because of the huge franchisor-franchisee imbalance of power and massive franchise fraud, 18 states 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), a CFIL mirror image. MFIL’s main purpose was to remedy perceived abuses by franchisors manipulating, coercing, or lying to unsophisticated potential franchisees.

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. 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. 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

3. Husain, n 2 supra at 869.
4. McCarthy, n 2 supra at p 1087.

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 Bessenese, 433 F2d 861 (CA 8, 1970).
14. Chisum, n 2 supra at 297.
15. Dias Statement, n 8 supra.
18. Bennett, n 9 supra at 136.
24. Id.
25. MCL 445.1502(3).
27. 15 USC 1221 et seq.
28. 15 USC 2801 et seq.

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