Bundy Law Firm PLLC

BUSINESS, FRANCHISE & DISTRIBUTION LAW

113 Cherry St Ste 70482
Seattle, WA 98104-2205
Tel: (425) 822-7888
Fax: (425) 307-6224
www.myfranchiselawyer.com

Howard E. Bundy
bundy@myfranchiselawyer.com

Caroline B. Fichter
fichter@myfranchiselawyer.com

January 5, 2022

North American Securities Administrators Association
750 First Street NE Ste 1140
Washington, DC 20002

By email to:
nasaacomments@nasaa.org
andrea.seidt@com.state.oh.us
dcantone@oag.stte.md.us

RE: Bundy Comments supporting proposed Statement of Policy re Franchise Questionnaires and Acknowledgments dated December 6, 2021

Dear NASAA members:

I write to offer my strong support for NASAA's proposed Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments ("SOP"), released for comment on December 6, 2021. I am a Washington attorney and have focused my practice on franchising for over four decades. I have served on the NASAA Franchise Law Working Group's legal advisory committee since January 1996. I have been an active participant in and commenter upon Federal Trade Commission (FTC) franchise rulemaking since about 1985. I am attaching to this Comment, as Exhibit A, and incorporating by reference, my letter to the Federal Trade Commission dated December 17, 2020, in which I addressed the same issues at pages 7 through 9. Although I have always done transactional work for franchisors, my advocacy and litigation practice has focused on representing the interests of franchisees. Most of my litigation has been based upon claims of fraud in the inducement and omissions of material facts that were necessary to avoid deceit.

NASAA's proposed SOP is one of the most important developments in franchising in 50 years, even though it adopts no new laws, amends no laws, and changes no rules. It is simply a clear statement of NASAA's correct interpretation of existing laws together with an indication that, in a radical change from the past, those existing laws will be enforced.

One of the unfortunate hallmarks of franchising, which has been magnified since 2007, is the ubiquitous "questionnaires", "acknowledgments" and clauses under other more creative names, all of which are nothing but disclaimers: disclaimers of liability; disclaimers of reliance; disclaimers of wrongdoing; disclaimers of misrepresentations; and otherwise, disclaimers of the franchisor's fraud—obtained at a time the franchisee had no clue they had been defrauded, much less how.

These waivers and disclaimers have appeared in obvious response to the twenty-six state legislatures that have adopted by statute some form of the anti-fraud provision of rule 10(b)(5) under the federal securities laws to franchise sales. Although the wording may differ slightly from state to state, the anti-fraud provisions are all, in form and substance as follows:

> It is unlawful . . . to sell or offer to sell by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading, to employ any device, scheme, or artifice to defraud, or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

See ARK. CODE ANN § 4-72-207; CAL. CORP. CORP. CODE § 31201; CONN. GEN. STAT. § 36b-67; FLA STAT. § 817.416; GA. CODE ANN. § 10-1-417; HAW. REV. STAT. § 482E-5; IOWA CODE § 551A.9; 815 ILL. COMP. STAT. 705/6; IND. CODE § 23-2-2-27; KY. REV. STAT. ANN. § 367.815; MD CODE ANN. BUS. REG. § 14-227; ME. STAT. tit. 32 § 4699; MICH. COMP. LAWS § 445.1505; MINN. STAT. § 80C.13; NEB. REV. STAT. § 59-1757; N.D. CENT. CODE § 51-19-11; N.Y. GEN. BUS. LAW § 687; OHIO REV. CODE ANN. § 1334.03; OKLA. STAT. tit 71 § 819; OR. REV. STAT. § 650.020; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-25; TEX. BUS. & COM. § 51.301; VA. CODE ANN. § 13.1-563; WASH. REV. CODE § 19.100.170; WIS. STAT. § 553.41.

For as long as they have had franchise laws, all but one of the franchise registration states have declared any waiver or purported waiver of a franchisee's rights under the act (or of the franchisor's duties) to be a violation of the law and void. These are generally referred to as "non-waiver statutes". CAL. CORP. CORP. CODE § 31512; HAW. REV. STAT. § 482E-6; 815 ILL. COMP. STAT. 705/41; MD CODE ANN. BUS. REG. § 14-226; MICH. COMP. LAWS § 445.1527; MINN. STAT. § 80C.21; N.Y. GEN. BUS. LAW § 687; N.D. CENT. CODE § 51-19-16; R.I. GEN. LAWS § 19-28.1-15; S.D. CODIFIED LAWS § 37-5B-21 and § 37-5B-26; VA. CODE ANN. § 13.1-571; WASH. REV. CODE § 19.100.220; WIS. STAT. § 553.76.[1]

Almost all franchisors now routinely avoid use of either the word "waive" or the word "fraud", but systematically require a prospective franchisee to "acknowledge" or "represent" or "disclaim" the existence of some or all of the elements of fraud. Those are among the specific questions/topics that the SOP would prohibit.

Often, before the prospective franchisee even reads the list of disclaimers, the franchisor, directly or through agents, tells the prospect how they must answer each question "or you won't be approved as a franchisee". They are told that if they do anything to cause delay, they will miss the next training session or that the location will be "snapped up" by another

[1] Please note that some of the non-registration states that have anti-fraud laws applicable to franchising also have anti-waiver statutes. I have limited this list to registration states. The only registration state without a specific anti-waiver statute is Indiana and it has some case law that may have the same effect.

interested party. They are also told that franchising is "highly regulated" and the Franchise Disclosure Document (FDD) has been "approved" by the state and the FTC, and they are an honest company, so of course the requested answers are true. Those answers are never revisited by anyone until the franchisee makes a claim for fraud in the inducement. Then they appear as the first exhibits offered by the franchisor.

Unfortunately, many judges and arbitrators do not understand the nature of franchising,or the nuances of franchise law, and the imbalance of power and legal knowledge between a franchisee and the franchisor, and there are some bad decisions that draw artificial distinctions between an unlawful waiver and a "disclaimer" of reliance or of the existence of some fact. In the best of situations, franchisees must spend tens of thousands of dollars just fighting to get past an initial motion to dismiss based on the waivers. If they cannot pass that initial hurdle, they are denied any remedy for the fraud they suffered, without ever being able to reach the merits, or even to conduct discovery.

As I know you are aware, anytime there is a law standing between a person or company and easy profits, some will choose to comply with the law and others will refuse to comply and will spend incredible amounts of money and energy trying to avoid liability under the law. That is what has happened in franchising and avoidance has become very easy because all one must do is include a long list of disclaimers (which get "approved" by the states) and then it does not matter what misrepresentations or omissions you use to sell franchises. You are effectively immune from liability. Some refer to it as a "get out of jail free card". The whole concept of enforcement of the anti-fraud provisions of the law has become a joke. Franchise salespersons, CEOs and their attorneys gleefully mock those who would comply and boast of their own skill at avoiding responsibility for their fraud and at how franchisees sign hundreds of pages of documents without fully understanding them. I have been told that, not advising clients to include extensive disclaimers, waivers, releases (including "questionnaires") in FDDs is legal malpractice. However wrong that is, it may be true given the current state of (non)enforcement. This is at the heart of virtually every disclosure issue in every Item of the Franchise Disclosure Document.

NASAA's proposed SOP will do more than any other possible action to remedy what is currently wrong with franchising—fraud that causes so many to lose their life savings with no ability to obtain a remedy because they signed a waiver labeled as a "questionnaire" or "acknowledgment". As a result, NASAA will inevitably encounter intense opposition to formally adopting the SOP. I will now address some of the arguments against it.

First Argument: Questionnaire help identify rogue sales people.

<u>Response: It is not the franchisee's obligation to ensure that the Franchisor's employees comply with the law and the Franchise Agreement should not be a compliance document.</u>

Theoretically, this argument has some appeal. In a perfect world, a good franchisor would want to know if one of their agents was violating the rules. In reality, that is seldom the case. With smaller franchisors, it is almost always the founder or CEO who is interfacing with the prospective franchisee. He or she knows exactly what they are doing and they are motivated, by the need or desire for cash, to say whatever it takes to make a sale and to use disclaimers to shield themselves from any consequences. In larger companies, reality is they are driven by sales quotas or targets or by high commissions. Sales staff quickly learn (or they knew from their prior employer) to do what it takes to close deals, to never tell the executive team what is going on, and to be sure to get the disclaimers signed. They become adept at explaining away the disclaimers with comments like: "oh, those are just something the state requires you to sign to be sure I didn't guarantee you a million dollars—you know I didn't make any guarantees". They are made to appear merely incidental to the deal—when, in fact, they become the most important document in defense of claims based on the behavior of the sales staff.

In addition, it is not the franchisee's job to "root out" unscrupulous salespeople—or even to recognize that they are unscrupulous. Virtually every state franchise statute clearly places upon the franchisor the burden of proving that they complied with the law. It is their owners, employees and agents that are committing the fraud. It is their responsibility, as principals, to know about what their sales staff is doing and how. It is the franchisor's job to know about, comply with and make sure their agents comply with the law. Requiring a franchisee to identify bad behavior in the franchise sellers is an inappropriate attempt to shift responsibility from the franchisor to the franchisee. That they are being required to identify bad behavior before they have the knowledge and information necessary to do so is unconscionable.

One of the purposes of every state franchise law is to impose consequences on franchisors if they engaged in fraud or failed to properly supervise their agents as they engaged in fraud on behalf of and for the benefit of the franchisor. Shifting that responsibility to the franchisee completely undermines the legislative purpose.

Second Argument: It is the franchisees who lie.

<u>Response: Franchisees struggle to distinguish between the FDD, the franchise agreement, and what they have been told. Determinations of credibility should be left the the trier of fact not a disclaimer disguised as a questionnaire.</u>

If one looks only at the document trail carefully built by franchisors, it sometimes appears that the franchisee lied. However, it distorts the franchise sales process. Prospective franchisees are groomed for weeks or months to believe that investing in a particular franchise is the answer to their economic and ego needs. They are told how intelligent they are and what good judgment and leadership skills they have. Their egos are stroked at every turn. They are required to make a financial investment very early by purchasing air fare and paying for a hotel room and meals to attend a "discovery day" at headquarters. At discovery day, they meet a bunch of very charming people, they are "wined and dined", and they are shown (but often not provided a copy of) a PowerPoint presentation designed to persuade them that the franchise will bring them success if not great wealth. They are told over and over how many people are lined up to buy and that they need to sign quickly and get scheduled for training or they will miss the opportunity. The significance and importance of the FDD is downplayed dismissively at every turn. Franchisees are kept busy for much of the 14 day waiting period with make-work projects instead of having adequate time to study a 100 plus page document.

The prospects return home from discovery day, emotionally committed (and, of course, they have spent several hundred dollars on travel so they are financially committed as well). They are told and led to believe that everything they have been told verbally is consistent with the information contained in the FDD. Their questions are met with well-rehearsed answers carefully designed to get them to stop analyzing and sign the agreement. By the time they have signed the agreement and are signing the "questionnaire", they truly believe what they have been told and that they have not been lied to. The franchisor has created ambiguity in their mind as to what is the "FDD" and what is not. They just know they have a large quantity of paper and that it all sounds consistent to them. They have been told it is consistent. Based on the information they have been spoon-fed, franchisees believe the statements are true—after all, they were written and presented by their new "partner" who would never do anything dishonest.

Additionally, the disclaimers and acknowledgements are presented toward the end of a hundred or two hundred page document and require franchisees to distinguish between what they were told, what they saw, and what the FDD and the Franchise Agreement say and then independently determine if those statements contradict, supplement or differ from each other. It is an impossible burden.

Finally, in the unlikely case of a crafty franchisee receiving information outside the FDD from a rogue salesperson but cunningly hiding that fact from the franchisor in order to be given the opportunity to invest in a franchise or who invents statements after the franchise fails, the legal system gives franchisors an opportunity to test the franchisee's claims and empowers the trier of fact to make determinations about their credibility. The American legal system is founded on the idea that a trier of fact is best suited to determine which party is telling the truth. It does not need to outsource this obligation to Franchisors and the franchise agreements they write.

These first two arguments against the SOP are part of the fraud itself. They are based, respectively. upon the false premises that a franchisor would walk away from a $50,000 initial fee if they knew their salesperson had materially "oversold" the opportunity; and that prospective franchisees are sophisticated investors and able to discern the subtleties of a 100 plus page document written for people with more than 20 years of formal education[2]. Both premises are untrue and the people arguing against the SOP know they are untrue. The only reason for not adopting the SOP is to continue not enforcing the anti-fraud statutes and to continue ensuring that franchisors are almost never held accountable for the fraud committed by them or their agents.

Third Argument: The SOP is too broad.

<u>Response: The SOP must be broad to prevent circumvention.</u>

Some would argue that the SOP goes too far in both prohibiting certain questionnaires and in requiring the proposed admonition. That is not the case. If you only prohibit certain specific questions, the industry's attorneys will just modify the wording slightly (but enough to create questions in the minds of judges and arbitrators) and continue the same

[2] Note that attorneys, in almost all cases, have only 19 years of formal education.

behavior. If you only require the proposed admonition, those same persons will require franchisees to waive the admonition. This is a situation where the law has been clear for decades, but the industry, as a whole, has ignored and disclaimed it with impunity. If the states are now intent on giving those anti-fraud and anti-waiver laws some teeth, then the states need to send a clear message that cannot be misunderstood or misconstrued and evaded.

In 41 years of representing franchisees, I have reviewed documents for and interviewed innumerable investors and prospective investors. None of them (including a number of investors who were attorneys) have ever understood that by signing the first, third, eighth and thirteenth questions in the always-present questionnaire that they are disclaiming the essential elements of a potential fraud claim. As some of you know, I have sat around the table with attorneys who write such questions and they always argue that their questionnaires should not be construed as "waivers" or "disclaimers"—but, somehow, as just "statements of fact". However, inevitably, when the law partners of those authors appear in response to a lawsuit or demand for arbitration, the very first words out of their mouths are "waiver" and "disclaimer"—asserting that, because the franchisee signed the questionnaire during the honeymoon period, they cannot obtain a remedy for the fraud that was committed at the beginning of the honeymoon. Unfortunately, judges and arbitrators, who almost universally do not understand franchising, often buy the argument and franchisees get their cases dismissed or drastically narrowed before they can even reach the merits.

Fourth Argument: The SOP will kill franchising.

Response: Franchising is a strong and vibrant industry and eliminating the bad actor franchisors will allow it to thrive.

You will hear that the SOP "will kill franchising" and thus "kill the economy". That is, at best, a red herring. The simple response is that, if fraud without consequences is necessary to sustain franchising then franchising ought to be killed. We hear the "kill" argument every time a state takes any action to regulate franchise sales or the franchise relationship. We hear it in court. That boy has cried "wolf" far too many times. In truth, companies have always continued to sell franchises because there is a market for them. That market will continue even if it is cleaned up. I would argue, especially if it is cleaned up.

One of many benefits of the SOP is that it will help to level the playing field in favor of those franchisors who do not want to rely upon fraud to sell franchises. As it is now, the good franchisors are at a distinct disadvantage just because they are honest. It is not unlike the "helmet rule" in football. If one team is routinely leading with the helmet and causing severe injuries to their opponents, the game quickly devolves to where every team does it because you have to "fight fire with fire". By prohibiting and penalizing the act of leading with the helmet, the game has been cleaned up and the playing field is more level. Along the way, a lot less players get life-shortening injuries. Similarly, in franchising, enforcing existing prohibitions against franchisors "leading with fraud" will level the playing field so that good franchisors will feel less pressure to stoop to the lowest common denominator and engage in the same behaviors as the bad ones. It will help avoid untold numbers of bankruptcies, losses of retirement savings, and defaults on Small Business Administration

(SBA) guaranteed loans. It will be good for the economy. Those franchisors that are doing sales right should welcome the SOP because it will benefit them and franchising as a method of distribution. With fewer franchisees failing, it will be easier to sell franchises. Those who oppose the SOP are saying, in essence, that franchising is dependent upon fraud to continue and therefore the states should continue to turn a blind eye to waivers of the anti-waiver provisions of their long-standing state anti-fraud statutes. Permitting those blatant violations to continue completely undermines the legislative purpose of the states—and of Congress in adopting Section 5 of the FTC Act. *See* 15 U.S. CODE § 45.

Fifth Argument: The SOP interferes with integration clauses.

<u>Response: Integration clauses were never intended to facilitate fraud.</u>

A proper integration clause simply says that the written document is the entire agreement of the parties regarding a certain subject matter. Modernly, in franchise agreements, franchisors have added language to what would otherwise be proper integration clauses to also disclaim reliance on facts (often including those stated in the FDD) in deciding to enter into the contract. It has long been the law that integration clauses do not prevent a plaintiff from proving fraud in the inducement, but too often franchisors have been able to use such language to prevent franchisees from proving both common law fraud and statutory fraud. Even in Indiana, which does not have an anti-waiver provision in its franchise statute, the courts have held that an integration clause does not bar fraud in the inducement claims—even if the plaintiff cannot prove that the integration clause itself was specifically fraudulently induced. *Wind Wire, LLC. V. Finney,* 977 N.E.2d 401 (Ct. of App 2012). It would be contrary to the anti-fraud laws and their anti-waiver provisions to permit a franchisor to require a franchisee to disclaim reliance on such information through the device of an expansive "integration clause" that goes beyond integrating the contract and becomes, primarily a waiver of liability for fraud, misrepresentation, or material omission. Such clauses violate the public policy embodied in the anti-fraud statutes. Because of the anti-waiver provisions contained in the franchise laws, such expansive integration clauses should be prohibited and not enforced, but they are often enforced, in what amounts to treating it as a waiver of the anti-waiver provision of the anti-fraud statute.

Sixth Argument: The SOP detracts from contractual certainty.

<u>Response: Appropriate regulation of contracts actually improves contractual certainty and levels the playing field.</u>

You will hear about "sanctity of contract" and "contractual certainty". Both are red herrings. It is well established that governments have the authority to limit the "freedom" of parties to contract. Contracts for an illegal purpose have long been rejected by the courts. *See Armstrong v. Toler,* 24 U.S. 258, 271-72 6 L. Ed. 468, 472 (1826) ("no principal is better settled, than that no action can be maintained on a contract, the consideration of which is either wicked in itself, or prohibited by law"). That was written by Chief Justice John Marshall. Governments regulate insurance contracts, consumer warranties, grave and funeral contracts, automobile dealer agreements; petroleum dealer agreements, agricultural equipment dealer agreements, securities offerings, airline contracts; labor contracts, time share contracts; dating service contracts, multi-level marketing contracts, utility contracts, mortgage contracts, and on and on. No one questions the right of the government, on proper justification, to regulate any of those. Regulation does not impair the certainty of the parties. In fact, it improves contractual certainty because everyone understands the rules and must live within them. Regulation levels the playing field among franchisors as much as it does between franchisors and franchisees. One of the problems we encounter is that a franchisor who wants to do everything right has to compete for prospective franchisees with many franchisors who have chosen fraud as a tenet of their business model. There is immense pressure to move to the lowest common denominator. Water does find its own level, but we have reached the point where the pond is nearly empty.

In conclusion, it is clear that the twenty-six states that have adopted some form of franchise anti-fraud statutes, all modeled after securities rule 10(b)(5), intended by the plain language of the statutes that franchisees should be able to rely upon every bit of information provided and every promise made by the person or company offering a franchise. It is incumbent upon the franchisor or other franchise seller to comply with that honesty in fact requirement while not omitting any facts necessary, in light of the affirmative statements made, to not be misleading.

Recognizing it is a difficult burden, franchisors have it within their power to prove that they told the truth, the whole truth and nothing but the truth. They may be able to prove that, had the franchisee heard the truth, they would have invested anyway. *See Morris v International Yogurt Co.,* 107 Wash. 2d 314, 729 P.2d 33 (1986). The proposed SOP would not "tip the scales" in favor of franchisees. It would simply implement and enforce existing anti-fraud and anti-waiver provisions of the franchise statutes.

No proposal is ever perfect, but the proposed Statement of Policy you are considering may be the most important development in franchising in half a century. I urge you to adopt it as the official policy of NASAA and its member states.

Sincerely,

Howard E Bundy

Bundy Law Firm PLLC

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113 Cherry St Ste 70482
Seattle, WA 98104-2205
Tel: (425) 822-7888
Fax: (425) 307-6224
www.myfranchiselawyer.com

Howard E. Bundy
bundy@myfranchiselawyer.com

Caroline B. Fichter
fichter@myfranchiselawyer.com

December 17, 2020

Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue N.W., Suite CC-5610 (Annex B)
Washington, DC 20580

RE: Franchise Rule Regulatory Review, 16 CFR Part 436, Matter No. R511003

Dear Commissioners:

I am a Washington State attorney. I have devoted most of my nearly 40-year career to representing franchisees—persons who invest in franchises. The record will show that I was very involved in the prior Rule review that concluded in 2007 after more than ten years of effort. I have represented franchisees in litigation and in legislative proceedings. I also have reviewed thousands of Franchise Disclosure Documents (f/k/a "Uniform Franchise Offering Circulars") and consulted with franchisees before they invested. Since 1996, I have served as a member of the Franchise Law Advisory Committee to the Franchise Law Working Group of the North American Securities Administrators Association. Finally, I have represented a number of small regional franchisors in drafting their franchise agreements and Franchise Disclosure Documents and in handling their state registration applications.

Although I will limit my substantive comments at this time to the three issues addressed in the recent workshops and as outlined in the Federal Register Notice, I remind the Commission that I previously submitted a letter dated May 13, 2019 in this matter and ask that all of the issues addressed there be addressed. There are many problems with the Rule as currently formulated and, if we have to wait another decade for the Commission to address them, it could be very harmful to the franchise community, including franchisors, franchisees, their employees, lenders and landlords.

I will address the three issues listed (Item 19 financial performance representations; the use of disclaimers; and the format of the FDD) as follows:

1. Item 19 financial performance representations.

a. Mandate financial performance data.

The Commission should mandate franchisors to provide financial performance data if they have a reasonable basis for it. Information that is accurately, truthfully and fully reported based on the immediately preceding five years based on unaudited reports from franchisees would be deemed to have a reasonable basis if all relevant contextual information is also reported.

Financial performance data is the single most important information to prospective franchisees. They are investing in an effort to make money and, in most cases, would not invest unless they receive some information about how the franchisor's units and/or the units owned by other franchisees have performed. In my experience, if there is no financial performance data in the FDD, franchise salespeople will make their own (usually false) financial performance representations to prospective franchisees. Our firm counsels prospective franchisees and helps them review the FDD. In our experience, a prospective franchisee who is considering whether to purchase a franchise is much more likely to receive illegal financial performance data from a franchise salesperson when there is no financial performance data included in the FDD. For example, my partner recently advised a prospective franchisee who was looking to purchase a franchise that serves pregnant women. The prospective franchisee explained that she was drawn to the franchise because of the strong first year sales and high profit data that that the franchisor shared with her. However the FDD stated that the franchisor did not share financial performance data with prospective franchisees. Ironically, the FDD instructed prospective franchisees to report any unauthorized sharing of financial performance data to the same franchisor employee who had shared the sales and profit information with our client. Approximately one third to one half of all of our prospective franchisee clients have received some type of unlawful financial performance data. Virtually, none of them realize it.

Most franchisees do not understand their legal rights, and few understand how unreliable and unlawful the information they receive is. Yet, as I will address in response to the second question, they are asked to sign vague representations that later get presented as waivers of their right to rely upon the very limited amount of financial performance data they receive.

I understand that, nearly twenty years ago (about mid-way through the prior rulemaking), the Commission rejected proposals to make financial performance data mandatory. The primary reasons proffered for the rejection at that time were that "some" franchisors did not collect it or had no way of determining its accuracy or that it might adversely affect new franchisors without franchisees.

The objections that the Commission adopted almost twenty years ago will always be present because some franchisors will continue to charge flat periodic fees instead of a percentage of gross or net revenues and because some franchisors will not enforce reporting requirements on franchisees. Those types of facts actually support making financial performance data mandatory and can be handled with an explanation and admonition. For example, as to the flat periodic fee franchisors, the Commission could require an explanation and admonition substantially as follows:

> We charge our franchisees only fees calculated as flat [weekly/monthly] fee(s) and no fees calculated as a percentage of gross or net revenues. Therefore, we do not collect information about the gross or net revenues or income and expenses of our franchisees. For that reason, we do not provide you with financial performance data. You should understand that if you invest in a franchise without receiving financial performance data, you are making a very risky investment.

Such a description and admonition would put the franchisor in the position that, if the franchisee later discovers that any statement in the paragraph is false (for example if the franchisor did, in fact collect financial performance data), the franchisee would have a fairly good fraud case, at least in the states with anti-fraud statutes. It would also incentivize such franchisors to find a way, at least as they sign new or replacement contracts, to collect financial performance data.

As to those franchisors who choose to not enforce reporting requirements or who have "legacy franchisees" who do not have contractual reporting requirements, they should be required to disclose financial performance data for the franchisees that have reported during the relevant period and provide a clear factual explanation and admonition substantially as follows:

> Before [date] we entered into franchise agreements that did not require franchisees to report gross or net revenues or operating expenses. We do not have gross or net revenues or operating expense information for any of those legacy franchisees. [number] franchisees still operate under those legacy agreements. Since [date] all of our franchisees have signed agreements requiring them to report gross or net revenues and operating expenses to us. The financial performance data that follows does not include any data from those legacy franchisees.
>
> Or:
>
> We have not enforced the contractual provision requiring franchisees to report to us their gross or net revenues or operating expenses. We have not engaged in selective enforcement. We are limiting the financial performance data that follows to only that from franchisees who have voluntarily complied with their reporting obligations. You should understand that our failure to enforce contractual reporting obligations may leave you with limited ability to make an informed decision whether to invest in a franchise among other things.

Such explanations would clearly inform the prospective franchise that information is missing, why, and the possible consequences of it being missing. They should address the reasons the Commission previously accepted for not mandating financial performance data. This should also incentivize franchisors to enforce reporting requirements going forward so they have accurate financial performance data to report.

Similarly, for new franchisors without franchisees (or company-operated units) that have opened in the previous five years to base financial performance data on, the Commission should require something like the following:

> We, our predecessors, and affiliates, have no franchisees or company-operated units of the type you would be investing in that have opened during the last five years. We have no basis for providing any financial performance information and do not do so.

b. Mandate only limited financial performance data.

Almost no franchisors offer franchises that have been in operation for any period of time, much less fifteen or twenty years or more. To the extent they do, they would be subject to the "exception" now contained in the Rule that permits a franchisor who is selling an operating unit to provide the actual financial statements of that unit to the prospective franchisee outside of the FDD. Because virtually all franchises sold are for new units to be opened (or units that have been open for only a short period), and because the most critical time frame for an investor is the time from opening until the business breaks even, I propose that the mandate require only financial performance data based on those outlets open five years or less (four full years plus the partial year during which the offer is made, to a date within 90 days of the offer date).

c. Permit only limited financial performance data.

For the reasons discussed above, the Commission should permit only financial performance data based on franchises (or company-operated units) opened during the immediately preceding four years plus the partial year during which the offer is made, to a date within 90 days of the offer date. Information about how franchises that have been in operation for longer periods have performed is much more likely to be deceptive than informative of an investment decision.

d. Mandate full disclosure.

Because the information that prospective franchisees need most is information about the "start-up" phase of the business, the very most important information is the performance of similar businesses during the first year. For that reason, the current guidance permitting franchisors to omit the first one to three years of data should be reversed. Some franchisors will protest that the data for the first one to three years is inaccurate or "all over the place." Assuming that is true, that is information franchisees need, in concrete form. They need to understand just how "all over the place" the numbers are. It is also possible, in many cases, that franchisors know that those early numbers show that it takes many months for franchisees to get their economic feet under them—and the franchisors are reluctant to disclose that truth to prospective investors. In all likelihood, it would reveal an implicit inconsistency with Item 7, which suggests, in most cases, that the franchise will be through the "initial phase" (franchisees see that as "breakeven") in three months. Prospective franchisees need to know it has taken others seven months . . . or seventeen months . . . to complete that "initial phase". They need to truly understand how large a reserve of operating capital they need to have in order to get to "breakeven". Their bankers and the Small Business Administration should care . . . but they are betting with taxpayer dollars. There is lots of talk about "cherry-picking", but the arbitrary exclusion of data from the first months or years of operation is the worst kind of cherry-picking. Exclusion should not be an option. In fact, for the first full year plus any partial year, to a date that is within 90 days of the "issuance date", the financial performance data should be broken out on a monthly basis. Only if franchisees have that data can they truly make an informed decision to invest.

e. Mandate Profit & Loss format.

Virtually every business, for tax and business purposes, uses a balance sheet and either a "profit and loss" (sometimes referred to as "income and expense") statement. Most franchise agreements in existence in 2020 require franchisees to maintain them and to provide copies to the franchisor. The Commission should require that financial performance data be provided to prospective franchisees in a simplified standard format, substantially as follows:

Gross or Net Revenue (whichever percentage fees are based on)
- Cost of goods
- Labor
- Occupancy Costs (rent)
- General and Administrative Expenses
- Fees required by franchise agreement (itemized)

EBITDA (Earnings before interest, taxes, depreciation, and amortization)

This gives prospective franchisees a common format that will facilitate comparing between franchise offerings and that their advisors may be able to understand. It should also be noted that this level of disclosure is probably required today by the anti-fraud laws of approximately twenty-one states. Most franchisors who give "revenue-only" financial performance representations are omitting relevant information that franchisees need in order to make the revenue figures not misleading—thus violating state anti-fraud laws and Section 5 of the FTC Act. The Commission should avoid giving franchisors false comfort that it is safe and acceptable to provide just revenues.

The Commission should consider either permitting or requiring that all numbers in the Profit and Loss disclosure below the "revenue" line be percentages (of the revenue number). In my view, that makes it easier for franchisees to understand and use. I would suggest requiring four categories for each year: Low, Median, Average and High. I would recommend a separate table for each of the previous four years (plus a partial year for the offering year current within 90 days of the offering date). For each year, the respective table should clearly indicate the period of time covered, the total number of relevant outlets (opened during each year or partial year), the number of outlets included in the data, and the number and/or percentage of outlets achieving each amount of EBITDA.

Some franchisors will argue that the reports they receive from franchisees are skewed because of tax avoidance expenses entered by franchisees. In other words, they will argue that some franchisees will expense a car or cell phone that is not truly used in or required of the business. Franchisors could be permitted, if they have a reasonable basis, to exclude such entries and amounts from EBITDA and, instead to list them in an additional line below the EBITDA line, entitled, in substance "Expenses not necessary to the franchise". They would have a reasonable basis if they required franchisees to segregate those entries.

Some franchisors (e.g., hotels) will argue that EBITDA is irrelevant to investment decisions in their industries (I do not believe such claims) so the Commission may want to permit them, in addition to the standardized Profit & Loss formatted presentation, to separately (but within Item 19) provide such other data that they believe is more important to their prospective investors.

f. Mandate contextual relevance disclosure.

Every franchisor knows, or reasonably should know, who their customer base is and where, geographically, the businesses they are offering as franchises are likely to perform well, or not. They know whether certain demographics or the weather or certain cultural or regional factors affect the business. It should be mandatory to disclose such facts if they are known. If they are not known, that should be clearly stated, with an admonition in substance:

> We [and/or our franchisees] have only operated businesses like you will be investing in in [describe]. The [franchisor tradename] franchise is untested in other locations and circumstances. We do not know whether geographic, demographic or cultural factors will affect your ability to make a profit.

The disclosure should not be limited to just geography, demographics and cultural factors, but should identify any and all contextual factors known by the franchisor to materially affect the business. Franchisors may argue that requiring such a disclosure will limit their ability to enter new markets. That is not true. Such a disclosure would provide prospective franchisees with a clear picture of the challenges they might face and the possible rewards. Some prospective franchisees would see an advantage of being a pioneer in a new market. Requiring franchisors to disclose to prospective franchisees that they will be a pioneer in their market serves the ultimate goal of the FCT by requiring franchisor to provide the information necessary for the prospective franchisee to make an informed decision.

g. Mandate phase-in.

Although the Commission should encourage franchisors to comply with the entire mandate immediately (they will probably have had several years while the revised Rule is being formulated and adopted to adjust), the Commission could provide for a three-to-five-year phase-in of the format requirement, and, perhaps, of the mandate itself. That gives franchisors time to make any necessary changes to the franchise agreements being offered to new prospects in order to collect the information needed to comply or to enforce reporting requirements and gather the information needed. Because the disclosure of financial performance data would be limited to the most recent five years, the burden of collecting and presenting old information would be reduced.

A stated goal of the Commission for the Franchise Rule has always been to provide franchisees with information they need in order to make an informed investment decision. Everyone knows, and most agree, that financial performance data is the most important piece of information in making such an informed decision. Indeed, it challenges credulity to suggest that any prospective investor could ever make an informed decision on a franchise without reliable and accurate financial performance data. The Commission has the ability and power to require disclosure of this essential piece of information and should do so at the earliest possible time.

h. The old Rule has failed franchisees.

The existing Rule (as revised in 2007/2008) has failed franchisees, particularly in its approach to financial performance data disclosures. Although the raw number of "voluntary" financial performance representations has increased, the number that are deceptive, or outright fraudulent, has increased exponentially. We review many FDDs every month and, after a bit of experienced scrutiny, it is very rare to find an Item 19 that is not deceptive.

It is a simple matter. Franchisors paint only the picture that they think will most encourage prospective franchisees to invest. They make statements that are factually true and rely upon that (and the disclaimers to be discussed in response to question 2) to serve as a shield against any claims the franchisee may later make. However, it is the omission of material information where many, if not most, Item 19 disclosures get into trouble. They disclose high revenue numbers that, while true, omit the full truth—that they were achieved after ten or twenty years of operation and in areas of the country where there was a high density of franchisees. They don't mention that even those highly successful "mature" franchisees took three to five years to break even—and that many of their peers failed.

Additionally, franchisors (with the tacit, if not express, approval of the FTC and the state regulators) routinely omit the first one to three years of data and only show the data for franchisees that survived the first two or three years—in the face of data from Franchise Grade (web site at www.franchisegrade.com) showing a very high percentage of franchisee failures during those first few years. We are familiar with one franchise system in which more than 50% of the franchisee owned units failed in the first two years. By excluding that data and, at the same time blending in data from very mature franchisees, franchisors succeed in skewing the historic performance numbers, so they are deceptively favorable. Meanwhile, franchisors are permitted to further hide the early year failure rate because of the current limitation contained in Item 20, in which franchisors only disclose the identity of those franchisees that have left the system during the last year. That means that, if the franchisor can nurse franchisees along until after one year, they never have to give the name and phone number of a failed franchisee. There is no way for a prospective investor to even find out that the failure happened, much less to talk with the failed franchisee to find out why. If they do reach the former franchisee, more likely than not the franchisee will have signed a contract to not talk to anyone about their experience. I realize that Item 20 is beyond the

Commission's current scope, but it should be addressed as part of fixing Item 19 because they work hand-in-glove.

Similarly, the current Rule fails franchisees because it has been construed and enforced in such a way that permits franchisors to require franchisees to sign disclaimers and waivers, some of which are deceptively vague—until they are presented to a judge or arbitrator. I will deal with those separately—in response to the Commission's second question—because they are a problem throughout the FDD, not just Item 19.

2. The use of disclaimers.

I will use the word "disclaimers" to describe things normally called "disclaimers", "waivers", "acknowledgments" and "questionnaires," among other labels. The purpose of all of them is to obtain a franchisee's written agreement to waive any and all claims of fraud against the franchisor before the franchisee can possibly learn of the fraud or understand the legal effect of the disclaimers. They are designed to give franchisors a "get out of jail free" card. They result in no person or entity being subject to being held accountable for even the most egregious and obvious of fraud.

In our practice, illegal financial performance data presented outside of Item 19 or deceptive financial performance information presented in Item 19 is endemic to franchising. In one study, 83% of franchisees reported receiving statements "related to sales, costs, and profits that were not included in the FDD."[1] However, the widespread defensive use of disclaimers means that franchisors can write their defense to fraud claims into the franchise agreement.

a. What is a disclaimer?

A disclaimer may or may not contain the word "disclaimer", "waiver", or any other particular key word. A disclaimer is any contractual language that seeks to shield a franchisor from liability for statements made by the franchisor or its agents that turn out to have been false or misleading or that omitted material information necessary in order to make what was said, although it might have been truthful, not misleading. It is essentially any language written with the intent of mitigating the franchisor's risk of liability to the franchisee for its own or its agents' fraud.

Disclaimers appear throughout the FDD, including in the franchise agreement and in the nearly omnipresent "questionnaire" that usually precedes the receipt. They are almost always carefully written to appear on the surface as if they are not a disclaimer, but their true character suddenly appears the instant a franchisee asserts a claim for fraud. When we, as franchisee counsel, send an opening letter to a franchisor to let them know our client is about to assert a claim, inevitably the first response, by telephone or email, from franchisor counsel argues that any such claims were waived by the disclaimers in the FDD. That is the first time anyone from the franchisor ever mentions the purpose of the language.

b. How are disclaimers used?

The true scope of the purported waiver claims based on the disclaimers does not surface until the franchisor files the inevitable motion to dismiss—based on the disclaimers. In preparation for this letter, I searched our files for examples. Unfortunately, most franchise cases are brought in arbitration and most of the arbitration rules (or the franchise agreement) impose confidentiality

[1] Caroline Fichter, Andrew Malzahn, and Adam Matheson, *Don't Tread on Me: A Defense of State Franchise Regulation*, 38 FLJ 32 (2018)

obligations on the parties and counsel. In both arbitration and in court cases, it is quite routine for franchisor counsel to obtain a protective order early in the case, purportedly to protect their “trade secrets”. In reality, they wind up marking virtually every document, including court exhibits and pleadings, “confidential” and subject to the protective order. The net effect is that it is very rare to find these motions to dismiss and other documents that can be shared with the Commission. We did find one such motion, in a case in Clark County Washington Superior Court where one early motion to dismiss and its supporting declaration were not marked “confidential”. I am attaching to this letter, as Exhibit A, a copy of relevant excerpts from that motion and a supporting declaration. It will show the Commission how, in one case, franchisor counsel tried to argue that the franchisees had waived all of their fraud claims by signing disclaimers that were in the FDD.

It is noteworthy that, in Exhibit A, counsel for the franchisor characterized the disclaimers as “warnings,” a word that appears nowhere in Exhibit A except in the argument of counsel. For the reader’s convenience, I have highlighted the portions of the copy of the FDD contained in Exhibit A that appear to be argued by counsel to be disclaimers. The first “disclaimer” appears on page 16—the integration clause. Integration clauses are widely used to try to not only bar verbal changes to a contract, but to go far beyond and bar claims of fraudulent inducement. The next disclaimer noted is on page 20 and is a paragraph that, in essence says that “results may vary”. That is followed by a statement to the effect that “we don’t represent you can do as well as we tell you above . . your success will depend on your ability”.

The next stop in the disclaimer tour is page 24 of Exhibit A where the franchisee is asked to represent that he or she has been told nothing by anyone that is not contained in the FDD. The typical FDD is 50 to 150 pages. By the time the franchisee signs the paragraph on page 24 of Exhibit A, the franchisee has been through hours of presentations and telephone calls and conversations with multiple franchisor representatives. There is no possible way to cross reference every verbal statement or even every written statement in every PowerPoint deck or webinar. As with the maternity services franchise mentioned above, frequently the person making the illegal financial performance representation, the person walking the franchisee through the FDD, franchise agreement and disclaimers is the same individual. Other times, it is a highly placed executive or the CEO of the franchise. It is unrealistic to expect a prospective franchisees to recall each and every communication with the franchisor, balance those statements against the information in the FDD, discover any inconsistencies or inaccuracies and consider whether or not every franchisor employee from their salesperson to the CEO has lied to them. They have no idea that they were given inconsistent and untrue or deceptive information. They certainly have not yet learned how key information was omitted.

At page 27 of Exhibit A, the “Statement of Franchisee” (often called “Questionnaire”) begins. As with the language on page 24, the language on page 27 asks the franchisee to sign a long list of legal conclusions masquerading as statements of fact, each of which is designed to enforce and reinforce the franchisee’s waiver of any fraud claims. Each of the statements in this example are superficially benign enough that most franchisees, most of whom are not experienced franchise attorneys, do not recognize them as disclaimers. In fact, many judges and arbitrators, in my experience, do not recognize them as such, but regard them as “statements of non-reliance” or something similar. At the end of the hearing, the effect is the same—to limit, reduce or mitigate the franchisees’ ability to hold the franchisor accountable for its fraud and deceit.

Keep in mind that, by providing only excerpts from a document that was approximately 100 pages and by highlighting the offending language, I am, effectively making it a lot easier for you to spot the disclaimers and to understand them than it is for a franchisee who has never seen a legal document anywhere near this length and complexity.

c. What can be done about disclaimers?

The Commission probably has only two tools at its disposal to try to control disclaimers. First the Commission could prohibit them; second, the Commission could mandate some corrective language.

Unfortunately, my advice to the Commission is that prohibitions alone do not work in this context. Some of the most brilliant contract lawyers in the world work in the franchise sector and they will find creative ways to draft around any prohibition. They have proven that by even finding ways to disclaim non-waivable statutory rights—and often the disclaimers work in court or arbitration. Just by creating a vague paragraph that allows them to argue that the franchisee has disclaimed rights or disclaimed reliance on certain information can make it difficult or impossible for a franchisee to hold the franchisor accountable for fraud. The problem is exacerbated by the willingness of many arbitrators and judges who, collectively, have a certain dislike of regulation and remedial statutes, to seize on any hint of a disclaimer as a means of denying franchisees a remedy.

Rather than trying to write a prohibition that would be effective, I propose the Commission issue a prohibition in the Rule and buttress it by requiring a statement to be added to the FTC Cover Page and to the Receipt Page (and, preferably to any other page of the FDD that contains "statements, questionnaires, or disclaimers") substantially as follows:

> The Federal Trade Commission prohibits any contract terms or statements that have the effect of limiting any franchisee's right to rely on any information provided by or on behalf of the franchisor or that could be interpreted to limit the franchisee's right to a remedy for fraud, deception or violation of any statute. Any such terms, to the extent they might be interpreted to impose such limits, whether within the FDD or a separate document, are void and unenforceable and a violation of the FTC Franchise Rule.

d. The old Rule has failed franchisees.

The Commission's stated purpose, since 1972, in having the Franchise Rule, has been to ensure that franchisees are provided with reliable information that they need so they can make an informed decision. Unfortunately, under the laisse faire approach that has evolved, franchisors are routinely giving franchisees information that is false or deceptive and omitting information that the franchisees need in order to not be deceived by what was given. By the simple expediency of requiring franchisees to sign superficially benign statements written in complex legalese, that can later be argued to be disclaimers of any responsibility on the part of the franchisor, franchisees are left to lose their substantial investments and have no remedy by which they can hold anyone accountable for their fraud. Yes, there are a few examples of franchisees being successful in litigation. However, the vast majority of claims get dismissed in the early stages or never get brought because franchisees do not have the resources left to pursue what is an expensive case to try to overcome the disclaimer defense, particularly given the odds of their case being promptly dismissed.

The Commission has properly focused on this crucial issue and I am hopeful that the above explanations and analysis will help in providing the protections for franchisees and their investments that the Commission has intended, consistent with Section 5 of the FTC Act.

3. The format of the FDD.

a. Problems with the current format.

The format of the FDD has not changed materially since its predecessor, the Uniform Franchise Offering Circular was adopted in the 1970s or early 1980s. It remains densely written legalese printed in black ink (or its PDF equivalent) on white paper (or its PDF equivalent). It has a linear structure, only an abbreviated table of contents, and a large number of multi-page exhibits or attachments that often are not organized so that they can easily be found. They contain no digital links and seldom have tabs (or the PDF equivalent). FDDs share many of the problems of the traditional prospectus in the securities context, except they tend to have less indexing.

We continue to hear reports, or at least opinions that franchisees do not read FDDs. Although, in our experience, most franchisees do try to read them, it is largely a futile effort—because the documents are structurally impenetrable to people who are accustomed to getting information by use of modern technology. In addition, franchisees simultaneously receive large amounts of information from franchisors via modern technology. That information if formatted in a readable fashion, presented with graphics, and easily accessible—via the franchisor's web site, and various webinar systems. It has all the modern navigational tools. Because it is more accessible it is easy to focus on it and that becomes the source of most of the information used to make the investment decision. It is easy to skim through the dense and difficult FDD just to satisfy themselves on a superficial level that they did their "due diligence". When nothing jumps out as being blatantly different, they put it aside. It is like asking a modern American to read and understand the magna carta in a PDF copy of the original.

Even if a prospective franchisee understands the information in the FDD, it is almost certain that they will not understand the legal aspects of the franchise agreement. Most non-lawyers do not understand what an integration clause means or what liquidated damages are. The majority of prospective franchisees do not hire an attorney to help them review the FDD and the franchise document. Many are actively discouraged from doing so by franchise sellers. In one study, only 48% percent of prospective franchisees had any attorney help them review the documents.[2] Another survey found that franchisees were represented by counsel just 26% of the time and even when franchisees were represented it was often by general practitioners unfamiliar with franchise law.[3]

This is a reality the Commission was able to ignore when key decisions were made in the 1990s leading to the 2007/2008 Rule revision. The Commission should not ignore it this time. Failing to address it would mean another decade or more of prospective franchisees receiving information in a format and through a medium that makes it unlikely to be useful in accomplishing what the Commission has sought to do—protecting franchisees' investments by insuring they get the information they need to make an investment decision. If the delivery document is not accessible by the average person, it is a waste of effort and a disservice to prospective franchisees.

b. Achievable goal.

Now compare that, essentially, paper document to how people in 2020 get the most important information that they use and rely on daily. Few homes even receive a paper newspaper. News magazines are either primarily online or gone. Software manuals and appliance manuals are online

[2] Supra at 1.

[3] Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 SAN DIEGO L. REV. 709, 718 (2014)

and searchable. Even building plans and construction drawings are digital. FDDs are one of the last remaining vestiges of an archaic communication medium—the "buggy whip" of franchising.

It is time for the Commission to move the franchise industry into the twenty-first century. I envision, ultimately, having FDDs so digital that they would be accessible on the tablets or smart phones that most people in the world rely upon for information. They could and should be written and organized in such a way that the reader could quickly find information that is important to them (or they could start at the front and read to the end if that was their style). Throughout the document the reader could be presented with tools (such as links) that would allow them to drill down to additional information on something that was extremely important. By way of example only, if the reader was in what is now Item 7 and wanted to see what the notes say about the amount of working capital needed, the information would be a click away, not buried in several pages of dense black text. Ultimately, the franchisee could be given the ability to drill down to information they currently do not have because of the Commission's fear of "bulking up" the document. For example, in Item 19, the franchisor could be required to provide a link to the "substantiating information"; in Item 13, the franchisor could be required to provide a link to the license agreement between the trademark owner and the franchisor; and on and on.

c. Practical steps toward a more accessible FDD.

I understand that it is not realistic to go instantly from the archaic format we have today to the ideal of an accessible and transparent FDD that people would actually access, read and understand using the modern tools we use in the rest of life. My proposal is that the Commission take "baby steps" and send a clear signal that it wants the industry to use some of its creativity to collectively create a better disclosure vehicle.

A good starting place would be to require all FDDs to be electronic, to use PDF format and to be published in a way that they are "searchable" using commonly available PDF reader software. "Bookmarks" should be mandatory, down to the Item level for the FDD and to the paragraph level for all contracts. Tables of Contents should be mandatory and should be linked to the relevant pages. Any internal cross reference, such as to another Item, to a contract, to an exhibit or attachment, or to a "note" should be linked. All of this could be done with current technology that every franchisor and every law firm use daily. The incremental cost would be negligible, and documents would be substantially more accessible. The Commission could and should immediately put an end to franchisees being given FDDs in literally the PDF equivalent of a paper document with no navigational tools.

At the same time that the Commission takes these immediate "baby steps", I recommend the Commission give clear notice to the franchise community that it will be collaborating over the next three to five years with all of the stakeholders and will then adopt a further revised format regulation requiring a fully accessible and usable FDD utilizing current technology. In that way, the stakeholders would have a voice and the Commission would have contributions from some of the top minds in franchising in devising a new format that will more effectively accomplish the mission of giving prospective investors the information needed to make informed decisions. It would also give opportunities for those stakeholders to secure whatever technology or tools they might need to produce future FDDs in whatever format(s) the Commission requires.

d. Substantive format issues.

Although it is not clear that the Commissions use of the word "Format" contemplates more than the accessibility issues addressed above, it is important to consider what I characterize as "more substantive" format issues. Although converting all FDDs to an accessible format by requiring certain immediate features and setting out a roadmap for full digitization would probably, eventually, take care of many of these substantive format issues, in reality, that conversion process will take at least a decade. It makes more sense to deal with some of the needed structural problems now.

i. Problems with the current format.

First, the current practice is to write FDDs using such advanced English that most people, with a normal vocabulary cannot understand it. The Commission is probably aware of the study some years back suggesting that comprehension of an FDD would require more years of schooling than the average lawyer has. In fact, I can say that I have had lawyers for clients who had little better understanding of the FDD they were looking at than did clients who had worked their lives as plumbers. The Commission can and should mandate that FDDs be written so that a person with a high school education could read and understand them.

Second, the current FDD structure is such that it appears to be calculated to bore the reader to death before they get to anything that appears to matter. Franchisees want and search for one thing: numbers. Those numbers need to be moved much closer to the front of the FDD.

Third, the contents of the FDD are organized in what appears to be a mostly random manner. I recommend that information of similar kind be grouped together in sections.

ii. Proposed more logical presentation of information.

(1) The first section should be very short. It should just describe the franchise being offered, the customers of the franchised business, and who the competitors are. The remainder of what is now in Item 1 should go elsewhere (see paragraph (3) below).

(2) The second section of the FDD (It need not be designated as such) would be what is now Items 5, 6, 7, 19, and 20—the "numbers Items". They should be reorganized so as to give the prospective investor a clear picture of the fees they have to pay to the franchisor and affiliates, the true amount of the total investment they will need to make, and the financial performance data that I have suggested being mandated (see question 1, above). I would also suggest including what is now Item 10 (financing) as part of this second section—because that is part of the "numbers" the franchisee needs.

As to what is now Item 20, it should have an expanded disclosure of franchisees who have left the system during the last 5 years. As to the list of current and former franchisees, I recommend requiring disclosure of last known email address(es) in addition to telephone numbers. This will make it easier, as those email addresses are later formatted as links, to communicate with current and former franchisees. As to the tables in Item 20, the Commission needs to try to find a solution to the manipulation of numbers that currently happens in some systems—where franchisors avoid disclosing failed or closed franchises by separating the franchise from the business and then "reselling" the franchises on a "secondary market" in a manner that it shows up as a "transfer" rather than the failure it was. I do not have a solution, but I urge the Commission to try to address it.

(3) The third section would be what is now the balance of Item 1 and Items 2, 3, and 4 (the "who you are dealing with Items"). As to Item 3, the Commission needs to make it more clear that arbitration decisions and settlements (where the franchisor pays or gives up valued claims or rights) are subject to disclosure. They are currently often not disclosed.

(4) The fourth section would be what is now Items 8, 11, 15, 16, and 17 (the "Operational Items"). As to what is now Item 11, I recommend splitting it into two Items (it could replace Item 9 which is obsolete and of no value). The first Item 11 should be limited to a list of those things the franchisor is contractually obligated to provide before opening, a list of those things the franchisor is contractually obligated to provide after opening, and a separate list of those things the franchisor provides or plans to provide but is not contractually obligated to perform. This is where the training table should go if the franchisor is contractually obligated to provide it. The lists should be distinct with no overlap. When there is a contractual obligation, there should be a link to the contract provision or paragraph that contains the obligation.

The second Item 11 should be a list of those things the franchisee is obligated to do before opening and a separate list for those things the franchisee is obligated to do after opening. This could be where the technology requirements are disclosed. Item 11 has become a bit of a dumping ground for miscellaneous disclosures. Those should be moved into appropriate categories which, in some cases, might be a subsection of either the first or second Item 11 (or both as appropriate) for "miscellaneous disclosures". It might even make more sense to rename what is now Item 18 (currently "Public Figures") to "Advertising and Miscellaneous" and deal with public figures (rarely used) in the same Item as some of the miscellaneous disclosures now included in Item 11 but with would not fit into the new construct. This might include the timing disclosures, advertising, cooperatives, and other things that don't fit elsewhere.

I have already mentioned that Item 9 should be eliminated. All it accomplishes is to put the reader to sleep. By the time they reach that point in the document, they either have figured out how to find things or they are hopelessly lost. Without links, it is just a page of meaningless gibberish. It takes up a valuable two pages that could and should be used for a better organization of the information presented in what I have referred to as the "Operational Items".

(5) The fifth section would be what is now Items 12, 13 and 14 (the "Territory and Intellectual Property Items"). Although an argument could be made that what is now Item 12 should go into the "Operational Items" section, I think it fits well here in conjunction with the other things the franchisee gets the right to use.

(6) Finally, the sixth section would be what is now Items 21, 22, and 23, in the same order they are now in. All of those Items are just placeholders (links, if you will) to exhibits or attachments to the FDD.

By re-ordering the information contained in the FDD so that the most important information for franchisees is closer to the front and so that similar or related information is grouped together, the FDD would become more readable and more accessible even while the FTC makes decisions on how to move to full digitization. Franchisees will be more likely to read more of the document and to understand the context because they can quickly get to meaningful and desired information. We have been trained for decades now that, if we don't find information that engages us in the first few seconds of looking at a web site, we click on the next one and never drill down to figure out what someone might have been offering. By engaging their attention—with the numbers—near the front of the book, we should improve the "stickiness" of the FDD and keep their eyes on it, hopefully all the way to the end. By keeping related information together, the reader can see the full presentation, instead of the current design where they have to remember that there was related information earlier and then flip back and find it.

In summary, my focus as to the three issues on which the Commission has sought comment is: (a) franchisees need complete and accurate financial performance data and it should be mandatory; (b) franchisors should not be permitted to shield themselves from their own fraud by burying disclaimers in the documents the franchisee will sign; and (c) in order to remain accessible and relevant the Commission needs to bring disclosure into the 21st century by requiring certain technologies and by re-ordering the FDD's presentation of information in the meanwhile to make it more relevant and readable.

I remain available to assist the Commission in its efforts.

Sincerely,

Howard E Bundy

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF CLARK

LMP Enterprises LLC, *et al.*, Plaintiffs, v. PAPA MURPHY'S INTERNATIONAL LLC, *et al.*, Defendants.	Case No. 14-2-00904-0 **MEMORANDUM IN SUPPORT OF THE PAPA MURPHY'S DEFENDANTS' MOTION FOR SUMMARY JUDGMENT ON THE CLAIMS OF PLAINTIFFS HEATHER AND GARY NYCHYK AND BAR-N, PIZZA LLC**

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
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20. The Item 19 financial performance representations also included a chart of the average sales, discounts, and expenses of 27 company-owned Papa Murphy's stores that operated during the entire fiscal year ending January 3, 2011. (FDD at NYC-0000124-125.) The stores were ranked by average net sales and then divided into three categories (High, Medium, and Low) with the same number of stores in each category. (*Id.*) The chart showed stores in the "High" category spent an average of 8.7% of net sales on advertising, stores in the "Medium" category spent an average of 10.7% of net sales on advertising, and stores in the "Low" category spent an average of 12.7% advertising. (*Id.*)

21. Nychyk admits that after reviewing the FDD, he knew his advertising expenditures might be 12.7% of net sales. (Nychyk Dep. 117:3-6.)

22. Item 19 also included warnings and disclaimers advising Nychyk that a variety of factors would influence his potential performance as franchisee:

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805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

The amount of sales realized and costs and expenses incurred will vary from store to store. The sales, costs and expenses of your Franchised Store will be directly affected by many factors, such as the Franchised Store's size, geographic location, menu mix, and competition in the marketplace; the presence of other Papa Murphy's Stores; the quality of management and service at the Franchised Store; contractual relationships with lessors and vendors; the extent to which you finance the construction and operation of the Franchised Store; your legal, accounting, real estate and other professional fees; federal, state and local income, gross profits or other taxes; discretionary expenditures; and accounting methods used. You should, therefore, use this analysis only as a reference to conduct your own analysis.

You should particularly note the following:

You are urged to consult with appropriate financial, business and legal advisors to conduct your own analysis of the information contained in this section.

The table of Company Stores' sales and average food and labor costs is not based upon the actual experience of Franchised Stores. The sales and average costs reflected in the analysis are of certain company-owned and operated stores and should not be considered as the actual or potential sales, costs, income or profits that you will realize. We do not represent that any franchisee can expect to attain the sales, costs, income or profits described in this section, or any particular level of sales, costs, income or profits. In addition, we do not represent that any franchisee will derive income that exceeds the initial payment for or investment in the Franchised Store. The individual financial results of any Franchised Store are likely to differ from the information described in this section, and your success will depend largely on your ability. Substantiation of the data used in preparing this analysis will be made available on reasonable request.

(FDD at NYC-0000125-126.)

23. Item 20 of the FDD, entitled "List of Franchise Outlets," identified the states where PMI franchises were located and the number of franchises in each state. (*Id.* at NYC-00131-134.) Table No. 3 in Item 20 showed that of the 1,206 total franchises in the Papa Murphy's system, just 7 were in Florida. (*Id.* at NYC-0000131.) One Florida location opened in 2009 and the rest had just opened in 2010. (*Id.*) There were no company-owned stores in Florida. (*Id.* at NYC-0000135.)

24. Exhibit B to the FDD listed the name of every current PMI franchisee and the address and phone number of each of their stores as of the end of the prior fiscal year. (*Id.* at NYC-0000142-186.) Exhibit B also listed the names and last known home

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that the stores in the "High" column were "stores primarily in mature markets" and in areas familiar with the PMI concept. (*Id.* ¶ 38.)

The Nychyks cannot show that they relied on the "Existing Store Performance" chart because they had full knowledge of the information that they claim was concealed by PMI. The Nychyks also cannot establish that they were "ignorant of the alleged falsity" before they decided to buy their franchise. PMI is entitled to summary judgment on the Nychyks' fraud, misrepresentation, and FIPA claims relating to the Item 19 disclosure.

2. <u>The Warnings in the Nychyks' FDD Preclude Reasonable Reliance</u>.

As a separate ground for summary judgment, the Nychyks had no right to rely on the average sales figures contained in Item 19 to project their own future financial performance because the very same document repeatedly warned them that individual store performance would be impacted by many variables. Item 19 included warnings advising the Nychyks that a variety of factors—including geography—would influence their performance as franchisees. (SOF ¶ 22.) For this reason, a prospective franchisee needs to perform its own due diligence rather than simply rely on select information contained in the FDD and Item 19. As a matter of law, a franchisee cannot reasonably rely on Item 19 financial performance representations to project its future results if that document also warns that the performance representations may not be representative of its actual or potential financial results. *Yogo Factory Franchising, Inc. v. Ying*, CCH Bus. Franchise Guide ¶15,291 (D. N.J. May 5, 2014) (reasonable reliance on Item 19 barred by warnings in FDD); *Avon Hardware Co. v. Ace Hardware Corp.*, 998 N.E.2d

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805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

1281 (Ill. App. Ct. 2013) (same); *Colo. Coffee Bean, LLC v. Peaberry Coffee Inc.*, 251 P.3d 9, 19 (Colo. Ct. App. 2010) (same); *Sherman v. Ben & Jerry's Franchising, Inc.*, 2009 U.S. Dist. LEXIS 72663, at *7-12 (D. Vt. Aug. 10, 2009) (same).

For example, in *Sherman v. Ben & Jerry's Franchising,* the franchisees alleged that the franchisor fraudulently induced them to buy a franchise by misrepresenting financial performance in Item 19, in particular data of existing franchisees' average and median gross sales and variable costs. 2009 U.S. Dist. LEXIS 72663, at *3, 6. However, the Uniform Franchise Offering Circular[7] in *Sherman* provided:

> The information set forth in this Item 19 aggregates the gross sales and key variable cost percentages of individual Scoop Shops. It should not be considered as the actual or probable sales or costs that may be realized by any franchisee. We do not represent that any franchisee or Scoop Shop can expect to obtain the reported results. Actual results vary from Scoop Shop to Scoop Shop, and we cannot estimate the results of any specific Scoop Shop. A new franchisee's Scoop Shop results are likely to differ from those of established Scoop Shops. We recommend that you make your own independent investigation and evaluation of the potential performance of your Scoop Shop, and consult with your attorney and other advisors before signing any franchise agreement. . . . Actual results are dependent on a variety of internal and external factors, none of which either we or a franchisee can estimate, such as competition, taxes, the availability of financing, general economic climate, demographics, weather, changing consumer preferences and the franchisee's own commitment to the business.

Id. at 9-10. The court held that the plaintiffs' reliance on Item 19 was unreasonable as a matter of law because "[w]here a seller expressly disclaims any express or implied warranty concerning specific representations, and a buyer expressly acknowledges the disclaimer and the need to conduct an independent investigation, that party may not sue

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[7] The FDD formerly was referred to as a "Uniform Franchise Offering Circular" or UFOC.

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on a claim she was defrauded into entering the contract in reliance on those very representations." *Id.* at 10-11. Other courts have reached the same result. *Yogo Factory Franchising*, CCH Bus. Franchise Guide ¶15,291; *Avon Hardware Co.*, 998 N.E.2d 1281; *Colo. Coffee Bean*, LLC, 251 P.3d 9.

Like the FDD in *Sherman,* PMI's 2011 FDD explicitly warned the Nychyks not to expect any particular level of sales or profits and that their results would vary depending on a variety of factors, including but not limited to geographic location. (SOF ¶ 22.) Contrary to these warnings, the Nychyks claim they relied on PMI's Item 19 to project what their store sales would be. (Nychyk Dep. 205:2-7.) As a matter of law, the Nychyks could not reasonably rely on Item 19 for that purpose.

3. **The Warnings In the Nychyks' Franchise Agreement Also Preclude Reasonable Reliance.**

For the same reasons, the Nychyks had no right to rely on Item 19 to project their anticipated sales because doing so also was directly inconsistent with the language in the Franchise Agreement. *Moxie Venture L.L.C. v. UPS Store, Inc.*, 156 F. Supp. 3d 967, 970 (D. Minn. 2016) ("the Franchise Agreement firmly establishes that even if [franchisor] made misrepresentations in connection with the sale of [franchisee's] franchise, [franchisee] did not rely upon any of them and, if it did (contrary to the express terms of the Franchise Agreement), such reliance was unreasonable as a matter of law"); *Sherman v. Ben & Jerry's Franchising, Inc.*, 2009 U.S. Dist. LEXIS 72663, at *10-11 (reasonable reliance on Item 19 barred by franchise agreement disclaimer); *JM Vidal, Inc. v. Texdis USA Inc.*, 746 F. Supp. 2d 599 (S.D.N.Y. 2011) (same). *See also*

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805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
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BP W. Coast Prods. LLC, 989 F. Supp. 2d at 1120 ("a party cannot reasonably or justifiably rely on a statement directly inconsistent with a subsequently executed contract"). For example, in *JM Vidal*, a Washington franchisee brought a FIPA claim alleging that the FDD misrepresented the initial investment required for a franchise. 746 F. Supp. 2d at 624. However, the franchise agreement in *JM Vidal* stated:

> YOUR SUCCESS LICENSING AND OPERATING [A MANGO] STORE IS SPECULATIVE AND WILL DEPEND ON MANY FACTORS INCLUDING, TO A LARGE EXTENT, YOUR INDEPENDENT BUSINESS ABILITY. . . . YOU HAVE NOT RELIED ON ANY WARRANTY OR REPRESENTATION, EXPRESSED OR IMPLIED, AS TO THE POTENTIAL SUCCESS OR PROJECTED INCOME OF THE BUSINESS VENTURE CONTEMPLATED HEREBY. NO REPRESENTATIONS OR PROMISES HAVE BEEN MADE BY US TO INDUCE YOU TO ENTER INTO THIS AGREEMENT EXCEPT AS SPECIFICALLY INCLUDED HEREIN. WE HAVE NOT MADE ANY REPRESENTATION, WARRANTY OR GUARANTY, EXPRESS OR IMPLIED, AS TO THE POTENTIAL REVENUES, PROFITS OR SERVICES OF THE BUSINESS VENTURE TO YOU AND CANNOT, EXCEPT UNDER THE TERMS OF THIS AGREEMENT, EXERCISE CONTROL OVER YOUR BUSINESS. YOU ACKNOWLEDGE AND AGREE THAT YOU HAVE NO KNOWLEDGE OF ANY REPRESENTATION MADE BY US OR OUR REPRESENTATIVES OF ANY INFORMATION THAT IS CONTRARY TO THE TERMS CONTAINED HEREIN.

Id. at 614. The court held that the franchisee's reliance on the FDD's initial investment estimate was unreasonable as a matter of law given this language. *Id.* at 625.

Similarly, in *Sherman v. Ben & Jerry's Franchising,* the franchisees alleged that Item 19 financial performance representations were fraudulent because the franchisor intentionally distorted the earnings information. 2009 U.S. Dist. LEXIS 72663. However, the franchisees signed a franchise agreement stating:

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

> OPERATOR acknowledges that it has conducted an independent investigation of the business of operating a scoop shop, and recognizes that the business venture contemplated by this Agreement involves business risks and that its success will be largely dependent upon the ability of OPERATOR . . . as (an) independent businessperson(s). BEN & JERRY'S expressly disclaims the making of, and OPERATOR acknowledges that it has not received, any warranty or guarantee, express or implied, as to the potential volume, profits, or success of the business venture contemplated by this agreement.

Id. at *10. The court explained that a prospective franchisee cannot claim she was defrauded into signing a franchise agreement in reliance on representations that she expressly acknowledged she did not receive or rely upon. *Id.* at *10-11. Therefore, the court dismissed the franchisees' fraudulent inducement claim for failure to show reasonable reliance as a matter of law. *Id.* at *11.

In addition to the warnings in Item 19 of the FDD, the Nychyks' Franchise Agreement stated:

> You recognize the uncertainties of the Franchised Business, and therefore acknowledge that, except as set forth in this Agreement, no representations or agreements have been made regarding the success, sales potential, or profitability of the Franchised Business or the suitability of any location.

(SOF ¶ 54.) As in *JM Vidal* and *Sherman v. Ben & Jerry's Franchising, Inc.*, it was unreasonable as a matter of law for the Nychyks to claim to have relied on Item 19 to project their sales when the FDD warned them not to do so and the Franchise Agreement stated that PMI did not make any representation regarding success, sales potential, or profitability.

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF CLARK

LMP Enterprises LLC, *et al.*, Plaintiffs, v. PAPA MURPHY'S INTERNATIONAL LLC, *et al.*, Defendant.	Case No. 14-2-00904-0 **DECLARATION OF MICHAEL R. GRAY IN SUPPORT OF THE PAPA MURPHY'S DEFENDANTS' MOTION FOR SUMMARY JUDGMENT ON THE CLAIMS OF PLAINTIFFS HEATHER AND GARY NYCHYK AND BAR-N, PIZZA LLC**

I, Michael R. Gray, hereby state and declare as follows:

1. I am a partner in the law firm Gray Plant Mooty and counsel for the Papa Murphy's Defendants and certain of the Individual Defendants.

2. I make this declaration in support of the Papa Murphy's Defendants' Motion for Summary Judgment on the claims of Plaintiffs Heather and Gary Nychyk and Bar-N, Pizza LCC. I have personal knowledge of each fact stated herein and am competent to testify thereto.

3. Attached hereto as **Exhibit A** are true and correct copies of excerpts of the deposition of Gary Nychyk, taken on July 29, 2015.

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805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

4. Attached hereto as **Exhibit B** is a true and correct copy of Deposition Exhibit No. 380 used during the deposition of Gary Nychyk on July 29, 2015.

5. Attached hereto as **Exhibit C** is a true and correct copy of Deposition Exhibit No. 382 used during the deposition of Gary Nychyk on July 29, 2015.

6. Attached hereto as **Exhibit D** is a true and correct copy of Deposition Exhibit No. 383 used during the deposition of Gary Nychyk on July 29, 2015.

7. Attached hereto as **Exhibit E** is a true and correct copy of Deposition Exhibit No. 384 used during the deposition of Gary Nychyk on July 29, 2015.

8. Attached hereto as **Exhibit F** is a true and correct copy of Deposition Exhibit No. 385 used during the deposition of Gary Nychyk on July 29, 2015.

9. Attached hereto as **Exhibit G** is a true and correct copy of Deposition Exhibit No. 386 used during the deposition of Gary Nychyk on July 29, 2015.

10. Attached hereto as **Exhibit H** is a true and correct copy of Deposition Exhibit No. 387 used during the deposition of Gary Nychyk on July 29, 2015.

11. Attached hereto as **Exhibit I** is a true and correct copy of Deposition Exhibit No. 388 used during the deposition of Gary Nychyk on July 29, 2015.

12. Attached hereto as **Exhibit J** is a true and correct copy of Deposition Exhibit No. 389 used during the deposition of Gary Nychyk on July 29, 2015.

13. Attached hereto as **Exhibit K** is a true and correct copy of Deposition Exhibit No. 390 used during the deposition of Gary Nychyk on July 29, 2015.

14. Attached hereto as **Exhibit L** is a true and correct copy of Deposition Exhibit No. 391 used during the deposition of Gary Nychyk on July 29, 2015.

15. Attached hereto as **Exhibit M** is a true and correct copy of Deposition Exhibit No. 392 used during the deposition of Gary Nychyk on July 29, 2015.

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
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16. Attached hereto as **Exhibit N** is a true and correct copy of Deposition Exhibit No. 393 used during the deposition of Gary Nychyk on July 29, 2015.

17. Attached hereto as **Exhibit O** is a true and correct copy of Deposition Exhibit No. 394 used during the deposition of Gary Nychyk on July 29, 2015.

18. Attached hereto as **Exhibit P** is a true and correct copy of Deposition Exhibit No. 395 used during the deposition of Gary Nychyk on July 29, 2015.

19. Attached hereto as **Exhibit Q** is a true and correct copy of Deposition Exhibit No. 397 used during the deposition of Gary Nychyk on July 29, 2015.

20. Attached hereto as **Exhibit R** is a true and correct copy of Deposition Exhibit No. 402 used during the deposition of Gary Nychyk on July 29, 2015.

21. Attached hereto as **Exhibit S** is a true and correct copy of an email chain dated October 18, 2011 bearing bates number NYC-0009825. The forgoing email was produced by the Nychyks on March 3, 2017, after the deposition of Plaintiff Gary Nychyk.

22. Attached hereto as **Exhibit T** is a true and correct copy of an email chain dated January 17, 2012 bearing bates number NYC-0009928. The forgoing email was produced by the Nychyks on March 3, 2017, after the deposition of Plaintiff Gary Nychyk.

I CERTIFY UNDER PENALTY OF PERJURY UNDER THE LAWS OF THE STATE OF WASHINGTON THAT THE FOREGOING IS TRUE AND CORRECT.

DATED: May 23, 2017

AT: Minneapolis, MN

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

MICHAEL R. GRAY

LANDERHOLM
805 Broadway Street, Suite 1000
PO Box 1086
Vancouver, WA 98666
T: 360-696-3312 • F: 360-696-2122

THE FRANCHISE RELATIONSHIP		
Provision	**Section in Franchise Agreement (unless otherwise indicated)**	**Summary**
s. Modification of the agreement	Sections 5.14. and 9.7. (FA); Section 12.8. (ADA)	(FA) We may modify the Operations Manual. Modifications to the FA must be in writing and signed by an authorized person from each of the parties. (ADA) All modifications must be in writing and signed by an authorized person from each of the parties.
t. Integration/merger clause	Sections 1.5., 9.8. and 9.13. (FA); Section 12.8. (ADA)	(FA) Only terms of Agreements and Operations Manual are binding. Any other promises may not be enforceable. (ADA) Only terms of Agreements are binding.
u. Dispute resolution by arbitration or mediation	Section 9.9. (FA)	(FA) Except for certain claims for immediate relief, all disputes must be first negotiated then subject to non-binding mediation in the city that United States Arbitration and Mediation Service, Inc. has an office nearest our headquarters office, unless otherwise mutually agreed. (ADA) No provision.
v. Choice of forum	Section 9.11. (FA); Section 11 (ADA)	(FA) Except for certain claims for extraordinary relief, dispute resolution will be in the applicable federal or state court for the judicial district in which Papa Murphy's International LLC has its principal place of business at the time the action is commenced, except as stated in State Addenda to this Disclosure Document. (ADA) All issues and disagreements must be tried, heard and decided in the applicable federal or state court for the judicial district in which Papa Murphy's International LLC has its principal place of business at the time the action is commenced, except to the extent modified by the State Addenda to this Disclosure Document.
w. Choice of law	Section 9.6. (FA); Section 11.1 (ADA)	(FA) Washington law applies to the contract, except to the extent governed by the United States Trademark Act, and except to the extent modified by the State Addenda to this Disclosure Document. (ADA) Washington law applies, except to the extent governed by the United States Trademark Act, except to the extent modified by the State Addenda to this Disclosure Document.

ITEM 18
PUBLIC FIGURES

We do not currently use any public figure to promote the sale of franchises, but we reserve the right to do so in the future.

ITEM 19
FINANCIAL PERFORMANCE REPRESENTATIONS

The FTC's Franchise Rule permits a franchisor to disclose information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the Disclosure Document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

This analysis is prepared in two parts:

All stores included in this ITEM 19 are traditional stores, that is the stores are not located within another retailer's space, such as a grocery or department store.

The first part is based on 1,131 Papa Murphy's Take 'N' Bake Pizza stores that were open and operating during the entire period of our fiscal year ended January 3, 2011. These stores represent 30 company-owned stores and 1,101 franchise-owned stores (collectively referred to herein as "**System Stores**").

The second part is based on the sales and operating costs of 27 of the Company Stores that were owned and operated by us for all of our fiscal year 2010 ("**Company Stores**"). Three Company Stores were acquired during the year from franchisees. We do not have audited financial performance data prior to our acquisition for the stores that were acquired during the year; therefore, the three acquired stores are not included in this portion of the analysis.

System Stores

The Net Sales part of this analysis was prepared based on the operating results of the System Stores. The System Stores were divided into three categories based on Net Sales results: top third ("**High**"), middle third ("**Medium**"), and lower third ("**Low**").

The System Stores used in this analysis include 1,131 traditional stores, the average of which was $538,493 ("**System Store Average")** in annual Net Sales per store. Of the 1,131 stores, 457 met or exceeded this average. These System Stores offer substantially the same menu and product mix that your Franchised Store will offer.

Bases and assumptions:

The 1,131 System Stores open and in operation for our entire fiscal year ending January 3, 2011, were ranked by average Net Sales and then divided into three equal groups with the same number of stores in each group. The High Group's average Net Sales are $792,515; the Middle Group's average Net Sales are $492,327; and the Low Group's average Net Sales are $330,636. The ranges of Net Sales and averages within the High, Middle and Low categories are listed below:

Failure Rate 7% (SBA)
Change off 3%ish

1st Right of Refusal

Existing Store Performance

VOLUME	HIGH	MIDDLE	LOW
Number of Stores	**377**	**377**	**377**
Net Sales			
Highest	$1,693,768	$580,592	$410,624
Lowest	$581,249	$410,972	$138,187
Average Net Sales by Category	**$792,515**	**$492,327**	**$330,636**
Number of Stores Exceeding Average Net Sales by Category	**152**	**193**	**224**
Total System Average Net Sales	**$538,493**		

Historical Store Performance Reference

Year*	Total System Average Net Sales (No. of Stores)	Number of Stores Exceeding Average Net Sales	Percentage of Stores Exceeding Average Net Sales	High Average Net Sales (No. of Stores)	Middle Average Net Sales (No. of Stores)	Low Average Net Sales (No. of Stores)
2010	$538,493 (1,131)	457	40.4%	$792,515 (377)	$492,327 (377)	$330,636 (377)
2009	$560,171 (1,072)	444	41.4%	$818,955 (357)	$517,871 (358)	$343,806 (357)
2008	$554,802 (994)	415	41.8%	$808,638 (331)	$515,358 (332)	$340,530 (331)
2007	$518,815 (899)	389	43.3%	$755,787 (300)	$484,320 (299)	$316,221 (300)
2006	$503,233 (816)	354	43.4%	$726,666 (272)	$470,672 (272)	$312,359 (272)
2005	$487,699 (801)	354	44.2%	$707,673 (267)	$462,256 (267)	$293,167 (267)

*The Net Sales information provided in this chart for each designated year reflects Net Sales for the entire fiscal year. Our fiscal year ends on the Monday closest to December 31. The Net Sales information for franchised stores reflected in this chart is based on information we received from our franchisees. Values for previous years were disclosed in the April 2010 Franchise Disclosure Document, April 2009 Franchise Disclosure Document, April 2008 Franchise Disclosure Document, April 2007 Uniform Franchise Offering Circular and April 2006 Uniform Franchise Offering Circular, respectively. The definition of System Stores used in the April 2010, April 2009 and April 2008 Franchise Disclosure Documents, and the April 2007 and April 2006 Uniform Franchise Offering Circulars is consistent with the definition used herein.

Of the System Stores, in the High category, all had revenues in excess of the System Store Average reflected above; in the Medium category, 80 exceeded the System Store Average and 297 had revenues that were less than the System Store Average; and in the Low category, none exceeded the System Store Average and all had less than the System Store Average.

New Store Performance

Of the 92 new stores opened in fiscal year 2010, 67 stores had 12 or more full operating weeks as of the week ended January 3, 2011. (In all cases, the first week of operation has been excluded due to inconsistency in operations for this week.) For these stores, the average week's Net Sales over their first 12 full operating weeks was $7,242. Of the 67 stores, 24 met or exceeded this average. The actual annual average Net Sales achieved may vary due to seasonality, location characteristics, owner involvement, marketing plans and competition, as well as other factors disclosed in this Disclosure Document.

Company Stores

The following analysis is based on 27 Company Stores owned and operating during the entire period of our fiscal year ended January 3, 2011. The average annual Net Sales for these 27 stores for that period was $436,098. Of the 27 stores, 12 met or exceeded this average. Each of the 27 Company Stores used a uniform accounting system, and the data pertaining to the Company Stores was prepared on a basis consistent with generally accepted accounting principles during the applicable period. The sales, discounts and expenses of the 27 Company Stores were divided into three categories. Company Stores with annual Net Sales in excess of $474,005 were placed in the High category, System Stores with annual Net Sales ranging between $393,976 and $468,930 were placed in the Medium category and System Stores with Net Sales below $326,390 were placed in the Low category.

Of the 27 Company Stores owned and operated for the entire period of our fiscal year ended January 3, 2011, 26 were included in the April 2010 Franchise Disclosure Document and 1 store was open all weeks after being temporarily closed in 2009.

Sales and store level operating costs for Company Stores operated by us(5) (expense percentages are of sales, net of discounts for fiscal year 2010(1)):

VOLUME CATEGORY		HIGH	MEDIUM	LOW
Number of Stores		9	9	9
By Category:	Notes			
Average Gross Sales	2	$717,491	$518,551	$344,249
Average Discounts (on Gross Sales)	3	17.1%	16.1%	19.1%
Average Net Sales	4	**$594,472**	**$435,180**	**$278,644**

VOLUME CATEGORY		HIGH	MEDIUM	LOW
Number of Stores Exceeding Average Net Sales		4	4	6
Average COGS*	5	36.3%	37.8%	39.1%
Average Employee Labor	6	15.1%	16.3%	20.4%
Average Management	7	6.4%	7.9	10.3%
Average Taxes & Benefits	8	3.7%	4.2%	5.7%
Average Operating Expenses	9	7.0%	8.0%	10.5%
Average Advertising	10	8.7%	10.7%	12.7%
Average Occupancy	11	6.2%	7.8%	11.9%
Average Royalty	12	5.0%	5.0%	5.0%
Average Store Contribution	13	11.7%	2.4%	-15.6%

The notes to the above table are an integral part of the bases and assumptions of this analysis.

The amount of sales realized and costs and expenses incurred will vary from store to store. The sales, costs and expenses of your Franchised Store will be directly affected by many factors, such as the Franchised Store's size, geographic location, menu mix, and competition in the marketplace; the presence of other Papa Murphy's Stores; the quality of management and service at the Franchised Store; contractual relationships with lessors and vendors; the extent to which you finance the construction and operation of the Franchised Store; your legal, accounting, real estate and other professional fees; federal, state and local income, gross profits or other taxes; discretionary expenditures; and accounting methods used. You should, therefore, use this analysis only as a reference to conduct your own analysis.

You should particularly note the following:

You are urged to consult with appropriate financial, business and legal advisors to conduct your own analysis of the information contained in this section.

The table of Company Stores' sales and average food and labor costs is not based upon the actual experience of Franchised Stores. The sales and average costs reflected in the analysis are of certain company-owned and operated stores and should not be considered as the actual or potential sales, costs, income or profits that you will realize. We do not represent that any franchisee can expect to attain the sales, costs, income or profits described in this section, or any particular level of sales, costs, income or profits. In addition, we do not represent that any franchisee will derive income that exceeds the initial payment for or investment in the Franchised Store. The individual financial results of any Franchised Store are likely to differ from the information described in this section, and your success will depend largely on your ability. Substantiation of the data used in preparing this analysis will be made available on reasonable request.

The analysis does not include any estimates of the federal income tax that would be payable on the net income from a store or state or local net income or gross profits taxes that may be applicable to the particular jurisdiction in which a store is located. Each franchisee is strongly urged to consult with its tax advisor regarding the impact that federal, state and local taxes will have on the amounts shown in the analysis.

Notes:

(1) Fiscal Year. Our fiscal year is based on 12 periods, rather than a full calendar year. Our fiscal year ends on the Monday closest to December 31. Therefore, the 2010 fiscal year ended on January 3, 2011.

(2) Average Gross Sales. The gross sales figures set forth above represent all food and beverage sales before any coupons or other discounts are taken. It does not include sales taxes collected.

(3) Discount Percentages. The percentages included above include coupons and discounts offered on promotional items or offers. The percentage is calculated on Gross Sales.

(4) Average Net Sales. The sales figures set forth above represent all food and beverage sales, net of discounts. This is the amount on which you will calculate your royalty payments.

(5) Cost of Goods ("**COGS**"). Average COGS includes all food inventory and packaging used in creating the product for sale, but excludes cleaning supplies and similar items. We negotiate contracts for quantity and price for both beverages and certain food products to take advantage of volume discounts. These suppliers are generally available to franchisees. (See ITEM 8.) However, certain items must be purchased locally, like fresh produce. The price of the products you purchase from other suppliers may vary according to the location of the Franchised Store, delivery costs, the amount of mark-up imposed, and other factors, all of which may differ from our historical experience.

(6) Labor. Hourly wages, both regular and overtime (including crew, assistant managers, shift leaders), for food preparation and service. No corporate management personnel are included in labor costs. The amount of hourly labor necessary to operate a Franchised Store will vary from unit to unit, but should incrementally increase or decrease with the sales volume of the Franchised Store. Hourly wages may vary significantly by geographic location, the supply of and demand on the local labor pool, and state and federally mandated minimum wage laws. Labor includes wages only and not payroll taxes, medical or workers compensation insurance or 401(k) plan contributions.

(7) Management. Management costs include payroll expenses (salaries, bonuses for meeting performance objectives, and vacation) for the Franchised Store manager. The number of managers may vary based on sales volume and your requirements may differ from those of a Company Store.

(8) Taxes and Benefits. Unemployment taxes (both federal and state), FICA, employee injury insurance or workers compensation where required, and the employer-paid portion of group health benefits and retirement benefits for managers are included in this category. Through economies of scale, we may be able to obtain and/or provide those benefits at a cost less than that available to you. Further, benefit costs may vary substantially depending on the geographic location of the Franchised Store and the level of benefits (i.e., medical insurance, retirement plans and vacation) provided by you.

(9) Operating Expenses. Operating expenses include the cost of utilities, repair, maintenance, janitorial, smallwares, credit card charges, uniforms, laundry and supplies. Utilities include electricity, gas, water and telephone costs for the operation of the Franchised Store. The pro rata share of common area utility costs are included under rent and lease payments. (See Note 11.) These costs are subject to local market conditions and may vary depending on the geographic location of the Franchised Store.

(10) Advertising. This category is comprised of four types of expenditures: (a) local store marketing and merchandising, (b) contribution to the Advertising and Development Fund, (c) contribution to the Sales Building Print Plan, and (d) your Franchised Store's designated percentage contribution to your local advertising cooperative, which can be different for each designated marketing area.

(11) Occupancy. Occupancy costs include rent and lease costs, common area maintenance expenses, tax and insurance due the landlord, property taxes and our property and casualty insurance. Rent and lease costs include the base rent and any percentage rent. Common area maintenance costs typically include franchisee's pro rata charges for parking lot maintenance, lighting, real estate taxes, taxes on the common areas and costs of maintaining the common areas. Rental costs will vary as a result of space requirements and local market conditions. Other occupancy costs include personal property taxes, other real estate taxes not included in rent and lease and other operating licenses required by state and local agencies. You should investigate property taxes in the area in which you plan to locate your Franchised Store.

(12) Royalty. Company Stores do not pay royalties, however, they have been included for purposes of our calculations. Royalties are based on 5% of sales, net of discounts.

(13) Store Contribution. This figure does not reflect other costs which you may incur as a franchisee that are not shared by Company Stores, which may include general and administrative costs, depreciation (consult with your tax advisor regarding depreciation and amortization schedules and the period over which the assets may be amortized or depreciated as well as the effect, if any, of recent and proposed tax legislation), office

expenses, costs of travel and entertainment, professional fees, and financing costs, if any. In addition, you will also pay local state and federal income taxes which are not reflected in the preceding table.

ITEM 20
OUTLETS AND FRANCHISEE INFORMATION

Table No. 1
Systemwide Outlet Summary for Years 2008 to 2010

Column 1	Column 2	Column 3	Column 4	Column 5
Outlet Type	Year	Outlets at the Start of the Year	Outlets at the End of the Year	Net Change
Franchised	2008	981	1,056	75
	2009	1,056	1,136	80
	2010	1,136	1,206	70
Company-Owned	2008	76	63	-13
	2009	63	35	-28
	2010	35	33	-2
Total Outlets	2008	1,057	1,119	62
	2009	1,119	1,171	52
	2010	1,171	1,239	68

Table No. 2
Transfers of Outlets from Franchisees to New Owners (other than the Franchisor) for Years 2008-2010

Column 1	Column 2	Column 3
State	Year	Number of Transfers
Alaska	2008	0
	2009	0
	2010	0
Arizona	2008	1
	2009	3
	2010	2
California	2008	10
	2009	3
	2010	7
Colorado	2008	5
	2009	0
	2010	11

CERTIFICATION OF FRANCHISE OWNER

Describe all promises and representations made by any of our representatives to you that are not expressly contained in the Franchise Agreement or the Franchise Disclosure Document, but that influenced your decision to sign the Franchise Agreement.

If the answer is "NONE," please write "NONE."

Your completion of this page is a material inducement for us to grant a franchise to you. If you fail to complete and sign this page, we will not execute the Franchise Agreement or we may void the Franchise Agreement if it already has been executed.

The undersigned hereby certifies that the information provided above is true, that the undersigned had an opportunity to obtain the advice of an attorney, and that the undersigned has executed this Certification.

[SIGNATURES ON FOLLOWING PAGE]

PAPA MURPHY'S INTERNATIONAL LLC

EXHIBIT J

STATEMENT OF FRANCHISEE

NYC-0000347

EXHIBIT J

STATEMENT OF FRANCHISEE

[Note: Dates and Answers Must be Completed in the Prospective Franchisee's Own Handwriting]

In order to make sure that no misunderstanding exists between you, the Franchisee, and us, Papa Murphy's International LLC (also called "**Papa Murphy's,**" the "**Franchisor**" or "**we**") and to make sure that no violations of law might have occurred, and understanding that we are relying on the statements you make in this document, you assure us as follows:

Representations.

1. No oral, written, visual or other promises, agreements, commitments, representations, understandings, "side agreements," options, right of first refusal or otherwise have been made to or with me with respect to any matter (including but not limited to advertising, marketing, site location, operational, marketing or administrative assistance, exclusive rights or exclusive or protected territory or otherwise), nor have I relied in any way on the same, except as expressly set forth in the Franchise Disclosure Document, Franchise Agreement or an attached written Addendum signed by me and Papa Murphy's, except as follows: ____

(If NONE, you should write NONE in your own handwriting and initial.)

2. No oral, written, visual or other promises, agreements, commitments, representation, understandings, "side agreements" or otherwise which expanded upon or were inconsistent with the Franchise Disclosure Document or the Franchise Agreement or any attached written Addendum signed by me and an officer of Papa Murphy's, were made to me by any person or entity, nor have I relied in any way on same, except as follows: ____

(If NONE, you should write NONE in your own handwriting and initial.)

3. Other than the information presented in the Franchise Disclosure Document, no oral, written, visual or other claim or representation (including but not limited to charts, tables, spreadsheets or mathematical calculations to demonstrate actual or possible results based on a combination of variables, such as multiples of price and quantity to reflect gross sales, or otherwise) which stated or suggested a specific level or range of actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or from which such items might be ascertained) from Franchised Stores, was made to me by any person or entity, nor have I relied in any way on any such, except as follows: ____

(If noneNONE, you should write NONE in your own handwriting and initial.)

4. No contingency, prerequisite, reservation or otherwise exists with respect to any matter (including but not limited to my obtaining financing, or my fully performing any of my obligations), nor have I relied in any way on same, except as expressly set forth in the Franchise Agreement or any attached written Addendum signed by me and Papa Murphy's: ____________

____

____

____

____

(If NONE, you should write NONE in your own handwriting and initial.)

5. The individuals signing for me constitute all of the executive officers, partners, shareholders, investors, owners, and/or principals. Each of such individuals has reviewed the Franchise Disclosure Document and all exhibits and carefully read, discussed, understands and agrees to the Franchise Agreement, each attached written Addendum, and any personal guaranties.

6. I have had an opportunity to consult with an independent professional advisor, such as an attorney or accountant, prior to signing any binding documents or paying any sums, and Papa Murphy's has strongly recommended that I obtain such independent advice. I have also been strongly advised by Papa Murphy's to discuss my proposed purchase of a Franchised Store with any existing Papa Murphy's franchisees prior to signing any binding documents or paying any sums and Papa Murphy's has supplied me with a list of all existing franchisees.

7. I understand that (a) entry into any business venture necessarily involves some unavoidable risk of loss or failure; (b) while the purchase of a franchise may improve the chances for success, the purchase of a Franchised Store or any other franchise is a speculative investment; (c) investment beyond that outlined in the Franchise Disclosure Document may be required to succeed; (d) there exists no guaranty against possible loss or failure in this or any other business; and (e) the most important factors in the success of any Franchised Store, including the one to be operated by me, are my personal business skills, which include marketing, sales, and management, and require sound judgment and extremely hard work.

If there are any matters inconsistent with the statements in this document or if anyone has suggested that you sign this document without all of its statements being true, correct and complete, immediately inform Papa Murphy's Legal Department (Telephone: (360) 260-7272).

You understand and agree that, other than the information presented in the Franchise Disclosure Document, we do not furnish, or authorize our salespersons, brokers or others to furnish any oral or written information concerning actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or information from which such items might be ascertained), from franchised or non-franchised units, that no such results can be assured or estimated, and that actual results will vary from unit to unit.

You understand and agree to all of the foregoing and represent and warrant that all of the above statements are true, correct and complete.

PROSPECTIVE FRANCHISEE:

By: ______________________________
Title: ______________________________
Date: ______________________________

By: ______________________________
Title: ______________________________
Date: ______________________________

By: ______________________________
Title: ______________________________
Date: ______________________________

By: ______________________________
Title: ______________________________
Date: ______________________________

By: ______________________________
Title: ______________________________
Date: ______________________________

By: ______________________________
Title: ______________________________
Date: ______________________________

REVIEWED BY FRANCHISOR:

By: ______________________________
Title: Victoria T. Blackwell
Senior Vice President and General Counsel
Date: ______________________________

Don't Tread on Me: A Defense of State Franchise Regulation

Caroline B. Fichter, Andrew M. Malzahn, and Adam Matheson

Ms. Fichter

Mr. Malzahn

Mr. Matheson

In the words of U.S. Supreme Court Justice Louis Brandeis, "it is one of the happy incidents of the federal system that a single courageous state may, if its citizens chose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country."[1] Brandeis urged that if courts are to be "guided by the light of reason," they "must let [their] minds be bold," and argued that "to stay the experimentation in things social and economic is a grave responsibility," adding that when courts are asked to exercise this power, "we must be ever on our guard."[2]

In the context of franchising, states have attempted to stop widespread abuses in the franchise industry by enacting statutes that both protected in-state franchisees from unscrupulous franchisors and punished bad-actor franchisors by prohibiting the most common abuses in the sale of franchises and the franchise relationship.[3]

The Federal Trade Commission explicitly recognized the importance of state regulation when it promulgated the Federal Trade Commission Rule on Franchising in 1979 (the FTC Rule). The FTC Rule states that "[t]he Federal Trade Commission does not intend to annul, alter, or affect, or exempt any persons subject to the provisions of this part from complying with the laws or regulations of any State, municipality, or other local government

1. New State Ice Co. v. Liebmann, 285 U.S. 262 (1932).
2. *Id.* at 311.
3. *See generally* Peter Lagarias & Bruce Napell, *Lessons from Thucydides on Distinguishing Statutory from Common Law Fraud in Franchise Disclosure Actions*, 35 FRANCHISE L.J. 601 (2016).

Caroline B. Fichter (fichter@bundylawfirm.com) is an associate with Bundy Law Firm PLLC in Kirkland, Washington. Andrew M. Malzahn (amalzahn@dadygardner.com) is an associate with Dady & Gardner in Minneapolis. Adam Matheson is Of Counsel with Albee Law, P.C. in Chicago.

EXHIBIT B, Page 1
Exhibit A - Letter to FTC

with respect to franchising practices except to the extent that those laws or regulations are inconsistent with any provisions of this part, and then only to the extent of the inconsistency."[4] The FTC explained that the FTC Rule set a floor, not a ceiling, for franchise legislation: "a law or regulation of any State, municipality, or other local government is not inconsistent [with the FTC rule] if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by this part."[5] The FTC encouraged states to enact more stringent franchise regulations, explaining that "the commission believes it is possible for state and local governments to enact franchise measures which provide greater protection, either because the governments are able to allocate greater resources to enforce efforts in this area or because their governments might uncover problems and devise solutions which are unknown at this time."[6]

A recent *Franchise Law Journal* article written by Daniel Oates, Vanessa Wheeler, and Katie Loberstein (the Oates Article)[7] argues that state franchise statutes are outdated,[8] less critical for today's franchisees,[9] and unconstitutional. Nothing could be further from the truth. State statutes are the embodiment of legislatures utilizing their judicially recognized rights as "laboratories of democracy" to protect franchisees and deter unethical practices in franchising according to each state's unique values and regulatory philosophy. Each state has tailored franchise statutes to address its own concerns and serve its values. States with a traditionally robust approach to consumer protection and securities regulation have drafted franchise statutes that protect franchisees and prohibit resident franchisors from engaging in sharp business practices.[10] Other states have taken a more *laissez-faire* approach and drafted statutes limited to protecting only franchises operating

4. 16 C.F.R. § 437.2 n.2.

5. *Id.*

6. Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59721 (Dec. 21, 1978) (hereinafter, Statement of Basis and Purpose).

7. Daniel J. Oates, Vanessa L. Wheeler, and Katie Loberstein, *A State's Reach Cannot Exceed Its Grasp: Territorial Limitations on State Franchise Statues*, 37 FRANCHISE L.J. 185 (2017).

8. The Oates Article incorrectly describes state franchise statutes as "largely unchanged for nearly fifty years." *Id.* at 185. This assertion ignores the fact that most states have amended their statutes at least once since they were enacted. In 2015, California dramatically amended its franchise statute, making California now "home to the toughest franchisee-protection" laws in the nation. *See* Rochelle Spandorf, *New California Franchise Relations Act: A Game Changer for Franchisors Operating in California*, *available at* https://www.dwt.com/The-New-California-Franchise-Relations-Act-A-Game-Changer-for-Franchisors-Operating-in-California-10-28-2015/.

9. The Oates Article claims that the statutes were "hastily enacted" after a few "less-than-savory entrepreneurs" bilked franchisees out of their life savings. Oates Article, *supra* note 7, at 214. Not only does this argument minimize the fact-finding and drafting efforts of a half dozen state legislatures, but it implies that any statute enacted after a tragedy is inherently suspect. Under this theory, the safety legislation that was passed after the Titanic's sinking should be repealed. The comparison may seem absurd, but, like the Titanic's passengers, a franchisee in a bad system has purchased something that does not perform as promised, is in the middle of a disaster, and has no viable escape route.

10. *See, e.g.*, CAL. CORP. CODE § 31000 et seq. (1971).

in their state.[11] These laws are equally or more important today than when they were enacted because there remains an extreme imbalance of power between franchisors and franchisees.[12] Courts have repeatedly ruled a state may regulate the franchise relationship, even if some aspect of that relationship occurs outside its borders, without violating the Dormant Commerce Clause.

What follows here is a response to the Oates Article. It is organized into three main sections. Part I examines the history of franchise regulation and how states have enacted legislation to protect franchisees and punish unscrupulous franchisors. Part II responds to and adds to the state-by-state survey in the Oates Article. Part III presents recent empirical research and other arguments demonstrating why franchisees are still in need of protection. Part IV explains why the extraterritorial application of state franchise statutes does not pose constitutional concerns.

I. History of Franchise Regulations

The promise of franchising is that individuals can make money by realizing the American Dream: owning their own business.[13] Ideally, franchising benefits both franchisors (by providing a way to distribute a product or service without making a significant capital investment) and franchisees (by providing a way to make use of an established business model).[14] Franchising began growing in the 1950s. During the early franchise booms, consumers complained of franchise sales abuses, including misrepresentations about the value of a franchise; false claims related to earning potential; unfair refusal by franchisors to honor refund provisions; and failure to disclose material facts about franchise offerings.[15]

In the 1960s, Congress held numerous hearings. Various bills were introduced, but they failed to address the abuses in the franchise arena.[16] In 1971, the FTC initiated a rule-making process to address franchise abuses but the FTC Rule would not actually go into effect until October 21, 1979.

First faced with inaction, and then with serious delay at the federal level, several states acted to protect franchisees and punish bad-actor franchisors. In 1970, California became the first state to enact legislation regulating franchises with the California Franchise Investment Law.[17] Washington and Wisconsin followed suit in 1971 and 1972. Fifteen states enacted legislation specifically regulating the offer and sale of franchises, and as many as eigh-

11. *See*, *e.g.*, ARK. CODE ANN. § 4-72-201 (1977).
12. *See infra*, Part IV.
13. FRANCHISING: CASES, MATERIALS, AND PROBLEMS 2 (Alexander Moore Meiklejohn, 2013).
14. *Id.*
15. *See* Statement of Basis and Purpose, 43 Fed. Reg. 59614, 59628–38.
16. Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1512 (1990).
17. *Id.* at 58; *see also* CAL. CORP. CODE §§ 31000 to §§ 31513 (1970).

teen states have enacted statutes that regulate some aspect of the franchise relationship.[18] Some of these statutes were enacted before the implementation of the FTC Rule, while others were enacted after. All state legislatures that passed franchise statutes have revisited those statutes at least once since the FTC implemented the FTC Rule.

II. Responses and Additions to the Oates Article's State-by-State Survey

The Oates Article categorizes state franchise laws as "strict," "moderate," and "questionably broad." Categories aside, the limitations imposed by state boundaries do not foreclose franchisee claims. Specifically, state franchise acts can and should apply to out-of-state franchisees.

A. *Franchisees Are Protected Regardless of Whether a Territorial Limit Is Strict, Moderate or Broad*

1. "Narrow" Territorial Limits Are Applicable Only to Portions of State Franchise Acts

A closer look at the states with narrow extraterritorial provisions reveals that the narrow limitations apply only to portions of the particular act. Although some state franchise statutes require that a franchisee maintain a "place of business" in that state, an out-of-state franchisee's ability to bring claims is not entirely foreclosed in these states.

In Connecticut, certain provisions of the Connecticut Franchise Act (CFA) are limited to franchise agreements that require the franchisee to establish or maintain a place of business in Connecticut.[19] These limitations, however, apply only to franchise termination, while all other provisions of the CFA apply to franchisees irrespective of whether the franchisee maintains a place of business in Connecticut.[20]

Similarly, portions of the Hawaii Franchise Investment Law (HFIL) are territorially limited. Relying on select HFIL provisions to claim that it is narrowly tailored, the Oates Article omits other provisions of the HFIL that are not similarly limited.[21] For example, the antifraud section makes it unlawful for "any person in connection with the offer, sale, or purchase of any franchise directly or indirectly" to engage in various actions, only

18. ABA Forum on Franchising, Fundamentals of Franchising, Appendix C (Rupert M. Barkoff et al., eds., 4th ed. 2015).

19. *See* Conn. Gen. Stat. § 42-133h (1985).

20. *See* Conn. Gen. Stat. § 42-133n (2006).

21. *See* Haw. Rev. Stat. § 482E-3(a) (2004) ("It is unlawful for any person to sell a franchise in this State unless such person has presented to the prospective franchisee or the franchisee's representative, at least seven days prior to the sale of the franchise, an offering circular containing [various information.]"); Haw. Rev. Stat. § 482E-5(a) ("Every person selling franchises in this State shall at all times keep and maintain a complete set of books, records, and accounts of such sales and shall thereafter at such times as are required by the director make and file in the office of the director a report setting forth the franchises sold by it and the proceeds derived therefrom.").

one of which is specifically limited to actions within Hawaii.[22] The HFIL goes on to state that "[a]ny person who is engaged or hereafter engaged directly or indirectly in the sale of a franchise or in business dealings concerning a franchise, either in person or in any other form of communication, shall be subject to this chapter, shall be amenable to the jurisdiction of the courts of this State, and shall be amenable to the service of process as provided by law and rule."[23] The plain language of the statute directly contradicts any contention that the HFIL is of limited scope and applies only to Hawaiian residents or franchises located in Hawaii.

2. Franchise Statutes with Territorial Limits May Still Apply to Out-of-State Franchisees

Even with a narrow extraterritorial limit, franchise statutes may still apply to out-of-state franchisees. For example, the Indiana Franchise Act (IFA) applies to franchises not physically located in Indiana. The IFA makes it "unlawful for any person in connection with the offer, sale, or purchase of any franchise, or in any filing made with the commissioner, directly or indirectly . . . to engage in any act which operates or would operate as a fraud or deceit upon any person."[24] The IFA applies to the offer of a franchise if the "offeree or franchisee is an Indiana resident."[25] Thus, a resident of Hammond, Indiana, who operates a franchise in Illinois may have a cause of action under the IFA even if the franchise is not located in Indiana.

The Iowa Franchise Act (IAFA) applies only to a new or existing franchise that "is operated in the state of Iowa."[26] The IAFA further states that "[t]he

---

22. Haw. Rev. Stat. § 482E-5(b)(1)-(5)(2004) states:

> It is unlawful for any person in connection with the offer, sale, or purchase of any franchise directly or indirectly:
>
> (1) To make any untrue statement of a material fact in any offering circular or report filed with the director under this chapter or willfully to omit to state in any offering circular or report, any material fact which is required to be stated therein.
>
> (2) To sell or offer to sell a franchise in this State by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading.
>
> (3) To employ any device, scheme, or artifice to defraud.
>
> (4) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.
>
> (5) To violate any order of the director.

23. *See* Haw. Rev. Stat. § 482E-3(c) (2004).

24. Ind. Code § 23-2-2.5-27(3) (2008).

25. Ind. Code § 23-2-2.5-2 (2008). *See, e.g.*, 7E Fit Spa Licensing Grp. LLC v. 7EFS of Highlands Ranch, LLC, No. 115CV01109TWPMPB, 2016 WL 4761562, at *9 (S.D. Ind. Sept. 13, 2016) (implying that the IFA would have applied to a franchise operating outside of Indiana if the court had found that the limited liability company operating the franchise was a resident of Indiana).

26. Iowa Code § 523H.2 (1995); *see also* Iowa Code § 537A.10.2. (2000), which has substantially similar language and applies to franchise agreements entered into on or after July 1, 2000.

provisions of this chapter do not apply to any existing or future contracts between Iowa franchisors and franchisees who operate franchises located out of state."[27] The Iowa legislature amended the latter provision in 1995 to clarify that the IAFA did not apply "between Iowa franchisors and franchisees who operate franchises located out-of-state."[28] Based on the latter provision, franchisors have argued that an Iowa franchisor dealing with an out-of-state franchisee who operates a franchise within Iowa does not need to comply with the IAFA.

The Iowa Supreme Court addressed this very argument in *Holiday Inns Franchising, Inc. v. Branstad*.[29] There, the court reviewed the legislative intent of the IAFA, which it noted was "to provide greater power to franchisees and place greater restrictions on the powers of franchisors."[30] Rejecting the franchisor's argument, the court reasoned that:

> [n]othing in the legislative history of this chapter supports the plaintiffs' contention that the general assembly intended to benefit Iowa franchisors in their dealings with out of state franchisees by excluding them from the reach of the chapter when the out of state franchisee operates a franchise within the borders of the state of Iowa.[31]

3. State Franchise Acts Are Interpreted in Accordance with the Spirit of the Statute

Several franchise statutes protect franchisees regardless of location. The Michigan Franchise Investment Law (MFIL) applies to "all written or oral arrangements between a franchisor and franchisee in connection with the offer or sale of a franchise. . . ."[32] The Michigan legislature directed courts to "broadly construe" the MFIL "to effectuate its purpose of providing protection to the public."[33] The Oates Article claims that the MFIL "appears to have a drafting mistake" because it is not limited to franchises "in this state."[34] But the legislature's choice not to include an "in this state" limitation reflects not poor drafting but rather an intent to provide broad protection to franchisees. Specifically, the MFIL requires that the franchise sale be "made" in Michigan.[35] Thus, the MFIL applies if the franchisee is domiciled in Michigan even if the franchise is not located, offered, accepted, or operated in Michigan. Similar to the Indiana/Illinois example above, this statute

27. *Id.*
28. *Compare* Iowa Code § 523H.2 (1993) *with* Iowa Code § 523H.2 (1995).
29. 537 N.W.2d 724 (Iowa 1995).
30. *Id.* at 729.
31. *Id.*
32. Mich. Comp. Laws § 445.1504(1) (1984).
33. Mich. Comp. Laws § 445.1501 (1984).
34. Oates Article, *supra* note 7, at 194–95.
35. *See* Mich. Comp. Laws § 445.1504(2)–(3) (1984). This can be accomplished numerous ways, including: (1) if the offer to sell is made in Michigan; (2) an offer to buy is accepted in Michigan; (3) if the franchisee is domiciled in Michigan; or (4) if the franchised business is or will be operated in Michigan. *See* Ward's Equip., Inc. v. New Holland N. Am., Inc., 493 S.E.2d 516, 520–21 (Va. 1997) (applying Michigan law).

also fits with the legislators' purpose that the MFIL be broadly construed to protect the public.

The Florida Franchise Misrepresentation Act (FFMA) is also interpreted pursuant to the spirit of the law. The FFMA makes it unlawful, when selling or establishing a franchise or dealership, for any "person" intentionally to make various misrepresentations.[36] The FFMA defines a "person" as "an individual, partnership, corporation, association, or other entity doing business in Florida."[37] Notably, unlike the language in other state statutes that indicate the statute applies to franchises physically located in that state, the FFMA merely requires that the party do business in Florida.

In 2006, the U.S. District Court for the Southern District of Florida clarified what "doing business in Florida" requires in *Lady of America Franchise Corp. v. Malone*.[38] Lady of America Franchise Corp. (LOA) argued that the FFMA did not apply because the former franchisee, Malone, operated a franchise in Michigan.[39] The franchisor was a Florida corporation with its offices in Florida, and the parties' agreement contained a choice-of-law provision applying Florida law. The court reasoned that "even though Malone's franchise was not located in Florida, LOA, a franchisor that does business in Florida, is the 'person' that allegedly made the misrepresentations" and is subject to the FFMA.[40] Accordingly, the court denied LOA's motion to dismiss.

B. *Franchisees Are Protected by Other State Statutes*

Franchisees that are harmed by franchisors, but without recourse due to the territorial limitations in state franchise statutes, might still assert claims under other state statutes. For example, the Connecticut Unfair Trade Practices Act (CUTPA) provides that "[n]o person shall engage in unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce."[41] The definition of "person" includes a corporation, limited liability company, and any other legal entity.[42] Connecticut courts have determined that even if the Connecticut Franchise Act does not apply, the "conduct of the [franchisor] may still violate CUTPA where the [franchisor's] actions violate the public policy of this state as expressed 'within at least the penumbra of some common law, *statutory*, or other established concept of unfairness.'"[43] Thus, although some provisions of the Connecticut Franchise Act are limited to franchises that maintain a place of busi-

36. Fla. Stat. § 817.416(2)(a)(1)–(3) (1971).
37. Fla. Stat. § 817.416(1)(a) (1971).
38. No. 05-61304-CIV, 2006 WL 7354110, at *2 (S.D. Fla. Feb. 13, 2006).
39. *Id.*
40. *Id.*
41. Conn. Gen. Stat. § 42-110b(a) (1976).
42. Conn. Gen. Stat. § 42-110a(3) (2004).
43. Diesel Injection Serv. Co. v. Jacobs Vehicle Equip. Co., No. X04CV980120289S, 2002 WL 959894, at *3 (Conn. Super. Ct. Apr. 16, 2002) (quoting Willow Springs Condo. Ass'n, Inc. v. Seventh BRT Dev. Corp., 245 Conn. 1, 43 (Conn. 1998)) (emphasis in the original).

ness in that state, Connecticut does not leave other franchisees without a remedy.

The Indiana Deceptive Franchise Practices Act (IDFPA) also applies to franchisees even if they do not operate a franchise in Indiana. The IDFPA prohibits a franchise agreement from containing certain provisions in an agreement between any franchisor and a franchisee "who is *either a resident of Indiana* or a nonresident who will be operating a franchise in Indiana."[44] Like the Indiana Franchise Act, the IDFPA applies to residents of Indiana (regardless of whether they operate a franchise in Indiana) and non-residents (who operate a franchise in Indiana).

III. Franchisees Still Need Statutory Protection at the State Level

In making its argument that extraterritorial application of state franchise statutes is unconstitutional, the Oates Article relies on the faulty premise that "yesterday's" franchise laws are less or no longer necessary or as important for "today's" franchisees.[45] However, this assertion ignores the fact that today's franchisees invest larger sums of money,[46] sign more onerous franchise agreements (often on a take-it-or-leave-it basis),[47] and often enter into the relationship without consulting an attorney.[48] As a result, prospective franchisees and existing franchisees are equally susceptible to fraud and other abuses today as they were many years ago, and the damages resulting from this misconduct are far higher.

A. *The Imbalance of Power Between Franchisors and Franchisees and the Fallacy That Franchisees Are Less Vulnerable or More Sophisticated*

The franchisor/franchisee relationship has appropriately been described as "[t]he Reliance Relationship: Superiority and Inexperience."[49] Consider its basic structure. Franchisors purport to have developed a unique and established business model capable of replication by franchisees. This type of offering naturally attracts individuals seeking to own a business despite having no prior experience because they perceive it as a reduced-risk investment that is already "proven."[50] The end result is the marriage of a sophis-

44. Ind. Code. § 23-2-2.7-1(1) (1987) (emphasis added).
45. Oates, *supra* note 7, at 185–86, 214–15.
46. The total Estimated Initial Investment for a Subway franchise is $147,050 to $320,700. *See* Subway May 1, 2017 FDD, Item 7. The total Estimated Initial Investment for a Burger King franchise is $317,100 to $3,046,600. *See* Burger King April 28, 2017 (as amended October 20, 2017) FDD, Item 7.
47. Oates Article, *supra* note 7, at 214.
48. *See infra*, Part IV.A.
49. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927, 961 (1990) ("the reliance relationship created by the franchisor's relative superiority and the franchisee's relative inexperience is an essential component of the typical franchise exchange").
50. Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 Alb. L. Rev. 193, 203–04 (2013).

ticated party with a relatively unsophisticated party. Franchisors generally are large, sophisticated companies with significant legal and financial resources,[51] whereas franchisees are individuals with fewer resources and limited business ownership or industry-specific experience, who are attracted to franchising because the franchisor has promised to train and assist them.[52]

This imbalance of power between franchisor and franchisee, and the relative lack of sophistication of franchisees, have been repeatedly verified with empirical evidence, including by the authors in a survey of their own.[53]

1. Franchisees Frequently Have No Prior Experience as Business Owners and No Prior Industry Specific Experience

Recent empirical evidence reveals that "new franchisees are unlikely to possess franchise unit ownership experience, or even any prior business ownership [experience]."[54] According to one study of 307 franchisees, "only 20 percent of the sample had actually been business owners before becoming franchisees."[55] Another study of seventy-four franchisees in a single franchise system revealed that only 6.7 percent of franchisees had owned an independent business prior to joining the franchise system.[56] In a survey that FranchiseGrade.com conducted of more than 1,100 franchisees nationwide, 63 percent of franchisees had never owned any type of business prior to becoming a franchisee.[57] Moreover, a substantial percentage of franchisees have no experience in the industry or sector in which they currently operate their franchises.[58]

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51. Service Employees International Union, *Petition for Investigation of the Franchise Industry*, at p. 2 (May 19, 2015), *available at* https://www.americanbar.org/content/dam/aba/publications/franchise_lawyer/ftc-req-for-investigation_final-may-19-2015.authcheckdam.pdf. Indeed, the top twenty-five U.S. franchisors account for 21 percent of all franchised units in the country, with combined revenue over $50 billion. *Id.* at p. 4 (compiling data from each of the top twenty-five franchisors' FDDs and SEC Form 10-Ks).

52. Emerson & Benoliel, *supra* note 50, at 203–04. Indeed, individuals with no or little relevant experience find franchising attractive, in part, because franchising promises site selection assistance, training, and operations manuals.

53. The authors conducted a survey of franchisees nationwide across several franchise systems and received 253 franchisee responses. The results of the survey are summarized in Appendix A, *infra*, Tables 1–6.

54. Emerson & Benoliel, *supra* note 50, at 206–09.

55. *Id.* at 206–07 (citing Kimberley A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. SMALL BUS. MGMT. 27, 30–31 Table 2 (1996)).

56. Emerson & Benoliel, *supra* note 50, at 216 (citing Alden Peterson & Rajiv P. Dant, *Perceived Advantages of the Franchise Option from the Franchisee Perspective: Empirical Insights from a Service Franchisee*, 28 J. SMALL BUS. MGMT. 46, 49–50 Table 1 (1990)).

57. FranchiseGrade.com, *National Survey of Franchisees 2015—An Analysis of Survey Results*, at p. 9 (2015), http://wearemainst.com/wp-content/uploads/2015/04/Nat-Survey-Franchisees-2015.pdf.

58. In the FranchiseGrade.com study, 69 percent of franchisee respondents had no management experience in the industry in which they currently franchised before becoming a franchisee, and 48 percent had never worked in that industry. *See National Survey of Franchisees 2015*, *supra* note 57, at 10–11. Emerson and Benoliel's review of empirical evidence yielded similar results. *See* Emerson & Benoliel, *supra* note 50, at 207.

Certain franchisors and certain franchisee recruiting websites specifically seek out inexperienced individuals. One franchisee recruiting website has a specific sub-category entitled: "No Experience Needed Franchises."[59] Franchisor websites similarly tout opportunities for individuals with no experience,[60] as exemplified by another website luring individuals to franchising with the following statement:

> For most careers, a degree of previous experience has to be demonstrated in order to get hired and be successful in that role [. . .] This practice seems straightforward and logical—and is the reality for most professionals. However, in the franchise world, this concept doesn't quite seem to apply. A quick glance at many franchise sales websites, and you'll see "no previous experience required.". . .[61]

2. Franchisees Frequently Do Not Consult with an Attorney Prior to Signing Their Franchise Agreements

In the authors' survey, 52 percent of franchisees did not consult with an attorney to review their franchise agreement or FDD/UFOC before purchasing their first franchise.[62] Another survey of "franchisor" attorneys revealed that franchisees were represented by counsel at signing just 26 percent of the time; even when franchisees were represented, as one franchisor attorney commented, it was often by general practitioners unfamiliar with franchise law.[63] Regardless, franchise agreements are often offered on a take-it-or-leave-it basis.[64] Even if negotiated, the changes made are often few and far between.[65]

Failing to appropriately assess the legal risks and nuances of franchising is further evidence of franchisees' lack of sophistication. Without the aid of counsel, franchisees will have difficulty sifting through the overwhelming

59. Franchise Solutions, https://www.franchisesolutions.com/business-services/no-experience-needed (last visited Jan. 29, 2018).

60. *See*, *e.g.*, Real Property Management, https://www.propertymanagementfranchise.com/no-experience-necessary/ (last visited Jan. 29, 2018); Watch Dog Home Inspections, https://www.watchdogsfranchise.com/own-a-franchise/no-experience-necessary/ (last visited Jan. 29, 2018).

61. ServiceBridge, https://www.servicebridge.com/articles/no-experience-needed-field-service-franchises (last visited Jan. 29, 2018).

62. *See* Appendix A, *infra*, Table 1. Additionally, in only 23 percent of instances did the franchisor's salesperson expressly tell franchisees that they could hire an attorney to review their franchise agreement. *See id.*, Table 2.

63. Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether to Hire Counsel*, 51 San Diego L. Rev. 709, 718 (2014) (citing its own "Franchise Lawyer Survey").

64. Some courts have correctly found that franchise agreements are contracts of adhesion. *See* Kubis & Perszyk Assocs., Inc. v. Sun Microsys., Inc., 680 A.2d 618 (N.J. 1996); Indep. Ass'n of Mail Box Ctr. Owners v. Super. Ct., 133 Cal. App. 4th 396 (2005); Ticknor v. Choice Hotels, Int'l, Inc., 265 F.3d 931 (9th Cir. 2001).

65. In the authors' survey, 27 percent of franchisees reported that their franchise salesperson expressly stated that their franchisor would not make any changes to the franchise agreement. *See* Appendix A, *infra*, Table 3. In the FranchiseGrade.com survey, 59 percent of the franchisees did not propose any changes; 28 percent had their proposed changes rejected; and only 13 percent of franchisors accepted at least one change to the franchise agreement. *See National Survey of Franchisees 2015*, *supra* note 57, at 13.

amount of information in the FDD and franchise agreement, as well as all other prospective information.[66] The inability to modify the one-sided provisions of a franchise agreement further compounds the imbalance of power.

3. Franchise Agreements Uniformly and Overwhelmingly Favor Franchisors

Standard, one-sided franchise agreements increase the imbalance of power. Franchise agreements are written by franchisors (and their attorneys) for franchisors.[67] As explained in Part II(B), *infra*, franchisees, compared with the franchisor, are at a significant disadvantage when it comes to their contractual rights and obligations.

4. The Majority of Franchisees Are Indeed Small Business Owners

Franchisees are often appropriately characterized as "small business owners." In the words of the longtime franchisor attorney and advocate, Bill Killion, "franchising is still dominated by the single-unit operator. . . ."[68] As Killion observes, FRANdata's database of 180,000 franchisees and 255,000 unit addresses from 1,300 brands reveals that 51 percent of all units were owned by single-unit operators.[69] The authors' survey yielded similar results, with 47 percent of franchisees claiming to own just one unit and another 21 percent owning just two units.[70]

5. The Franchise Structure Leaves Franchisees in a Vulnerable Position

In a typical franchise arrangement, a franchisee pays the franchisor an initial franchise fee and then incurs significant expenses to locate a site, secure a lease, build out the premises, and comply with the franchisor's exacting standards and specifications.[71] Frequently, franchisees take on loans, sign personal guaranties, and depend upon profits from the franchised business as their sole source of income.[72] Moreover, an unprofitable franchisee generally has no contractual right to terminate the franchise agreement because the franchisee is losing money. The franchisee may remain bound to a lease, may obtain only minimal salvage value for highly specific supply and equipment purchases, may be personally liable for the current and future debts of the franchise, and is at risk of bankruptcy.[73] By making a sunken investment in a highly specific business, franchisees are incentivized to stay in business

66. *See infra*, Part IV.C.
67. *See* Peter C. Lagarias & Edward Kushell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 FRANCHISE L.J. 3, 3 (2013) (noting that "[f]ranchise agreements are written by franchisors and seldom reflect the interests and concerns of franchisees").
68. William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for A More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23, 28 (2008).
69. *Id.*
70. *See* Appendix A, *infra*, Table 4.
71. Lagarias & Kushell, *supra* note 67, at 4.
72. *Id.*
73. Hadfield, *supra* note 49, at 960.

despite losing additional money because the costs of exiting are too high.[74] This leaves franchisees susceptible to franchisor "opportunism."[75]

In contrast, the franchisor's risk is minimal. Aside from the opportunity cost of training and working with the franchisee, the franchisor has almost nothing invested. A franchisor will be paid a nonrefundable initial franchise fee and other ongoing fees until the franchisee stops operating.[76] A franchisor usually reserves the right to repurchase equipment at salvage value, use it elsewhere, and resell the franchise, earning yet another franchise fee.

B. *Franchise Agreements Today Are Not What They Used To Be*

Any progress made by franchisees since the first wave of franchise laws has been offset by the modern franchise agreement.

Although courts have ruled both ways on the issue, many courts still do not find a franchise agreement to be a contract of adhesion. These courts consider franchise agreements to be "commercial contracts" and follow a misguided blanket rule that all franchise agreements are freely negotiated.[77] However, franchise agreements in most cases *are* contracts of adhesion. The imbalance of power between franchisors and franchisees and the relative lack of franchisee sophistication found in the majority of franchise relationships render franchise agreements as adhesion contracts that are not freely negotiable.[78]

Common provisions in franchise agreements demonstrate why modern franchisees still need protection through various state franchise laws.[79]

1. The Franchisor's Right to Modify the System at the Franchisee's Expense

Franchise agreements often reference the franchisor's unique "System" and stress the franchisee's obligation to comply with the System in all re-

74. *Id.* at 951–52.

75. *Id.* Franchisee investments are so specific that, once expended, they are not easily recoverable if the franchisee goes out of business. And if franchisees do go out of business, they are likely to be sued for damages for early termination of the agreement.

76. Additionally, many franchisors seek lost future royalties and marketing fund fees from the franchisee if the franchise agreement is prematurely terminated.

77. *See, e.g.*, Shaffer v. Graybill, 68 F. App'x 374, 377 (3d Cir. 2003) ("We are unaware of any relevant cases in which the court has found an adhesion contract when dealing with the purchase of a franchise rather than a consumer purchase."); *In re* Tornado Pizza, LLC, 431 B.R. 503, 513 (Bankr. D. Kan. 2010) ("In this case the Franchise Agreements were not consumer transactions, and Debtor cannot prevail under Kansas law on the premise that the termination provisions of the Franchise Agreements are unenforceable adhesion contracts.").

78. *See supra* note 65 citing empirical evidence that clearly shows that franchise agreements are almost always non-negotiable; *e.g.*, *supra* note 64 (citing cases in which courts that have correctly found that franchise agreements are contracts of adhesion).

79. The following provisions are found in most modern franchise agreements. Peter Lagarias and Edward Kushell observed the "Commonality in Franchise Agreements," specifically, ten common one-sided provisions, in their article *Fair Franchise Agreements from the Franchisee Perspective*. *See* Lagarias & Kushell, *supra* note 67. The Service Employees International Union also reviewed the franchise agreement of fourteen large franchisors, totaling over 94,000 franchise units, and observed that the franchise agreements were all strikingly similar and one-sided. *Petition for Investigation of the Franchise Industry*, *supra* note 51, at 7–9.

spects. Because of the unpredictability of market conditions over the long term of franchise agreements (often ten or more years), franchisors invariably reserve the right to modify the System, through the operations manual or by other directives, in the franchisor's "sole discretion" or "business judgment," all at the franchisee's sole expense.[80] Indeed, a typical business judgment rule provision leaves no doubt that a franchisor may act in its own self-interest without regard to the franchisee.

Such extensive reservations tilt the battlefield in the franchisor's favor when tension inevitably arises from a franchisor's modification of the System. For example, a System modification may result in franchisees being forced to fund expensive promotional programs; renovations; or equipment, software, and hardware upgrades. The franchisor's express right to make certain changes, coupled with its unbridled discretionary standard, may even be outcome determinative in favor of the franchisor when franchisees challenge the system changes under the principle of good faith and fair dealing.[81]

With these types of provisions, franchisees have to choose between complying with the franchisor's directive, even if the investment is cost-prohibitive,[82] or challenging the changes under the franchise agreement's dispute resolution procedures and facing an uphill (and expensive) battle.[83]

2. Territorial Provisions

Territorial provisions in franchise agreements operate as *de facto* reservations of the franchisor's rights to encroach upon its franchisees. Depending on the franchise system, a franchisee may or may not receive an exclusive territory. In the worst-case scenario, a franchisee has no exclusive territory, allowing the franchisor or a third-party franchisee to operate a competing

80. *See* Lagarias & Kushell, *supra* note 67, at 7 (franchisors often reserve the right to modify the "System" "at will or under its sole discretion"); Brian B. Schnell, Ronald K. Gardner, Jr., *Battle over the Franchisor Business Judgment Rule and the Path to Peace*, 35 FRANCHISE L.J. 167, 168 (2015) (noting that, "[i]n recent years, however, franchisors have sought to replace or frame the good faith and fair dealing discretionary standard with a corporate law doctrine: the business judgment rule.").

81. *See*, *e.g.*, Johnson v. Arby's Inc., Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000) (permitting Arby's to require that new stores comply with its new building design in part because Arby's reserved its "sole discretion" to implement system standard changes in its operations manual); *see also* La Quinta Corp. v. Heartland Props., LLC, 603 F.3d 327 (6th Cir. 2010); Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306 (11th Cir. 2009).

82. For instance, in 2014, Wendy's sued one of its largest multi-unit franchisees for failure to remodel its franchises (estimated to cost $450,000 to $650,000 per franchise) and for failure to install a new point-of-sale system. Dan Eaton, *One of Wendy's Biggest Franchisees Won't Follow Remodeling Program, Gets Sued*, COLUMBUS BUS. FIRST, Dec. 31, 2014, https://www.bizjournals.com/columbus/news/2014/12/31/one-of-wendy-s-biggest-franchisees-won-t-follow.html?page=all. In turn, the franchisee countersued, claiming that remodeling its restaurants would provide no return on investment and would cost $75 million in the aggregate. Beth Ewan, *Wendy's Remodel Offers "No ROI," DavCo Counters in Lawsuit*, FRANCHISE TIMES, Feb. 19, 2015, *available at* http://www.franchisetimes.com/news/February-2015/Wendys-Remodel-Offers-No-ROI-DavCo-Counters-in-Lawsuit/.

83. For information on the one-sided dispute resolution procedures, *see infra*, Part III.B.6.

franchise in any location, regardless of the proximity to, or the financial impact on, the franchisee.[84]

Additionally, in nearly all franchise agreements, whether the franchisee has an exclusive or non-exclusive territory, franchisors still reserve the right to compete with their own franchisees through alternative methods.[85]

Permitting or encouraging intra-brand competition among franchisees in close proximity is especially harmful because franchisee customers generally have no allegiance to particular locations but rather to the uniform products and services offered at all franchise locations.[86] If a second franchise location is opened nearby or a franchisor begins competing over the Internet, the competition for the same customers inevitably cannibalizes sales.[87]

Franchisees in the 1990s had some success fighting off franchisor encroachment under the principle of good faith and fair dealing;[88] however, more recently several courts ruled that if the franchise agreement expressly permits the franchisor to open a competing franchise wherever it chooses, the implied covenant of good faith and fair dealing cannot override the express terms of a franchise agreement.[89] As a result, these territorial provisions and reservations can have a devastating effect on franchisees' profitability.

3. Restrictions on Renewal

Standard franchise agreements are for a fixed initial term and either expressly provide that the franchisee may renew the franchise only subject to

84. For instance, the McDonald's franchise agreement states: "[t]his Franchise establishes the Restaurant at the location specified on page 1 hereof only and that no 'exclusive,' 'protected,' or other territorial rights in the contiguous market area of such Restaurant is hereby granted or inferred. . . ." *See* McDonald's May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(e). Burger King's franchise agreements states: "This franchise is for the specified location only and does not in any way grant or imply any area, market or territorial rights proprietary to Franchisee." *See* Burger King April 28, 2017 as (amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement § 1.

85. *See*, *e.g.*, Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement §§ 1(C), (D) (containing some, but not all, of the typical franchisor reservations to compete with franchisees).

86. Lagarias & Kushell, *supra* note 67 at 13.

87. *Id.*

88. *See* Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991); *In re* Vylene Enters., 90 F.3d 1472, 1477 (9th Cir. 1996).

89. *See* Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999) (refusing to follow Scheck v. Burger King Corp.); *see also* Cohn v. Taco Bell Corp., No. 92-cv-5852, 1994 WL 13769, at *6 (N.D. Ill. Jan. 14, 1994) (no breach of the implied covenant of good faith and fair dealing where a franchise agreement contains a provision that expressly permits the franchisor to open competing franchises or company stores wherever it wants); Servpro Indus., Inc. v. Pizzillo, No. M2000-00832-COA-R3, 2001 WL 120731, at *4 (Tenn. Ct. App. Feb. 14, 2001) (allegations of encroachment do not constitute a claim for breach of the implied covenant of good faith and fair dealing where there is no evidence that the franchisor "bore any kind of malice against" the franchisee, that the franchisor "wished to damage or destroy [the franchisee's] franchise," or that the franchisor "colluded with" a competing franchisee to expand the competing franchise allegedly at the expense of the plaintiff franchisee); *but see* Handlers-Bryman v. El Pollo Loco, Inc., Case No. MC026045 (Cal. Super. Ct. Mar. 30, 2017) (holding that a "reservation of rights" clause for a franchisor to put a store wherever it wanted when there was no exclusive territory was unconscionable and unenforceable).

several onerous renewal conditions[90] or that the franchisee has no right to renew.[91]

Having no renewal right is especially harmful because the franchisee develops all the goodwill and eventually has to stop operating the franchise, cannot sell it, and has to give it back to the franchisor. Even with renewal rights, the renewal conditions can significantly alter the status quo and make the mere continuance of operating as a franchisee not feasible.

4. Conditions to Transfer

Although franchisees are generally permitted to transfer their interests in the franchise agreement, most franchise agreements, similar to renewal provisions, force the franchisee to meet a host of onerous conditions.[92]

Conditions to transfer pose two major problems for franchisees. First, the franchisor may rely on these provisions to disrupt or slow down a sale.[93] By disrupting the sale, the franchisor can attempt to force the franchisee to sell to a preferred buyer or purchase the franchise itself at a discount. Second, by forcing the franchisee or the transferee to modernize the franchise in accordance with current system standards, or by forcing a transferee to sign the franchisor's then-current form of franchise agreement, a franchisor can make the franchise much less valuable and drive down the sale price.

90. Common renewal conditions include: (1) the franchisee must sign the franchisor's then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must sign a release of all claims against the franchisor or its affiliates; (4) the franchisee must pay a renewal fee; and (5) the franchisee must be in compliance with, or have never defaulted on, not only that specific franchise agreement, but all other agreements entered into with the franchisor. *See* Dunkin' Donuts' April 3, 2017 FDD, Exhibit B-1, Franchise Agreement § 2.4(b) (containing some, but not all, of these typical provisions).

91. For instance, the McDonald's current form franchise agreement expressly provides that there is "no promise or representation as to the renewal of this Franchise or the grant of a new franchise. . . ." *See* McDonald's May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(a).

92. Common transfer conditions include: (1) the transferee must sign the franchisor's then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee or transferee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must have never been in default of the franchise agreement or any other agreement entered into with the franchisor or the franchisor's affiliates; (4) the transferee must meet the franchisor's criteria for new franchisees; (5) the franchisee or the transferee must pay a transfer fee; and (6) the franchisee must first provide the franchisor with the right of first refusal to purchase the business on the same terms as the transferee. *See, e.g.*, Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement § 12(D) (containing some, but not all, of these typical provisions).

93. See, e.g., Burger King Corp. v. H&H Rest., LLC, 2001 WL 1850888 (S.D. Fla. Nov. 30, 2001) (finding that Burger King Corporation did not unreasonably withhold its consent to a proposed transfer because it had the "sole discretion" to determine whether the proposed transfer was acceptable).

5. Cross-Default Provisions

In most franchise agreements, cross-default provisions grant the franchisor the right to terminate a franchise agreement if the franchisee defaults under any other agreement entered into with the franchisor or its affiliates. Cross-default provisions are becoming more common and are extremely dangerous because franchisees are commonly required to enter into leases and additional ancillary "supplier," "software," or "hardware" license agreements with their franchisors or their affiliates, and because franchisees may enter into additional franchise agreements with their franchisor in the future. Cross-default provisions, if enforced, provide franchisors with an extreme amount of leverage over franchisees and further perpetuate the imbalance of power. By using such a provision, a franchisor can, or can threaten to, take multiple franchises away from the franchisee for numerous reasons—even if the default is an inadvertent mistake or unrelated to the operation of the franchise.[94]

6. Dispute Resolution Provisions

Most modern franchise agreements contain extensive dispute resolution procedures that favor the franchisor. Franchisees are often forced to agree: (1) to arbitrate in the franchisor's home state; (2) to accept that the law applied to all disputes is the law of the franchisor's home state; (3) to waive the right to a jury trial; (4) to limited damages; (5) to shortened statutes of limitations; (6) to not join with other franchisees as a class to file an action against the franchisor for common problems; and (7) to pay their franchisors' attorney fees and costs if they bring a lawsuit against the franchisor and the franchisor prevails.

These provisions can make it costly, and even cost-prohibitive, for a franchisee to bring a claim against its franchisor.[95] Additionally, these provisions limit franchisors' litigation risks.[96]

The modern franchise agreement has evolved from fewer than ten pages to between thirty pages (on the low end) and ninety pages (on the high end), with multiple exhibits and ancillary agreements.[97] Prior franchise agreements were not so drastically one-sided.[98] Today, franchise agreements have evolved to in-

94. *See, e.g.*, Gun Hill Rd. Serv. Station, Inc. v. ExxonMobil Oil Corp., No. 08 CIV. 7956 PKC, 2013 WL 395096, at *11 (S.D.N.Y. Feb. 1, 2013).

95. *See infra*, Part III.E (noting a Florida franchisee testifying about the devastating expenses for franchisees seeking to vindicate their rights according to franchise agreement dispute resolution procedures); Lagarias & Kushell, *supra* note 67, at 23–29 (detailing the significant costs for franchisees to follow the procedures in the franchise agreement for dispute resolution).

96. Lagarias & Kushell, *supra* note 67, at 23–29.

97. *Id.* at 4. Massage Envy's 2017 franchise agreement is fifty-two pages, excluding attachments, and Burger King's 2017 franchise agreement for individuals is thirty-three pages, excluding attachments. *See* Massage Envy's April 20, 2017 FDD, Exhibit B, Franchise Agreement; Burger King's April 28, 2017 (as amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement.

98. One example of the evolving nature of franchise agreements is the relatively new "business judgment rule" provision setting forth an extremely lenient discretionary standard for franchisors. *See generally* Schnell & Gardner, *supra* note 80.

clude, in most cases, the entirely one-sided provisions noted above and many more.[99] The ultimate result is the perpetuation of the imbalance of power between the franchisor and franchisee.

C. *The "Balance of Information in the Age of the Internet" Does Not Diminish the States' Legitimate Interest in Regulating Franchisors*

The Oates Article argues that franchisees no longer need the protection of state franchise laws because there has been "a dramatic change in the access individuals have to information on about business, finance, and the law."[100] This has, as the Oates Article puts it, "diminished" the states' legitimate interest in regulating franchise sales.[101]

On the contrary, a large number of franchisees enter into a franchise agreement with no prior franchise experience, without an attorney reviewing the FDD or franchise agreement, and without the aid of counsel in negotiating the franchise agreement's terms.[102] Inevitably, prospective franchisees will simply be unaware of the business and legal risks of entering into a franchise agreement. The Oates Article points out that prospects will have an FDD, a franchise agreement, and the Internet available to them.[103] But how helpful are each of these pieces of information for someone with no background in franchising, business, or the law?

Empirical evidence, as well as common sense, suggests that the information available to franchisees is less helpful than franchisor advocates believe.[104] Indeed, FDDs are dense, technical documents containing legal disclosures and financial data that are hundreds of pages in length.[105] Similarly, franchise agreements are filled with legal jargon and are generally more than thirty pages long. Sifting through these documents is a daunting task for anyone. It is no surprise that empirical evidence reveals that, rather than review, analyze, and understand FDDs, many franchisees ignore the FDD altogether.[106] Regardless, for those that do not completely ignore the FDD, the authors' survey revealed that 33 percent of franchisees either disagreed

99. Additional one-sided provisions not listed above include, but are not limited to, the franchisor's right to restrict the sourcing of franchisee required purchases of products and services; post-term non-competition clauses preventing the franchisees from working in their former line of work; and the franchisor's express right to sue for lost future profits (royalty and advertising fees).

100. Oates Article, *supra* note 7, at 214.

101. *Id.*

102. *See supra* Part IV.A.2.

103. Oates, supra note 7, at 214.

104. Emerson & Benoliel, *supra* note 50, at 215 (concluding that there is a false assumption that franchisees are sophisticated business people who consider all relevant information and make informed business decisions prior to entering into a franchise relationship).

105. For example, Subway's May 1, 2017 FDD, including exhibits, is more than 500 pages, and Burger King's April 28, 2017 (as amended October 20, 2017) FDD is more than 1,000 pages.

106. Kimberley A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. Small Bus. Mgmt. 27, 30–31, Table 2 (1996). As explained by Professors Emerson and Benoliel, a novice franchisee aspiring to own a franchise and reviewing all relevant information "will face

or strongly disagreed with the statement that the FDD was an accurate and complete description of the franchise investment.[107]

The Oates Article also assumes that information on the Internet is true, accurate, and reliable and that an average franchisee is capable of sifting through the information, identifying its source, and putting it to meaningful use. The authors believe that none of these assumptions reflects reality. Similar to a prospect reviewing an FDD and franchise agreement, franchisees searching the Internet for franchise information likely face the same "overwhelmed" feeling due to the sheer amount of information available. Further, how is a prospect to know what is accurate and credible, what is helpful and not helpful, who is providing this information, and what is the provider's motivation? Regardless, franchisors utilize merger and integration clauses to disclaim the very information that is suggested to help franchisees evaluate franchise opportunities. The franchisor's own documents state that it is unreasonable to rely upon anything not stated in the FDD. Yet, now franchisees are "protected" by information they specifically *may not* rely upon?

In reality, "the balance of information in the age of the Internet" does not level the playing field for franchisors and franchisees.

D. *Franchise Fraud, Deception, and Other Misleading and Abusive Practices Continue*

Despite a claimed increase in franchisee sophistication, statutorily mandated disclosures, and information on the Internet, franchisees today remain susceptible to fraud, deception, and other misleading and abusive practices at the hands of their franchisors. Empirical and anecdotal evidence proves this point. For instance, franchisees have complained about many franchisor actions: (1) the franchisor's FDD is not a complete and accurate description of the franchise investment;[108] (2) franchisors continue to make financial performance representations via the Internet and outside of Item 19 of the FDD;[109] (3) franchisors continue fraudulently to induce franchisees to enter into franchise agreements;[110] (4) franchisors terminate franchisees

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three cognitive obstacles: the unawareness problems, screening difficulty, and comprehension limitations." Emerson & Benoliel, *supra* note 50, at 209–10.

107. *See* Appendix A, *infra*, Table 5.

108. Only 28 percent of franchisees in one survey agreed or strongly agreed that the franchisor's FDD is a complete and accurate description of the franchise investment, while 33 percent disagreed or strongly disagreed. *See* Appendix A, *infra*, Table 5.

109. In the authors' survey, 17 percent of franchisees stated that their franchise salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC. *See* Appendix A, Table 6; *see also Petition for Investigation of the Franchise Industry*, *supra* note 51, at 12–13 (outlining blatant Item 19 violations in franchise advertisements such as "Makes more Money," ". . . recently launched locations hitting one million dollars of revenue in their first year," and "Profits, from day 1").

110. *See* Checkers Drive-In Rest., Inc. v. Tampa Checkmate Food Servs., Inc., 805 So. 2d 941, 943 (Fla. Dist. Ct. App. 2001).

and then sue them for "lost future profits;"[111] (5) franchisors improperly use money from system-wide advertising funds;[112] (6) franchisors attempt to intimidate franchisees and force them out of their franchises;[113] (7) franchisors retaliate against members of franchisee associations;[114] and (8) franchisors engage in the practice of "churning."[115]

As a result, the need for franchise laws protecting franchisees in both the sales process and throughout the relationship remains important today.

E. *Recent Franchise Legislation Demonstrates the Continuing Need for Statutory Protection for Franchisees*

The Oates Article claims that state franchise laws have "remain largely unchanged for nearly fifty years."[116] A survey of numerous states that continually propose and enact "pro-franchisee" laws, or propose and amend current franchise laws, stands in stark contrast not only to this claim, but also to the Oates Article's claim that the states' legitimate interest in regulating franchisors and franchisees has diminished over time. The testimony in support of recent franchise legislation and its stated purposes proves that inequities in the franchise relationship continue today.

For example, in 2007 Rhode Island enacted the Rhode Island Fair Dealership Act (RIFDA), which provides the typical protections found in franchise relationship laws.[117] Although RIFDA ended a seventeen-year drought in enacting franchise "relationship" laws in the United States, other efforts have been made but came up short.[118]

Most recently, in October 2015, California's legislature enacted sweeping franchise legislation, which has been described as "the toughest franchisee-protection law in the nation."[119], Specifically, the California Franchise Rela-

111. Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, 1717 (1996) (franchisor terminated franchisee for missing royalty payments and sued for seven years of estimated "lost future profits" (royalties and advertising fees) for the remainder of the term of the franchise agreement).

112. *Tim Hortons franchisee group files new lawsuit against parent company*, NAT'L POST, Oct. 6, 2017, http://nationalpost.com/pmn/news-pmn/canada-news-pmn/tim-hortons-franchisee-group-files-lawsuit-against-parent-company (these allegations have not been proven at this preliminary stage).

113. Hollie Shaw, *Tim Hortons Franchisees Sue Corporate Parent for $850M, Alleging Bullying and Intimidation*, FIN. POST, Oct. 6, 2017, http://business.financialpost.com/news/retail-marketing/tim-hortons-franchisees-sue-corporate-parent-for-850m-alleging-bullying-and-intimidation (these allegations have not been proven at this preliminary stage).

114. Sean Kelly, *7-Eleven Whistleblower Alleges Predatory Practices, Franchise Churning & Personal Vendettas*, BLUE MAUMAU, May 7, 2015, http://www.bluemaumau.org/7eleven_whistleblower _alleges_predatory_practices_franchise_churning_personal_vendettas.

115. *Id.*; *Franchisees Paint Grim Scenes of Dunkin'*, BLUE MAUMAU, July 13, 2011, http://www.bluemaumau.org/10538/franchisees_paint_grim_scene_dunkin.

116. Oates Article, *supra* note 7, at 185.

117. 6 R.I. Pub. Laws § 6-50-1 (2007).

118. Joseph J. Fittante, Jr., Meredith Bauer, *Defaults and Terminations: An Unfortunate Reality of A Challenging Economy*, 28 FRANCHISE L.J. 214 (2009) (noting that in 2007, Kansas and Tennessee considered, but ultimately did not pass, the Kansas Responsible Franchise Practices Act and the Tennessee Franchise Disclosure Act).

119. *See* Spandorf, *supra* note 8.

tions Act (CFRA) was amended to include significant additional protections for franchisees facing termination or nonrenewal without fair compensation for their franchised businesses.[120] Assembly Bill No. 525 addressed what the California legislature clearly found were inequities in the modern franchise relationship.[121]

In recent years, bills aimed at protecting franchisees have been introduced in state legislatures across the country, including in Florida, Maine, Massachusetts, and Pennsylvania.[122] Even though franchisor advocates and lobbyists have successfully opposed these bills and prevented their enactment, testimony in support of these bills underscores the problems that many franchisees continue to face today. Examples include:

- A franchisee wrote a letter in support of franchisee renewal rights, stating: "[p]resently Franchise Owners who adhere to brand standards and honor their obligations can only watch their equity evaporate as the end of their franchise term nears. Without reasonable assurances of renewal, our family businesses essentially become rent-a-businesses and are worthless to anyone except the Franchisor. Franchise Owners are often presented with one of two options: Sign a more draconian new

120. California Legislative Information, Assembly Bill No. 525, *available at* http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB525&search_keywords=%22Franchisee%22.

121. The bill passed with a large majority in the California legislature, 56–12 in the Assembly and 37–0 in the Senate. Michel Guta, *A Break for California Franchise Owners? New Law Gives Them More Control*, SMALL BUS. TRENDS, Nov. 2, 2017, https://smallbiztrends.com/2015/11/california-franchise-owners-assembly-bill-525.html. Chris R. Holden, one of the legislators who championed the bill, drafted a letter to the Chief Clerk of the California State Assembly to ensure the intent of the bill was clear. He stated, among other things, that: (1) owning a franchise requires significant investment and risk on the part of the franchisee—risk often not shared between franchisee and franchisor; (2) the bill was intended to ensure that terminated franchisees recoup a portion of their investment in items specific to the franchise that the franchisor can use or sell to another franchisee; (3) the bill was to protect franchisees that are forced to pay large fees for franchise assets that remain owned by the franchisor; (4) the intent of the bill was to provide a clear and transparent process for the transfer of a franchise and to prohibit franchisors from arbitrarily withholding consent to a sale when a qualified buyer is presented; and (5) it was the legislative intent that a franchisee has the legal right to obtain injunctive relief to prevent the selling or takeover of his business by a franchisor during any legal action. *See* Letter to E. Dotson Wilson from Chris R. Holden, CAL. BUS. & PROF. CODE § 20020 (West), Historical and Statutory Notes, 2017 Main Volume.

122. *See* A.B. 525, Gen. Assemb., Reg. Sess. (Cal. 2015), *available at* http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB525&search_keywords=%22Franchisee%22; H.P. 1043, L.D. 1458, 126th Gen. Assemb., Reg. Sess. (Me. 2015), *available at* http://www.mainelegislature.org/legis/bills/getPDF.asp?paper=HP1043&item=2&snum=126; S.B. 1843, 187th Gen. Assemb., Reg. Sess. (Mass. 2011), *available at* https://malegislature.gov/Bills/187/S1843; S.B. 73, 188th Gen. Assemb., Reg. Sess. (Mass. 2013), *available at* https://malegislature.gov/Bills/188/S73; S.B. 114, 189th Gen. Assemb., Reg. Sess. (Mass. 2015), *available at* https://malegislature.gov/Bills/189/S114; H.B. 1913, 201st Gen. Assemb., Reg. Sess. (Pa. 2017), *available at* http://www.legis.state.pa.us/CFDOCS/Legis/PN/Public/btCheck.cfm?txtType=PDF&sessse=2017&sessInd=0&billBody=H&billTyp=B&billNbr=1913&pn=2705; H.B. 1913, 201st Gen. Assemb., Reg. Sess. (Pa. 2017), *available at* http://www.legis.state.pa.us/cfdocs/legis/PN/Public/btCheck.cfm?txtType=PDF&sessYr=2017&sessInd=0&billBody=H&billTyp=B&billNbr=1913&pn=2705.

form franchise agreement or walk away from their life's work and family's business equity."[123]

- A franchisee testifying as to franchisor abuses explained that, after he had made improvements to both of his franchised stores, his franchisor singled him out and terminated his two franchises based upon a pretext, all so the franchisor could resell his franchises at a profit.[124]
- A former franchisee, and then attorney, testified that, despite positive changes to a particular franchisor's franchise agreement, "[t]he fact is there are bad actors. That's why you need a minimal level of behavior."[125]
- A Pennsylvania legislator championing a franchise bill noted to his colleagues: "Pennsylvania is lagging behind the curve when it comes to franchise regulation. The laws in place do not do enough to protect franchisees from unfair practices in the sale and operation of franchised businesses."[126]
- Florida franchisees recently testified about the very real, common, and *current* problems and abuses franchisees face, including franchisors taking franchised businesses (and the franchisees' established goodwill) without "good cause," the devastating costs of litigation for franchisees, and the fact that nearly all franchisors require franchisees to bet their personal and family wealth on the success of the franchise venture by requiring a personal guaranty.[127]
- A representative of several franchisee associations testifying in support of franchisee protection summarized the inherent problem in franchising without state franchise laws, stating: "[franchising is the] perfect symbiotic relationship . . . unless [there is] a bad franchisor," in which case it turns "into a nightmare" for franchisees.[128]

Indeed, although certain "pro-franchisee" bills have passed and others have failed, despite any alleged "balance of information in the age of the Internet," franchisees are telling state legislatures that they rely on statutory protections at least as much today as they did in the past.

123. *Id.* at 26.

124. *Id.* This process is known as "churning," a franchisor ploy to opportunistically terminate a franchise agreement of an otherwise efficient and profitable franchisee in order to resell the franchise at a premium or to operate the profitable franchise as a company-owned outlet. Uri Benoliel & Jenny Buchan, *Franchisees' Optimism Bias and the Inefficiency of the FTC Franchise Rule*, 13 DEPAUL BUS. & COM. L.J. 411, 415–16 (2015).

125. *See Franchisees Paint Grim Scenes of Dunkin'*, *supra* note 115.

126. Representative Thomas P. Murt, House Co-Sponsorship Memoranda—Pennsylvania Franchise Law, Oct. 26, 2017, *available at* http://www.legis.state.pa.us//cfdocs/Legis/CSM/showMemoPublic.cfm ?chamber=H&SPick=20170&cosponId=24778 (last visited Oct. 29, 2018).

127. Florida Senate, Committee on Regulated Industries, Senate Committee Meeting, Apr. 4, 2017, *available at* http://www.flsenate.gov/media/videoplayer?EventID=2443575804_2017041034& Redirect=true (testimony beginning at 21:00).

128. *Id.*

IV. Extraterritorial Application of State Franchise Laws Does Not Violate the Dormant Commerce Clause

The Oates Article flatly asserts that some state franchise statutes "raise constitutional issues" and that courts have not properly addressed what interest a state may have in regulating the sale or operation of franchises not owned by their residents or operated in their state.[129] The authors of this article believe neither assertion is true.

The U.S. Constitution grants Congress the power to "regulate commerce . . . among the several States."[130] Courts recognize "that this affirmative grant of authority also encompasses an implicit or dormant limitation on the authority of states to enact legislation affecting interstate commerce."[131] The Commerce Clause reflects "the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and the autonomy of the individual states within their respective spheres."[132]

A court analyzing a Commerce Clause challenge applies two tiers of scrutiny: a "discrimination" tier and an "undue burden" tier. Under the discrimination tier, "when a statute clearly discriminates against interstate commerce," either on its face or in its effect, "it will be struck down unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism."[133] Such statutes are *per se* invalid.[134] Under the undue burden tier, the court will uphold statutes that "regulate evenhandedly to effectuate a legitimate local public interest" and have "only incidental effects" on interstate commerce unless the party challenging the statute can show that the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.[135]

In the franchise arena, courts have unanimously rejected franchisor challenges to state franchise statutes under the discrimination tier.[136] Courts have held that franchise statutes are facially neutral in that they regulate both resident franchisors and foreign franchisors, and franchisors have been unable to prove a discriminatory effect on interstate commerce.

A. *State Franchise Statutes Are Not Unconstitutionally Extraterritorial*

Although state laws that have "the practical effect of regulating commerce occurring wholly outside the state's borders" are invalid under the Com-

129. Oates Article, *supra* note 7, at 213.
130. U.S. Const. art. I § 8, cl.3.
131. Healy v. Beer Inst., 491 U.S. 324, 326 n.1 (1989).
132. *Id.* at 335–36.
133. Wyoming v. Oklahoma, 502 U.S. 437, 454–55 (1992).
134. Instructional Sys., Inc. v. Computer Curriculum Corp., 35 F.3d 813, 824 (3d Cir. 1994).
135. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).
136. *See* Yamaha Motor Corp., USA v. Jim's Motorcycle, Inc., 401 F.3d 560 (4th Cir. 2005); *see also* Int'l Franchise Ass'n, Inc. v. City of Seattle, 97 F. Supp. 3d 1256, 1268–69 (W.D. Wash. 2015).

merce Clause,[137] not every law that has some measurable out-of-state impact violates the Commerce Clause. As the court in *Instructional Systems v. Computer Curriculum* noted, "it is inevitable that that a state's law . . . will have extraterritorial effects."[138] Courts "never suggested that the Dormant Commerce Clause requires Balkanization, with each state's laws stopping at the border."[139] Although some state franchise statutes affect franchise relationships in other states, they do not, as the Oates Article suggests, "raise constitutional issues."[140]

To determine whether a state's legislation has an impermissible extraterritorial effect, courts focus on the applicability and effects of the statute as well as the risk of inconsistent legislation between different states. In *Healy v. Beer Institute*, Justice Blackmun summarized the Court's approach to extraterritoriality: "taken together our cases . . . stand at a minimum for . . . three propositions."[141] First, the Commerce Clause "precludes the application of a state statute to commerce that takes place *wholly* outside of the State's borders."[142] Second, a statute that "directly controls commerce occurring *wholly* outside the boundaries of a State exceeds the inherent limits of the enacting State's authority and is invalid regardless of whether the statute's extraterritorial reach was intended."[143] The reviewing court will inquire "whether the practical effect of the regulation is to control conduct beyond the boundaries of the state."[144] Third, any assessment of the "practical effect" of a statute must consider "how the challenged statute may interact with the regulatory schemes of other states," including what the effect would be if "many or every State adopted similar legislation."[145] A statute that violates any of the propositions is *per se* invalid.

1. State Franchise Statutes Do Not Apply to Conduct Wholly Outside State Borders

The Oates Article argues that courts have generally invalidated state franchise statutes that apply to non-resident franchisees operating in other states as violations of the Commerce Clause because they require "non-residents to obtain the approval of the regulating state before they can implement spe-

137. *Healy*, 491 U.S. 324, 336–37.
138. 35 F.3d 813, 826 (3d Cir. 1994).
139. *Id.*
140. Oates Article, *supra* note 7, at 212. Although issues of extraterritoriality could be discussed in the context of other constitutional provisions such as the Full-Faith-and-Credit Clause, courts typically "treated extraterritoriality, when it has arisen in the context of a dormant commerce clause case, as if it were a dormant commerce clause problem." *Instructional Sys.*, 35 F.3d at 824 n.17.
141. 491 U.S. at 336 (1989).
142. *Id.; see also* Edgar v. MITE Corp., 457 U.S. 624, 642–43 (1982) (emphasis added); Brown-Forman Distillers Corp. v. New York State Liquor Auth., 476 U.S. 573 (1986).
143. *Healy*, 491 U.S. at 337.
144. *Brown-Foreman*, 476 U.S. at 579.
145. *Id.*

cific business practices elsewhere."[146] This analysis ignores the fact that even the "broadest" of state franchise statutes apply "only when an important aspect of the franchise transaction," such as an offer to sell or buy, acceptance of the offer, or the actual sale occurs in the regulating state.[147,148]

Under Justice Blackmun's analysis in *Healy*, a statute's extraterritorial reach is void only if it applies to conduct that occurs *wholly* outside the enacting state's borders. *Healy*, for example, struck down a liquor pricing statute that attempted to regulate the price of alcohol in other states.[149] Similarly in *Edgar v. MITE Corp.*, the U.S. Supreme Court struck down a statute that required state regulators to approve corporate takeover offers, even if such offers would affect no Illinois shareholders.[150]

However, a statute that applies to conduct that occurs both inside and outside of the state is permissible. Thus, in *Instructional Systems v. Computer Curriculum Corp.*, the court rejected a challenge to the extraterritorial application of the New Jersey Franchise Practices Act, holding that a franchisee who was a party to a multi-state franchise agreement could assert claims under the Act (even though several of the franchise outlets were located outside of New Jersey) because the franchisee had a location in New Jersey.[151] Similarly, in *Mon-shore Management, Inc. v. Family Media Inc.*, the court held that the New York Franchise Sales Act did not violate the Dormant Commerce Clause by regulating the sales of franchises in circumstances "where the offer originates, is extended or is accepted in New York."[152] In that case, the court explained that "while the primary thrust of the [Franchise] Act was full disclosure," it also attempted to "forge a comprehensive legal structure to thwart, combat, and rectify franchise sales abuses."[153] The court pointed to the legislative finding of the Act stating that "New York has a valid interest in protecting franchisees from unscrupulous franchisors" and noted that by extending the Act's protection to franchisees in other states, as long as the offer or acceptance took place in New York State, the legislature was acting not only to protect franchisees but also to "protect

146. Oates, *supra* note 7, at 212.

147. Mon-Shore Mgmt., Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D.N.Y 1984).

148. The Oates Article relies on a parade of horribles to bolster its claim that state franchise statutes pose a risk of extraterritorial application, noting that that it is "troubling . . . that courts in New York and Florida are willing to impose their state's franchise statutes even when there have been no contacts with the state other than a choice of law provision." Oates, *supra* note 7, at 213. The Oates Article fails to cite any cases to support its concern. In fact, courts have repeatedly held that a franchisee may not make claims under a state's franchise statute when the franchisee had no contact with the state even when the parties agree that law of the state applies. *See* Taylor v. 1-800-Got-Junk?, LLC, 632 F. Supp. 2d 1048 (W.D. Wash. 2009); Cromeens Holloman, Sibert, Inc., v. AB Volvo, 349 F.3d 376, 386 (7th Cir. 2003). Even New York courts have reached that conclusion. *See* Peugeot Motors of Am., Inc. v. E. Auto Distrib., Inc., 892 F.2d 355, 358 (4th Cir. 1989).

149. *Healy*, 491 U.S. at 337.

150. 457 U.S. 624 (1982).

151. *Instructional Sys.*, 35 F.3d at 826.

152. *Mon-Shore Mgmt.*, 584 F. Supp. at 189–90.

153. *Id.* at 189.

and enhance the reputation of the State, which is in and of itself, a legitimate and substantial state interest."[154]

Indeed, it would be nonsensical, for example, for Minnesota to discourage franchise sales abuses by enacting a law that protected Minnesota residents from all unscrupulous franchisors, but allowed franchisors, Minnesota-based or foreign, to engage freely in franchise sales abuses in Minnesota as long as their victims are non-residents.

The Oates Article argues that the decision in *Mon-Shore* "contradict[s] the more sound reasoning of the U.S. Supreme Court in *Edgar v. MITE Corp*."[155] This is not true. The *Mon-Shore* court extensively discussed and distinguished *Edgar*, noting that "while superficially appealing," the "analogy between [the statute at issue in *Edgar*]" and New York's Franchise Sales Act "is inapposite."[156] In *Edgar*, the Supreme Court held that the statute violated the Dormant Commerce Clause because the challenged statute could have "permanently thwarted" a nationwide tender offer from a non-resident actor even if none of its resident shareholders were affected by the offer, and that the State of Illinois has no legitimate interest in protecting non-resident shareholders in out-of-state transactions.[157] Conversely, in *Mon-shore*, the regulated transaction, the sale of a franchise, occurred within the boundaries of the regulating state. *Mon-Shore* and later courts have repeatedly held that state franchise laws generally do not regulate extraterritorially because each statute "only becomes operative when an important aspect of the franchise relationship" occurs within the state.[158] The authors believe the Oates Article unreasonably narrows the meaning of the word "commerce" by focusing exclusively on the residence of the franchisee or the location of the franchise, removing the entire franchise sales process from the equation.

In addition to ignoring key differences between the challenged statute in *Edgar* and state franchise laws, the Oates Article fails to mention a distinguishing factor—that the challenged Illinois statute was preempted by federal legislation and that the state statute conflicted with federal law.[159] The same is not true with franchise law. Under the FTC Rule, states are not only explicitly empowered to enact statutes that provide greater protection, they are encouraged to do so.[160] The Oates Article's comparison between the statute in *Edgar* and state franchise statutes would be valid only if the FTC removed the FTC Franchise Rule language empowering states to enact broader franchise legislation, and if state franchises statutes applied to all franchise transactions irrespective of the residence of the franchisor, the franchisee, the franchise outlet, and the location(s) of the transaction.

154. *Id.* at 191–92.
155. Oates, *supra* note 7, at 213.
156. *Mon-Shore Mgmt.*, 584 F. Supp. at 190.
157. *Edgar*, 457 U.S. at 642–43.
158. *Mon-Shore Mgmt.*, 584 F. Supp. at 191.
159. *Edgar*, 457 U.S. at 640.
160. 16 C.F.R. § 436, n.2.

A state franchise statute in Kentucky regulating sales made in Nevada by a Georgia franchisor would probably violate the Dormant Commerce Clause.

2. State Franchise Statutes Do Not Affect Commerce Wholly Outside State Borders

Franchisors have also argued that franchise statutes are unconstitutional because they have extraterritorial effects. Again, this misrepresents the actual legal standard. A statute that regulates extraterritorially is *per se* invalid only if it "directly controls commerce occurring *wholly* outside the boundaries of a State."[161] Thus, *in Volvo Trademark Holding Aktiebologet v. AIS Construction Equipmen*t, the court held that the Arkansas Unfair Trade Practices Act was not *per se* invalid because "at least one end [of the transaction] must be in Arkansas" and therefore the statute could not regulate "commerce occurring wholly outside Arkansas."[162]

The Oates Article argues that "courts have not properly addressed what interest, if any, states have in regulating franchises" that are not located in or operated by residents of the regulating states.[163] A cursory review of the case law demonstrates this is not true. Several courts have discussed why legislatures may choose to regulate franchises that are sold but not located in their state. In *Mon-Shore Management*, discussed earlier, the court noted that the New York legislature "did not attempt to protect only the residents of this State," but by extending the protections of the Act to franchisees who received or accepted an offer in New York, the legislature acted to "protect and enhance the commercial reputation of the State itself."[164] Similarly, in *Red Lion Hotels Franchising, Inc., v. MAK, LLC*,[165] the court noted that "it was easy to see why the Washington legislature might have wanted to apply" the Washington franchise statute's relationship provisions to nonresident franchisees of a Washington franchisor: "the legislature might have wanted to reassure potential out-of-state franchisees that they would be treated fairly by, and thereby encourage them to do business with, Washington franchisors."[166]

Several franchise statutes expressly apply to a franchise "offered" or "sold" "in this state."[167] It is difficult to imagine that, despite this plain language,

161. *Healy*, 491 U.S. at 336.

162. Volvo Trademark Holding Aktiebolaget v. AIS Constr. Co., 416 F. Supp. 2d 404 (W.D.N.C. 2006).

163. Oates Article, *supra* note 7, at 213.

164. *Mon-Shore Mgmt.*, 584 F. Supp. at 191.

165. 663 F.3d 1080 (9th Cir. 2011).

166. *Id.* at 1091.

167. *See* Cal. Corp. Code § 31013 (1971); R.I. Gen. Laws § 19-28.1–4 (1993); Or. Rev. Stat. § 650.015 (1973); Mich. Comp. Laws § 445.1507a (1989); N.D. Cent. Code § 51-19-02(14)(b) (1993); Wash. Rev. Code § 19.100.020 (2012); Minn. Stat. § 80C.03 (1986); Wis. Stat. § 553.21 (2017); 815 Ill. Comp. Stat. 705/3(20) (2009); S.D. Codified Laws § 37-5B-2 (2008); Md. Code Ann., Bus. Reg. § 14-203(a) (1992).

state legislators would permit fraudulent activity by in-state franchisors merely because the franchisee victims are out-of-state.[168]

3. State Franchise Statutes Do Not Pose a Risk of Inconsistent Legislation

Finally, franchisors have argued that the state franchise statutes violate the Dormant Commerce Clause because they subject franchisors to inconsistent state regulations. However, "state laws which merely create additional, but not irreconcilable, obligations" are not considered to be "inconsistent" for the purpose of a Dormant Commerce Clause challenge.[169] The party challenging the law bears the burden of demonstrating that the challenged statute creates "actual conflict amongst state regulations."[170] Thus, in *Instructional Systems, Inc., v. Computer Curriculum Corp.*, the court concluded that the New Jersey Franchise Protection Act's limitations on terminations were not *per se* invalid because "while the laws of other states might permit [the franchisor] to conduct its franchise relationship with [the franchisee] under a different framework than the one required by NJFPA, that difference in approach by different states is not sufficient to require *per se* invalidation."[171] The court explained that state franchise statutes that require the franchisor to register prior to selling franchises or which require additional disclosures would also not be *per se* violations.[172]

Applying the principle that a state law is not *per se* invalid unless it would create "actual conflict among state regulations," it is clear that state franchise registration statutes are not unconstitutionally extraterritorial. The mere fact that something may be subject to stricter sale requirements in one state than in another does not violate the Dormant Commerce Clause. For example, the fact that a gun seller may have to comply with stricter regulations to sell a gun in the state of Washington than in Texas (regardless of which state the gun purchaser resides in) does not violate the Dormant Commerce Clause. If states were to enact legislation that imposed no more regulations than the least restrictive state, states would cease to be "laboratories of democracy" and would instead become participants in a race to the bottom in which the state with the least regulations would set the standard for the nation.

If state franchise statutes truly burdened interstate commerce, one would expect to see some impact on the franchise economy in the states with the

168. *See, e.g.*, Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 890 F.2d 165, 171 (9th Cir. 1989) (correctly holding that the California Franchise Investment Law applied to a franchise agreement negotiated and executed in California, even though franchise was purchased by nonresidents and operated in the Virginia–Maryland–D.C. area).

169. *Instructional Sys.*, 35 F.3d at 826 (quoting Buzzard v. Roadrunner Trucking, 966 F.2d 777, 784 n.9 (3d Cir. 1992)).

170. *Id.* (quoting Old Bridge Chems., Inc. v. New Jersey Dep't of Envt'l Prot., 965 F.2d 1287, 1293 (3d Cir. 1992)).

171. *Id.* at 826.

172. *Id.*

broadest regulations. The data does not support this conclusion. Florida and New York have franchise statutes specifically criticized by the Oates Article. Their franchise economies are booming. In New York, there are more than 29,000 franchise outlets and the International Franchise Association predicts that number will grow by 1.3 percent in 2018.[173] Similarly, in Florida there are more than 48,000 franchise outlets and the IFA predicts that number will grow by almost 3 percent in 2018.[174] The IFA also ranked Florida as one of the top five states for franchise employment growth in 2017.[175]

B. *State Franchise Laws Do Not Pose an Undue Burden on Interstate Commerce*

State franchise statutes have not only survived decades of judicial scrutiny under the "anti-discrimination" tier of Dormant Commerce Clause litigation, they have also withstood challenges to their constitutionality under the "undue burden" tier. With one exception, state franchise statutes have passed the balancing test enunciated in *Pike v. Bruce Church*, in which the U.S. Supreme Court explained that, when a statute addresses a "legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[176] Every court evaluating state franchise statutes has held that states have a legitimate interest in (1) "encouraging full disclosure . . . and prohibiting fraud,"[177] (2) curbing "franchise sales abuses and unfair competitive practices,"[178] and (3) "addressing the disparity in bargaining power"[179] between franchisors and their franchisees.

Courts have broadly rejected franchisor claims that state statutes which require registration or which regulate aspects of the franchise relationship (1) "impose a straightjacket on" a franchisor's operations, (2) "ultimately harm the consumers by prohibiting the creation of an efficient distribution system," or (3) place an "onerous" burden on franchisors by imposing detailed disclosure and record keeping requirements.[180] As the court noted in *Instructional Systems*, "even assuming this to be true," a statute may be invalidated under *Pike* only if it "imposes a discriminatory burden on interstate commerce."[181] A statute that evenhandedly imposes a burden on all com-

173. International Franchise Association, https://franchiseeconomy.com/NY.html (last visited Feb. 1, 2018).

174. International Franchise Association, https://franchiseeconomy.com/FL.html (last visited Feb. 1, 2018).

175. Kate Roger, *Here's Where America's billion-dollar franchising industry is growing fastest*, CNBC (Jan. 24, 2017, 4:13 P.M.), https://www.cnbc.com/2017/01/24/heres-where-americas-franchising-industry-is-growing-fastest.html.

176. *Pike*, 397 U.S. at 142.

177. *Mon-Shore Mgmt.*, 584 F. Supp. at 192.

178. Morris v. Int'l Yogurt, Co., 729 P.2d 33 (Wash. 1986).

179. Yamaha Motor Corp., USA v. Jim's Motorcycle, Inc., 401 F.3d 560 (4th Cir. 2005).

180. *Instructional Sys.*, 35 F.3d at 827.

181. *Id.*

merce is generally constitutional. In the single case where a court has invalidated a portion of a franchise statute under the *Pike* test, the court noted the challenged portion "had no parallel in the law of any other state" and imposed "heavy burdens on out of state interest" and that the challenged section offered no benefits to a state interest beyond those offered by other sections of the statute.[182]

VI. Conclusion

To borrow from Mark Twain, the Oates Article's report about the death of the need for state franchise regulation is an exaggeration. State franchise laws that protect the interests of franchisees and discourage unscrupulous franchisors remain necessary. Franchisees are still significantly less experienced and sophisticated than franchisors. The vast majority of franchisees have never operated their own business and do not have independent counsel advising them. Franchise agreements are frequently presented as "take it or leave it" propositions, and the franchisor retains significantly more power than the franchisee in managing the relationship.[183] Accordingly, more than a dozen states have enacted specific statutes regulating both franchise sales and the franchise relationship. Rather than being the relic of a dark time, many states have either amended their statutes to broaden their protection or have considered doing so.

Finally, the differences between these statutes and their extraterritorial application are not unconstitutional. Rather, these statutes are the embodiment of the federalist system in which each state acts to protect its residents from unscrupulous businesses and prohibit its businesses from behaving unscrupulously. The Oates Article implies that these states should instead surrender that decision-making authority to the federal government by relying exclusively on the FTC Rule, which does not even allow for private right of action. This conclusion not only contracts the FTC Rule itself, but it is antithetical to our entire system of government. State legislatures should be encouraged to continue looking for better ways to protect franchisees and encourage fair and equitable franchise practices through franchise legislation.

182. *Id.* at 570–71.

183. The implied theory in the Oates Article that franchisees have become so sophisticated that they have "outgrown" the need for state statutory protection is questionable. Even if true, however, the franchisor's viewpoint is moot because there are exemptions at the state and federal levels that exclude large, sophisticated franchisees from statutory protection. *See* 16 C.F.R. § 436.8(a)(5)(i) ("large investment" exemption for franchise investments totaling more than $1,143,100); 16 C.F.R. § 436.8(a)(6) ("large franchisee" exemption for franchisees in business for at least five years and a net worth of at least $5,715,500). Certain states have crafted similar exemptions to their franchise laws. *See, e.g.*, Ill. Admin. Code tit.14, § 200.201(c) ("large investment" exemption); Md. Code Regs. 02.02.08.10(E)(1) (same); S.D. Franchise Investment Act § 13(1) (same); Wis. Stat. § 553.235(1)(a) (same); Cal. Corp. Code § 31109 ("large franchisee" exemption); 815 Ill. Comp. Stat. 705/8(a)(2) (same); R.I. Gen. Laws § 19-28.1-6(4) (same); S.D. Codified Laws § 37-5B-13(2) (same); Wash. Rev. Code § 19.100.030(5) (same); Wis. Stat. § 553.235 (same).

Appendix A
Results of Franchisee Survey (253 Respondents)

Table 1
An attorney reviewed my franchise agreement, franchise disclosure document (FDD), and/or Uniform Franchise Offering Circular (UFOC) before I purchased my first franchise.

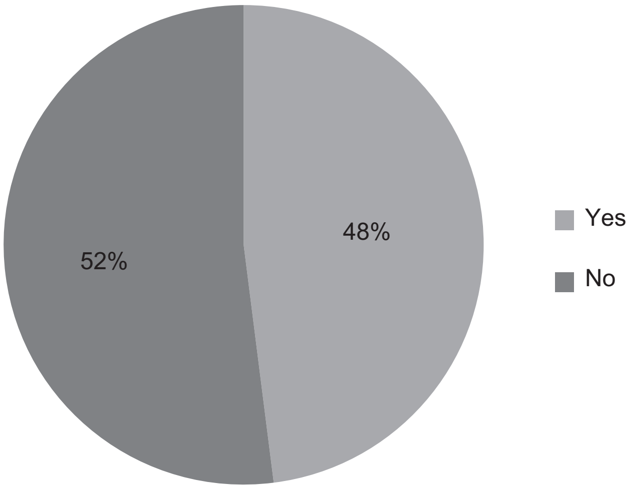

Table 2
During the franchise sales process, my franchisor's salesperson told me that I could hire an attorney to review my franchise agreement.

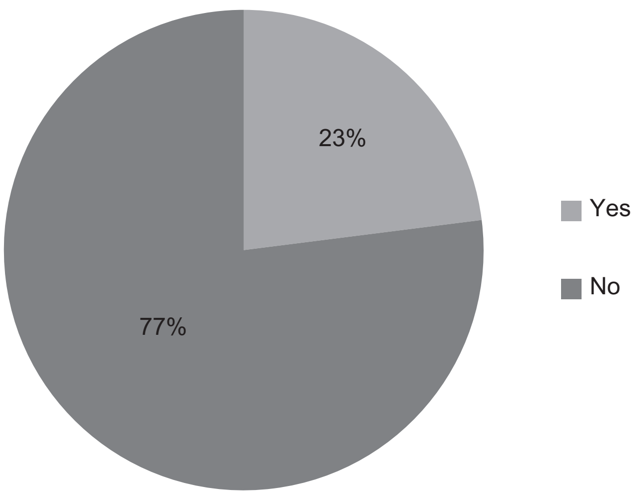

Table 3
During the franchise sales process, my franchisor's salesperson told me that my franchisor would not make any changes to the franchise agreement.

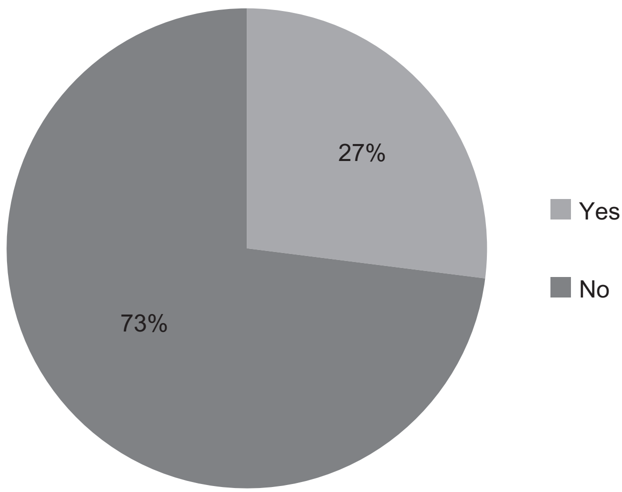

Table 4
Number of franchise units owned by franchisee respondents.

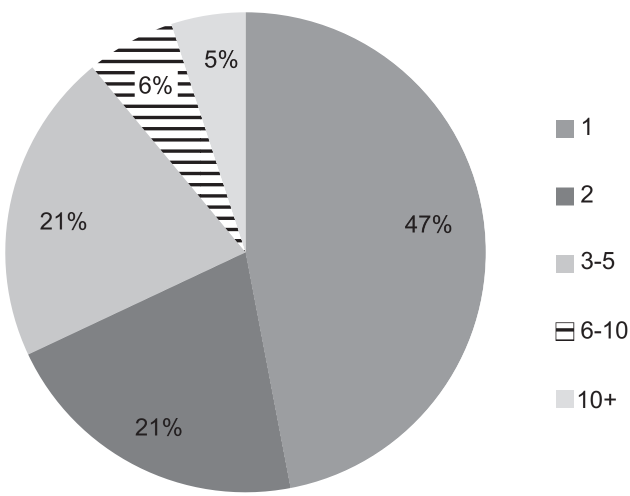

Table 5
The franchise disclosure document (FDD) (or Uniform Franchise Offering Circular (UFOC)) I received was an accurate and complete description on my franchise investment.

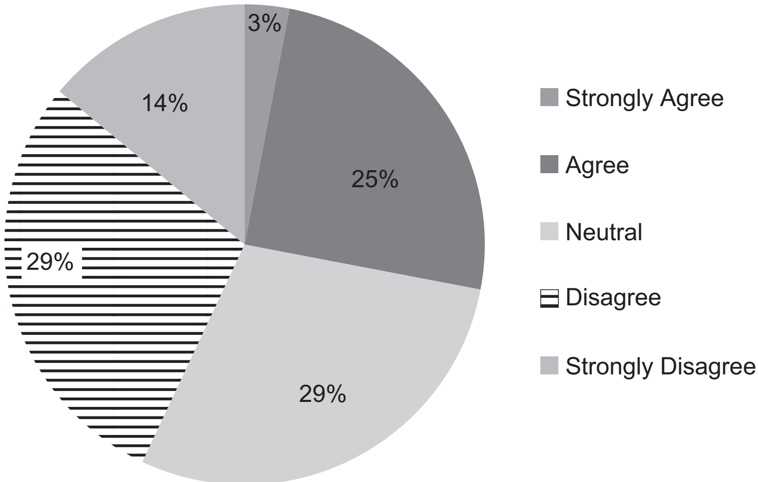

Table 6
During the franchise sales process, my franchisor's salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC.