FRANCHISING: A CRITICAL ASSESSMENT OF STATE AND FEDERAL REGULATION

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INTRODUCTION

Franchising, an increasingly popular method of doing business,[1] is extensively regulated both at the federal[2] and state levels. There are two basic types of regulation of the franchising relationship: disclosure rules and substantive rules. Certain states have enacted laws which require a franchisor to register and to prepare and file a disclosure statement that must be given at a prescribed time to prospective franchisees.[3] Other states have, instead, adopted substantive legislation dealing with specific franchising practices.[4] Some states have both forms of regulation.[5] The federal government, through the Federal Trade Commission (FTC), has adopted the disclosure form of regulation but it does not require filing or registration with the FTC.[6] Furthermore, overlap-

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1. It is estimated that one-third of U.S. retail sales of goods and services are made by franchised outlets. U.S. Dept. of Commerce, *Franchising in the Economy 1978-80.*

2. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436 *et. seq.* (1980) [hereinafter "The FTC Rule"].

3. The following states have franchise disclosure regulation and it is expected that other states will be adopting similar rules: CAL. CORP. CODE § 31110 *et. seq.* (West 1977); HAW. REV. STAT. § 482E (1976); ILL. ANN. STAT. ch. 121 1/2, § 701 *et. seq.* (Smith-Hurd Supp. 1980-81); IND. CODE. ANN. § 23-2-2.5-1 *et. seq.* (Burns Supp. 1980); MD. ANN. CODE art. 56, § 345 *et. seq.* (1957); MICH. COMP. LAWS § 445.1501 *et. seq.* (Supp. 1980-81); MINN. STAT., § 80C.01 *et. seq.* (1978); N.D. CENT. CODE § 51-19-01 *et. seq.* (Supp. 1979); OR. REV. STAT. § 650.005 *et. seq.* (1979); R.I. GEN. LAWS § 19-28-1 *et. seq.* (Supp. 1979); S.D. COMPILED LAWS § 37-5A-1 *et. seq.* (1977); VA. CODE § 13.1-557 *et. seq.* (1978); WASH. REV. CODE § 19.100.010 *et. seq.* (Supp. 1980-81); WIS. STAT. ANN. § 553.01 *et. seq.* (1977). The New York legislature on June 30, 1980 passed a registration and disclosure law to become effective on January 1, 1981. N.Y. [GEN. BUS.] §§ 680-695; BUSINESS FRANCHISE GUIDE (CCH) ¶3320.01-.16 (1980). A number of states which do not have disclosure type regulation for the offer and sale of franchises have such regulation concerning the sale of business opportunity ventures. *See, e.g.*, NEB. REV. STAT. § 59-1701 *et. seq.* (Supp. 1979).

4. *See, e.g.* ARK. STAT. ANN. § 70-818 *et. seq.* (Supp. 1979). There are only five states which have no legislation directly dealing with the franchising relationship: Alabama, Alaska, Colorado, Montana and Wyoming. Fern, *The Overbroad Scope of Franchise Regulation: A Definitional Dilemma*, 34 BUS. LAW. 1387 (1979).

5. *See, e.g.*, ILL. ANN. STAT. ch. 121 1/2, §§ 704.1 to 704.4 (Smith-Hurd Supp. 1980-81).

6. FTC Rule, *supra* note 2, at § 436 *et. seq.*

ping the specific regulation of franchising are the federal anti-trust laws and state and federal prohibitions of "unfair methods of competition" and "unfair or deceptive acts or practices" as they may apply to certain franchise practices.

The direct regulation of the franchising relationship is a recent phenomena. California, the first state to adopt a franchise investment law, enacted its legislation in 1970.[7] Prior to that time franchisees who claimed that they had been misled were relegated to the common law theories of misrepresentation, deceit, or fraud in the inducement, and often they were unable to meet the burden of proof required by these theories.[8] Franchisees also employed antitrust theories in an attempt to obtain relief from unsatisfactory relationships. For example, some franchisees claimed that the franchise agreement imposed illegal tying arrangements upon the franchisee, but franchisees had difficulty recovering on this theory.[9] Likewise, franchisees who claimed that clauses preventing the franchisee from assigning his contract violated the anti-trust laws, also were unsuccessful.[10] Some franchisees claimed that the securities laws were applicable and sought relief on the basis that the franchisor had failed to register or that the franchisor had violated the anti-fraud provisions of the securities laws; the courts were unwilling to find that the typical franchise was a security and, therefore, the franchisees were again unsuccessful.[11]

Franchise laws were enacted to cure the abuses perceived to exist in this new business relationship. The Illinois Franchise Disclosure Act states:

> (1) The General Assembly finds and declares that the widespread sale of franchises is a relatively new business phenomenon which has created numerous problems in Illinois. Illinois residents have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor—franchisee relationship, the details of the contract between the franchisor and franchisee, the prior

7. CAL. CORP. CODE § 31110 *et. seq.* (West 1977).

8. *See, e.g.*, Taute v. Econo-Car Int'l, Inc., 414 F.2d 828 (9th Cir. 1969); Scott-Douglas Corp. v. Greyhound Corp., 304 A.2d 309 (Del. Super. Ct. 1973).

9. *See, e.g.*, Kugler v. Aamco Automatic Transmissions, Inc., 460 F.2d 1214 (8th Cir. 1972); Nelligan v. Ford Motor Co., 262 F.2d 556 (4th Cir. 1959); Beefy Trail, Inc. v. Beefy King Int'l, Inc., 348 F. Supp. 799 (M.D. Fla. 1972). *Cf.* Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971).

10. *See, e.g.*, Seligson v. Plum Tree, Inc., 361 F. Supp. 748 (E.D. Pa. 1973); Hannigan v. Wheeler, 19 Ariz. App. 49, 504 P.2d 972 (Ct. App. 1972).

11. *See, e.g.*, Bitter v. Holby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974); Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Col. 1970).

> business experience of the franchisor and other factors relevant to the franchise offered for sale.
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> (2) It is the intent of this Act: (a) to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered for sale; and (b) to protect the franchisee and the franchisor by providing a better understanding of the business and the legal relationship between the franchisor and the franchisee.[12]

States which adopted substantive rather than disclosure legislation sought to regulate certain areas of the franchise relationship which they believed to be subject to serious abuse. Primary emphasis has been placed on regulating the termination, renewal and assignment of franchise rights.[13]

This regulatory activity presents a maze for the businessman and the attorney to attempt to master. The combinations of applicable regulations are awesome and raise questions of preemption, conflict of laws, civil liability for damages, criminal penalties, control person liability, aider and abettor liability, and other problems. In order to provide a primer for those who may be involved in counseling a franchisor or a franchisee, this Article will outline some of the various forms of franchising regulation.

The Nebraska Franchise Practices Act[14] will be discussed as an example of substantive regulation of certain franchising practices. In comparison, the Illinois Franchise Disclosure Act[15] will be discussed as an example of state registration and disclosure regulation. Illinois is one of fourteen[16] states which have adopted the Uniform Form of Offering Circular (UFOC). Therefore, the UFOC, which was adopted by the Midwest Securities Commission Association in 1975, will be discussed in some detail. Next, the FTC rule[17] will be reviewed with emphasis on its interrelationship with state disclosure rules. Finally, Nebraska's Seller-Assisted Marketing Plan Act[18] will be considered as an example of the registration and disclosure rules applicable to so-called business opportunity ventures.

Before addressing the different forms of franchising regula-

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12. ILL. ANN. STAT. ch. 121 1/2, § 702 (Smith-Hurd Supp. 1980-81).
13. *See, e.g.*, NEB. REV. STAT. § 87-401 *et. seq.* (Cum. Supp. 1978); ARK. STAT. ANN. § 70-807 *et. seq.* (1979); CONN. GEN. STAT. ANN. §§ 42-133e to 42-133h (Supp. 1980).
14. NEB. REV. STAT. § 87-401 *et. seq.* (Cum. Supp. 1978).
15. ILL. ANN. STAT. ch. 121 1/2 § 701 *et. seq.* (Smith-Hurd Supp. 1980-81).
16. See note 3 *supra*.
17. FTC Rule, *supra* note 2, at § 436 *et. seq.*
18. NEB. REV. STAT. § 59-1701 *et. seq.* (Supp. 1979).

tion, it is necessary to define the term franchise. Franchising regulation only becomes applicable when a franchise is involved. Like the securities law where the term "security" includes much more than stocks or bonds, relationships which few would classify as franchises may fit within the statutory definitions.

THE DEFINITION OF A FRANCHISE

The term franchise has been defined differently by certain states and the FTC. For example, the Nebraska Franchise Practices Act defines a franchise as:

> a written arrangement for a definite or indefinite period, in which a person grants to another person for a franchise fee a license to use a trade name, trade-mark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise. . . .[19]

The Illinois Franchise Disclosure Act defines the term franchise differently.[20] There, the agreement need not be in writing. It does not require that a license to use a trade or service name or mark be granted; it only requires that the franchisee's business be substantially associated with the franchisor's trade or service name or mark, logotype, advertising, or other commercial symbol. It does require that the franchisee operate under a marketing plan or system prescribed or suggested in substantial part by the franchisor which seems less inclusive than the Nebraska requirement which only states that there be a community of interest in the marketing of the goods or services. The third element of

19. NEB. REV. STAT. § 87-402(1) (Cum. Supp. 1978) The term franchise fee is defined to include "any payment made by the franchisee to the franchisor other than a payment for the purchase of goods or services, for a surety bond, for a surety deposit or for security for payment of debts due." *Id.* § 87-402(5).

20. ILL. ANN. STAT. ch. 121 1/2, § 703(1) (Smith-Hurd Supp. 1980-81) which provides:

> (1) "Franchise" means a contract or agreement, either express or implied, whether oral or written, between 2 or more persons by which:
> (a) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services, under a marketing plan or system prescribed or suggested in substantial part by a franchisor; and
> (b) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and
> (c) the person granted the right to engage in such business is required to pay, directly or indirectly, a franchise fee of $100 or more;
> Provided that this Act shall not apply to any franchised business which is operated by the franchisee on the premises of the franchisor or subfranchisor as long as such franchised business is incidental to the business conducted by the franchisor or sub franchisor at such premises, including, without limitation, leased departments and concessions.

the Illinois definition requires that the person granted the right to engage in the business pay the granting party, directly or indirectly, a franchise fee of $100 or more. Unlike the Nebraska definition of franchise fee, payment for goods or services may be considered as payment of a franchise fee in Illinois unless purchased at a bona wholesale or retail price.[21]

The FTC rule takes yet a different approach. It defines a franchise as any continuing commercial relationship whereby one person sells to another goods or services identified by the selling party's trade or service name or mark, or commercial symbol or, whereby one party requires another to meet certain quality standards in operating the business and the business is associated with the granting party's trade or service mark, name or commercial symbol.[22] This language encompasses both package and product franchises which also would be covered under the Nebraska and Illinois legislation.[23] A second element of the FTC definition requires that the franchisor have authority to exert a significant degree of control over the franchisee's method of operation or give significant assistance to the franchisee. This may be a materially different standard than the "community of interest" standard in the Nebraska Franchise Practices Act. A third element of the definition requires that the franchisee pay the franchisor $500 or more within six months after commencing operation.

Each definition contains the same three elements: 1) payment of a fee; 2) the use by one party of another's trade name or symbol; 3) some continuing interest or control by the granting party. However, the differences in the terms used, i.e., "community of interest," "prescribed marketing plan," "significant assistance," are perplexing. One problem is that the varying definitions are confusing; another is that the definitions are broad. As one commentator has stated, only one thing is clear:

> It is apparent that the current definitional techniques employed to define a 'franchise' are likely to result in a sweeping application of the statutes designed to regulate franchising to other more traditional business relationships over which such regulation was not intended. Unless the courts construe the current statutory definitions

21. *Id.* at § 703(14).
22. FTC Rule, *supra* note 2, at § 436.2.
23. In a package franchise, the franchisee adopts the business format developed by the franchisor and identified by the franchisor's trademark; in a product franchise, the franchisee distributes goods produced by the franchisor which bear this franchisor's mark. *See* Black, *New Federal Trade Commission Franchise Disclosure Rule: Application to Distributorship Arrangements*, 35 BUS. LAW. 409, 413 (1980).

> of a 'franchise' more narrowly than do the authorities charged with administering franchise statutes, it is likely that legislation and regulations designed to regulate franchising will be applicable to a wide range of business relationships not generally considered by the public to be franchises, such as concessions, distributorships and trademark licenses.[24]

Informal advisory opinions issued by the staff of the Federal Trade Commission substantiate the fears of the quoted commentator.[25] For example, in an opinion given to United States Solar Industries, Inc., the staff advised that an advertisement which promised prospective distributors training in all technical areas and an impressive retail back-up constituted a promise of significant assistance within the meaning of the FTC rule.[26] Likewise, in the interpretive guides to the FTC rule, eight paragraphs are devoted to defining the terms "significant control" and "significant assistance" with one of the paragraphs stating: "the Commission's interpretation of the term 'significant' recognizes that significance also is a function of the degree of reliance which franchisees are reasonably likely to place upon the controls or assistance."[27] The broad and nebulous terms used to define a franchise will require attorneys to review every dealer agreement or marketing arrangement quite carefully to be certain that it is not arguably a franchise. If the relationship is a franchise relationship, it will be subject to the regulation discussed in the remainder of this Article.

NEBRASKA FRANCHISE PRACTICES ACT

In July of 1978, Nebraska enacted its Franchise Practices Act (FPA).[28] It is relatively brief, encompassing only ten sections. The FPA defines certain crucial terms such as: franchise, franchisor, franchisee, sale, transfer, assignment and good cause. It outlines when the act is applicable and provides substantive rules with respect to certain issues likely to arise in a franchise relationship. These rules:

24. Fern, *supra* note 4, at 1397.

25. A discount buying club service was determined to be a franchise under the FTC rule definition, though state regulatory officials in Kentucky had determined that it was not within that state's definition of a business opportunity venture. *Informal Staff Advisory Opinion to International Consumers Club*, BUSINESS FRANCHISE GUIDE (CCH) ¶6413 (May 5, 1980).

26. *Informal Staff Advisory Opinion to United States Solar Industries, Inc.*, BUSINESS FRANCHISE GUIDE (CCH) ¶ 6411 (April 25, 1980).

27. *Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule*, 44 Fed. Reg. 49966 (1979) [hereinafter cited as *Final Guides*].

28. NEB. REV. STAT. § 87-401 *et. seq.* (Cum. Supp. 1978).

1) Impose notice requirements on a franchisor who wishes to terminate, cancel, or not renew a franchise.[29]
2) Prohibit a franchisor from terminating, cancelling, or failing to renew a franchise without good cause.[30]
3) Impose notice requirements on a franchisee who wishes to sell, transfer, or assign his franchise.[31]
4) Require a franchisor either to accept a franchisee's proposed sale, transfer, or assignment of his franchise, or to notify the franchisee in writing of the unacceptability of the proposed transferee which writing must state material reasons for the franchisor's refusal.[32]
5) Prohibit the franchisor:
   a) from requiring a franchisee to waive any of the protections of the Franchise Practices Act;[33]
   b) from limiting a franchisee's right of free association;[34]
   c) from requiring or prohibiting any change in management of any franchisee unless for good cause;[35]
   d) from restricting the sale or transfer of any securities of the franchisee to certain designated people if such sale or transfer does not have the effect of accomplishing a sale of the franchise;[36]
   e) from imposing unreasonable standards of performance upon a franchisee;[37]
   f) from imposing any term or condition in any agreement collateral to the franchise agreement which violates the FPA.[38]

As remedies for violation of these rules, the FPA permits suits to be brought by a franchisee for damages or for injunctive relief.[39] The prevailing party in an action is entitled to costs and reasonable attorney's fees.[40] Alternatively, the FPA provides a comprehensive defense to a franchisor for any action brought by a franchisee. The franchisor has a complete defense to any action, "if it be

29. *Id.* at § 87-404.
30. *Id.*
31. *Id.* at § 87-405.
32. *Id.*
33. *Id.* at § 87-406(1).
34. *Id.* at § 87-406(2).
35. *Id.* at § 87-406(3).
36. *Id.* at § 87-406(4).
37. *Id.* at § 87-406(5).
38. *Id.* at § 87-406(6).
39. *Id.* at § 87-409.
40. *Id.*

shown that such franchisee has failed to substantially comply with requirements imposed by the franchise and other agreements ancillary or collateral thereto."[41]

The effectiveness of this legislation must be seriously questioned. First of all, the FPA will be applicable only "when gross sales of products or services between the franchisor and franchisee covered by such franchise shall have exceeded thirty-five thousand dollars for the twelve months next preceding the institution of suit . . . and . . . when more than twenty percent of the franchisee's gross sales are intended to be or are derived from such franchise."[42] This provision eliminates many franchise relationships from coverage under the FPA. The typical "package franchise"[43] in which a franchisee adopts the business format established by the franchisor and identified by the franchisor's trademark, but which does not require the franchisee to purchase products for resale from the franchisor, will not be covered, unless the royalty fee paid to the franchisor, assuming that this can be considered a payment for a service, was $35,000 in the prior twelve months. Assuming a seven percent royalty fee, the franchisee would have to have $500,000 of gross sales to be within the FPA. Thus, many package franchises like car washes, transmission centers, rust proofing services, tax preparation services, and accounting services will not be covered by the FPA. Likewise, even the typical fast food franchise will not be covered by the FPA if the franchisee does not buy the hamburger, the chicken, or other products from the franchisor, unless the franchisee has a high volume of sales. However, the "product franchise," in which the franchisee purchases trade-marked goods from the franchisor for resale, will be covered if the product purchases and other service fees exceed $35,000 during the past twelve months.

Why the legislature would want to protect the "product franchisee" rather than the "package franchisee" is a mystery. Indeed, if this classification is irrational, the FPA's constitutionality may be questioned.[44]

Thus, the effect of the FPA is to prohibit franchisors from arbitrarily terminating or failing to renew prosperous package fran-

41. *Id.* at § 87-408.
42. *Id.* at § 87-403(2)-(3).
43. See note 23 *supra.*
44. The rule . . . is that while it is competent for the legislature to classify, the classification, to be valid, must vest on some reason of public policy, some substantial difference of situation or circumstances, that would naturally suggest that justice or expediency of diverse legislation with respect to the objects classified. Ernesti v. City of Grand Island, 125 Neb. 688, 692, 251 N.W. 899, 900 (1933).

chisees, and maybe less prosperous product franchisees, and from arbitrarily denying prosperous package franchisees the right to sell or transfer their franchises. While it may be reasonable for a legislature to provide these rules, they are only remotely related to the reasons normally given to support the regulation of franchising. The FPA does nothing to help the franchisee avoid entering an unsatisfactory relationship.

When one further analyzes the statutory scheme, however, its most favorable aspect is that it fortunately will not apply to many franchise relationships. There have been no reported cases under the FPA, but the courts will have quite a time interpreting this statute. For example, it is a violation of the FPA for the franchisor to impose unreasonable standards of performance upon a franchisee.[45] How one is to distinguish reasonable from unreasonable standards is unclear. The legislature provides no guidance. Is a franchisor who requires all employees of a franchisee to wear their hair at a certain length, or who requires that all light bulbs be 60 watts and be replaced within 24 hours after burning out, guilty of imposing unreasonable standards? If they are standards that the franchisee knows about before signing the franchise agreement, can they be considered unreasonable? Is it equitable or rational to attempt to determine whether a particular requirement viewed in isolation is reasonable? To have a court determine whether a particular requirement is important to the franchisor's overall system is to assume an expertise that probably does not exist. What is reasonable, fair or equitable probably depends on the knowledge and expectations of the parties, but this would lead to a disclosure-type system which Nebraska has not adopted.

The statutory provision dealing with the franchisee's right to sell or transfer his franchise also may be unmanageable. It requires the franchisee to give written notice of the planned transaction and basic information concerning the proposed transferee to the franchisor. The franchisor has sixty days to accept the proposed transaction or give written notice "of the unacceptability of the proposed transferee setting forth material reasons relating to the character, financial ability or business experience of the proposed transferee."[46] Assume that a franchisor decides not to accept the proposed transfer of the franchise and writes a letter setting forth his reasons. Evidently, the legislature did not intend that this would end the matter. If that were its intention, it could have provided that the franchisor may, in its discretion, consent or

45. NEB. REV. STAT. § 87-406(5) (Cum. Supp. 1978).
46. *Id.* at § 87-405.

not to a proposed transfer as long as he notified the franchisee in writing of his decision. Requiring the franchisor to state "material" reasons relating to these specific items: character, financial ability, or business experience, must be significant. Evidently, this requirement is related to the concept that restrictions on the transfer of property may not be absolute and that a franchisor should not be permitted to unreasonably withhold his consent to a transfer. Even assuming that it is appropriate to apply this property concept to the contractual franchise setting, will it be effective? Can a court determine with any degree of accuracy whether the reasons listed by a well-counselled franchisor are material reasons for denying a transfer to the proposed transferee?

It does not appear difficult to draft a letter stating why one believes that a party is not qualified to act as a franchisee. When the franchisor drafts such a letter, it seems that the burden would be on the franchisee to prove to the court that the franchisor's reasons were not material. If the court desires to allow the franchisee flexibility to sell, it will, rather than analyze this particular transferee's character, financial ability and experience in the abstract, compare him to other franchisees to whom the franchisor has granted a franchise. This would appear to be the only way to objectively determine whether the franchisor was rationally opposing the transferee. However, if this is what the legislature intended, why did it not draft a provision requiring the franchisor to accept a proposed transferee if he is equal to or better than the profile of existing franchisees or current applicants for a franchise? Even with such a standard, it is interesting to contemplate how one determines whether one person's character is equal to or better than another person's character, assuming one knows what character means.

Maybe the clearest rule that could be adopted would be to require the franchisor to accept any transferee whose financial ability and experience was equal to or better than that of the existing franchisee when he first applied. The existing franchisee would then be in a position to fairly accurately determine to whom he could sell his franchise.

The very last sentence of the statutory provision on transfer states: "No such transfer, assignment or sale shall be valid unless the transferee agrees in writing to comply with all the requirements of the franchise then in effect."[47] If the phrase "franchise then in effect" implies that the profile of acceptable franchisees being used by the franchisor is part of the franchise, then apparently

47. *Id.*

the proposed transferee would have to meet those standards. If it only means that the transferee will be bound by the terms in the transferor's franchise agreement, it probably adds nothing to what is already in the well-drafted franchise agreement.

The statutory provision concerning termination, cancellation, or failure to renew also raises more questions than it answers. First, it sets forth advance notice periods for termination, cancellation, or failure to renew which vary depending on the grounds for such action.[48] It also requires the notice to be in writing and to state the franchisor's reasons for its decision.[49] Interestingly, here the legislature did not use the phrase "material reasons." In addition to those procedural requirements, it also states that: "It shall be a violation . . . for a franchisor to terminate, cancel or fail to renew a franchise without good cause."[50] The statutory definition of good cause states that it is "limited to failure by the franchisee to substantially comply with the requirements imposed upon him by the franchise."[51] Again it is left to the courts to decide what constitutes a "failure to substantially comply."[52]

In setting forth different advance notice periods, the legislature varied the amount of notice required according to the alleged reasons for termination, cancellation, or failure to renew.[53] Generally, the franchisee is entitled to sixty days notice. However, if the alleged reason is voluntary abandonment by the franchisee of the franchise relationship, the franchisee must be given only fifteen days notice. If the alleged reason is falsification by the franchisee of records required by the franchisor, the notice is effective immediately upon receipt.

Because certain reasons are listed in delineating various notice periods, it may be inferred that those reasons are valid grounds for termination, cancellation, or failure to renew. Arguably, each of the listed reasons would constitute good cause and other grounds would not *per se* constitute good cause unless it be proved that they establish a failure to substantially comply. At

48. *Id.* at § 87-404.

49. *Id.*

50. *Id.* The Eighth Circuit has recently held that there is a fiduciary duty owed by at least some franchisors to their franchisees. Such duty precludes termination except for "good cause" as a matter of common law. Arnott v. American Oil Co., 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 100 S. Ct. 1852 (1980).

51. NEB. REV. STAT. § 87-402(8) (Cum. Supp. 1978).

52. For examples of the difficulties that the Nebraska Supreme Court has faced in determining what constitutes good cause for termination under the Nebraska Motor Vehicle Industry Licensing Act, *see* S & T Motors v. General Motors Corp., 203 Neb. 188, 277 N.W.2d 701 (1979); Chrysler Motors Corp. v. Nebraska Motor Vehicle Industry Licensing Board, 202 Neb. 230, 274 N.W.2d 862 (1979).

53. NEB. REV. STAT. § 87-404 (Cum. Supp. 1978).

first, this seems to be a justifiable interpretation of the statutory pattern. For example, if the franchisee abandons the franchise, it seems reasonable that this should *per se* be ground for termination. However, suppose that the franchisee falsifies a record or defaults in a payment due the franchisor, both of which are in the list of grounds which require no advance notice of termination, do these also *per se* constitute good cause? If the falsification or default in payment is not material, should the court, nevertheless, treat these specified grounds as *per se* reasons for termination, or may a court determine that a non-material violation by the franchisee is not sufficient ground for termination? It is reasonable to expect that the court will require the franchisor to prove a failure of substantial compliance by the franchisee in all cases. However, if this is what the legislature intended, its intention is far from clear.

Moreover, in the last sentence of this section, the legislature created additional confusion in the renewal area. This sentence provides:

> This section shall not prohibit a franchise from providing that the franchise is not renewable or that the franchise is only renewable if the franchisor or franchisee meets certain reasonable conditions.[54]

Basically, this eliminates any rights to renewal that the franchisee may have thought he had when reading the first part of this section. If the franchisor inserts in the franchise agreement that it is not renewable, the franchisee may not argue at renewal time that he had substantially complied with the franchise terms during the initial term and, therefore, the franchise must be renewed. If this agreement states that it is not renewable, that may present a marketing problem to the franchisor. However, this will not pose a legal problem because of the quoted section.

The proposed California legislation concerning termination appears to provide a better and clearer solution to these difficult problems.[55] It prohibits a franchisor from terminating the relationship other than for good cause but it defines good cause to include "the failure of the franchisee to comply with *any* lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure."[56] It further provides that the occurrence of certain events will allow the franchisor to terminate

54. *Id.*
55. BUSINESS FRANCHISE GUIDE (CCH) ¶4050.01-4050.24 (1980).
56. *Id.* at ¶4050.13.

immediately without requiring him to give the franchisee an opportunity to cure. These events include franchisee bankruptcy, abandonment of the franchise by the franchisee, repetition of a previously cured failure to comply with the franchise agreement, or failure by the franchisee to pay franchise fees.[57]

Likewise, the proposed California legislation gets at the heart of the problems in the failure to renew area.[58] It requires that 180 days notice be given by the franchisor of its intention not to renew. It also prevents the franchisor from failing to renew if his reason is to convert the existing business to a franchisor operated business. If the franchisor intends to operate the business he must either allow the franchisee to sell the business to a third party or purchase the business from the franchisee. This prevents the franchisor from taking the goodwill of the franchise business without compensating the franchisee. The legislation does provide other grounds for nonrenewal such as the franchisor's withdrawal from the market.

In summary, the Nebraska Franchise Practice Act does not deal with the most serious abuses in franchising which occur when the franchisee is unable to commence business, since he may not have understood the initial investment required, or he may not be able to find a suitable location, or he may have been misled about the basic terms of the relationship. Indeed, no abuse will be covered unless a fairly substantial amount of sales or revenues are produced by the franchisee. Furthermore, the areas of termination, renewal and sale of the franchise, sensitive areas in franchising, are left quite confused.

THE ILLINOIS FRANCHISE DISCLOSURE ACT

The Illinois' Franchise Disclosure Act[59] is an example of the registration and disclosure form of franchise regulation. Those experienced with state securities regulation will recognize the similarities between the existing blue-sky format and this new franchise reigmen.[60] Indeed, prior to the adoption of franchise disclosure laws, there was a substantial amount of litigation concerning whether a franchise was a security. Generally, it has been held that a franchise is not a security and, therefore, federal and state securities regulations do not apply to the franchising relation-

57. *Id.* at ¶4050.14.
58. *Id.* at ¶4050.15.
59. ILL. ANN. STAT. ch. 121 1/2, § 701 *et. seq.* (Smith-Hurd Supp. 1980-81).
60. *Compare* ILL. ANN. STAT. ch. 121 1/2, § 701 *et. seq.* (Smith-Hurd Supp. 1980-81) *with* NEB. REV. STAT. § 8-1101 *et. seq.* (Reissue 1974).

ship.[61] However, one of the goals of securities regulation, full and fair disclosure to purchasers, has been adopted as a goal in franchise disclosure acts.[62]

The Illinois Act provides a rather broad definition of a franchise. It covers any agreement, whether oral or written, which grants one party who pays a fee of $100 or more the right to offer, sell, or distribute goods or services under a marketing plan or system prescribed or suggested in substantial part by the other party, if the plan or system is substantially associated with the granting party's trade mark, service mark, trade name, logotype, advertising, or other commercial symbol.[63] Though the definition excludes leased departments and concessions, it encompasses many arrangements which the parties may never have considered to be franchises.[64]

The basic prohibitions of the Act are in Section 704.[65] That section makes it unlawful for any person to offer or sell a franchise in the state unless the person making the offer or sale is registered in the state. This is a carryover from the broker-dealer and issuer-dealer registration requirements embodied in most state securities acts.[66] Section 704 also makes it unlawful to offer or sell a franchise unless the prospective franchisee has received, at least seven days prior to signing an agreement or paying consideration, a copy of an effective disclosure statement which has been registered with the Illinois Secretary of State.

Section 705 outlines the information required to be in the disclosure statement.[67] As in securities disclosure regulation, part of the information required concerns the business history of the franchisor and its management, and the financial history of the franchisor. Some disclosures are particularly tailored for the franchise relationship and are designed to give a prospective franchisee relevant decision making information. For example, the offering circular must disclose:

1) any affiliates of the franchisor which the franchisor will recommend as suppliers of goods or services to the franchisee;
2) the responsibilities of the franchisor to train, supervise and help in promotion;

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61. See note 11 *supra*.
62. ILL. ANN. STAT. ch. 121 1/2, § 701 (Smith-Hurd Supp. 1980-81).
63. *Id.* at § 703(1).
64. See Black, *supra* note 23.
65. ILL. ANN. STAT. ch. 121 1/2, § 704 (Smith-Hurd Supp. 1980-81).
66. See, *e.g.*, NEB. REV. STAT. § 8-1103 (Reissue 1974).
67. ILL. ANN. STAT. ch. 121 1/2, § 705 (Smith-Hurd Supp. 1980-81).

3) the amount of the initial franchise fee and whether this fee will be uniformly charged to all franchisees;
4) the application by the franchisor of franchise fee proceeds;
5) an estimate of the total investment that a franchisee will be required to make to get the franchise business underway;
6) all fees, in addition to the franchise fee, that the franchisee will be required to pay;
7) whether any required sources of supply will be imposed on the franchisee and the payments, if any, that the franchisor will receive from such sources;
8) if the franchisor plans to use actual or projected franchisee earnings or sales information in his franchise offer, a statement setting forth the basis for such projections;
9) the number of franchises in operation including company-owned outlets;
10) the territorial rights given a franchisee;
11) the conditions for termination or failure to renew a franchise by the franchisor, and the franchisee's rights and duties upon termination or nonrenewal;
12) any conditions relating to the franchisee's ability to sell or assign the franchise;
13) the names and addresses of certain other franchisees.

The Illinois Act requires that the disclosure statement be renewed each year.[68] Amendments to the disclosure statement must be filed during the year if material events occur.[69]

In addition to these disclosure requirements, the act includes a fraudulent practice section which is almost identical to rule 10b-5 of the Securities Exchange Act of 1934.[70] Thus the other goal of securities regulation, fraud prevention, is incorporated into

68. *Id.* at § 716.2.
69. *Id.* at § 715.
70. *Id.* at § 706 provides:

It is unlawful for any person, in connection with the offer or sale of any franchise, to directly or indirectly:

(a) Employ any device, scheme, or artifice to defraud;
(b) Make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading;
(c) Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Id. For Rule 10b-5, see 17 C.F.R. § 240.10b-5 (1980) which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

franchising regulation. An additional substantive provision allows the Attorney General to escrow or impound franchise fees or to obtain a surety bond from the franchisor, if he finds that is necessary to protect franchisees.[71]

The enforcement and liability provisions of the act also are similar to the securities regulation framework. The Attorney General can suspend, terminate, prohibit, or deny the sale of any franchise or the registration of any franchise, franchise broker, or salesperson.[72] The statute outlines eleven different grounds on which he may rely to employ these enforcement powers.[73] They are quite broad and basically permit him to act if the franchisor has not complied with the disclosure rules or has engaged in or is about to engage in fraudulent activity. In addition, the statute gives the Attorney General "merit regulation" powers similar to those in state securities regulation statutes.[74] For example, the act provides that the Attorney General must suspend, terminate, prohibit, or deny the sale or registration of any franchise if it appears to him:

> (10) that there are conditions affecting the soundness of the franchisee so that the sale thereof would be fraudulent, inequitable or would work or tend to work a fraud upon prospective franchisees or subfranchisors.[75]

As an adjunct to his enforcement powers the Attorney General has investigative and subpoena power.[76] He may proceed by seeking injunctive relief or he may summarily issue a cease-and-desist order. Moreover, the Attorney General may bring an action for civil

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> (a) To employ any device, scheme or artifice to defraud,
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

71. ILL. ANN. STAT. ch. 121 1/2, § 711 (Smith-Hurd Supp. 1980-81).

72. *Id.* at § 718(a).

73. *Id.*

74. *Compare* ILL. ANN. STAT. ch. 121 1/2, § 718(a)(8)(9)(10) (Smith-Hurd Supp. 1980-81) *with* NEB. REV. STAT. § 8-1109.01 (Reissue 1977).

75. ILL. ANN. STAT. ch. 121 1/2, § 718(19) (Smith-Hurd Supp. 1980-81). Rule 604, passed pursuant to the Illinois Franchise Disclosure Act, states in part that:

> Conditions which affect the soundness of a franchise include, but are not limited to the following:
> (a) The capitalization, nature of assets, net worth, income or cash flow of a franchisor or subfranchisee are insufficient to enable the franchisor or subfranchisee to satisfactorily meet current and proposed obligations.

76. *Id.* at § 726.

penalties of up to $10,000 against a corporation or any of its officers who have committed any illegal act.[77] The statute also provides for criminal prosecution.[78]

In addition to administrative enforcement, the act also permits franchisees to bring private civil actions for damages against the franchisor, salespersons, or other participants who have violated the act.[79] A successful suit entitles the franchisee to the costs of the action including reasonable attorney's fees. The franchisee is also given the right to rescind an unlawful franchise sale and to recover what he has paid plus interest and reasonable attorney's fees. The act states that the franchisor, franchise broker, salesperson, and any other persons who participated or aided in making the sale shall be jointly and severally liable. Like the securities laws,[80] the statute also imposes liability on controlling persons of the franchisor. Thus, personal liability may be imposed on officers and directors of corporate franchisors.[81]

The statute also requires that advertising which offers a franchise for sale be distributed only after it has been filed with the Attorney General.[82] By rule or order the Attorney General may prohibit the use of advertising deemed false, fraudulent, misleading, or deceptive.

This comprehensive registration, disclosure, and anti-fraud regulatory scheme has been adopted by a number of states.[83] Though the laws of each of the states are not uniform, there has been some coordination among them so that a Uniform Franchise Offering Circular may be used. However, much like the blue-sky regulatory scheme for securities, each state is adopting its own rules and regulations. Also, the Administrators in different states may have different interpretations of similar statutory provisions. For example, one state may be very strict about impounding all franchise fees for a certain period of time while another administrator may have a much more liberal interpretation. Some states have limited the use of earnings projections by franchisors.[84] Moreover, if the statute grants the Administrator merit regulation powers, it is difficult to predict how or when they will be employed. Therefore, to adequately represent the franchisor, a comprehen-

77. *Id.* at § 719.
78. *Id.* at § 720.
79. *Id.* at § 721.
80. *See, e.g.*, 15 U.S.C. § 77(o) (1971).
81. ILL. ANN. STAT. ch. 121 1/2, § 721(3) (Smith-Hurd Supp. 1980-81).
82. *Id.* at § 725.
83. *See* note 3 *supra*.
84. CALIF. ADM. CODE, ch. 3, § 310.114.1(c)(4).

sive search of the law, rules, and regulations must be conducted in each state where a franchise is offered for sale.

There are no limited offering or isolated sale exemptions in the typical franchise statutes, so they are much broader in scope than the typical state securities statute.[85] The Illinois statute does give the Attorney General the power to exempt any franchisor or seller of franchises from registration if he finds that the "enforcement of the Act is not necessary in the public interest (1) for the protection of any class of prospective franchisees or subfranchisors or (2) by reason of the investment involved or (3) because of the limited character of the offering."[86] Only experience will tell whether this exemptive power will be liberally construed.

As described, provisions quite similar to the anti-fraud provisions of securities regulation have been imported to the franchise regulation arena; experience will indicate how the courts will apply these anti-fraud rules. Since they originated from the securities area, will the standards of materiality that have developed and continue to be developed in the securities laws be applied to the franchising area?[87] Will the franchisee who brings a suit for damages or recission have to prove that he relied on a particular misrepresentation?[88] Will reliance have to be proved if the action is brought by the entire class of franchisees?[89] Will reliance have to be proved if the basis of the franchisee's suit is a material omission in the disclosure statement?[90] Will the franchisee have to prove that the particular mistatement or omission alleged caused his loss?[91] Will negligent mistatements or omissions be considered a violation?[92] Will the courts apply common law fraud principles to

85. *See, e.g.*, NEB. REV. STAT. § 8-1111(9) (Reissue 1977).

86. ILL. ANN. STAT. ch. 121 1/2, § 712 (Smith-Hurd Supp. 1980-81).

87. For the definition of materiality being applied in the federal securities law context, see TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438, 449 (1976). The FTC Rule defines "material" to "include any fact, circumstances, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee." 16 C.F.R. § 436.2(n) (1980).

88. *Cf.* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied sub. nom.*, List v. Lerner, 382 U.S. 811 (1965).

89. *Cf.* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

90. In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), positive proof of reliance in a failure to disclose case was not a prerequisite to recovery. *Id.* at 153.

91. *Cf.* Note, *Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

92. In actions for damages under section 10b and rule 10b-5 of the Securities Exchange Act of 1934 the plaintiff must allege and prove that the defendant acted with intent to deceive, manipulate or defraud. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-201 (1976). Likewise, the Supreme Court has recently held that the Securi-

answer these questions or will they apply principles adopted under federal securities laws or state securities laws?

In some respects the disclosure form of regulation seems more desirable than the substantive form of regulation adopted in the Nebraska Franchise Practice Act. It is to be hoped that if the disclosure format is not too complex, a prospective franchisee will have information in digestable form which will help him make a reasoned decision. Disclosure concerning the total investment that a franchisee will have to make to commence operations, and concerning the number of prior franchisees that have failed, is particularly meaningful. Likewise, disclosure concerning a franchisee's right to sell his franchise and his rights with respect to termination and renewal seems to be necessary to allow a franchisee to properly make his investment decision. Ideally this may limit the amount of subsequent litigation, which would be desirable for both franchisors and franchisees. However, the disclosure system can be very costly, especially if the states do not adopt uniform regulation. To the extent that each state adopts varied rules or regulations, the cost of compliance will correspondingly increase, resulting in higher costs to franchisees and the ultimate purchaser of franchise goods and services. Further, since many franchisees are small businessmen, these increased costs, though intended to protect him, will make it more difficult for him to succeed economically.

Also, many franchisors are not giant companies, though we sometimes think only of the household names.[93] To the extent that franchising is considered a financing method used by a franchisor who may not be able to raise capital by other means, any increase in the costs of franchising is another barrier to the growth of small business. Thus, it is interesting to note that this heightened regulation in the franchising area is taking place at the very time that the federal securities laws are being changed to make it easier for small businesses to raise capital. In recent years, a new form S-18 has been adopted by the Securities and Exchange Commission which permits a more streamlined disclosure format for companies seeking to raise up to $5 million in capital. This registration statement also can be used to qualify the securi-

ties and Exchange Commission is required to establish scienter as an element of a civil enforcement action to enjoin violations of section 10b of the Securities Exchange Act of 1934. Aaron v. SEC, 48 U.S.L.W. 4609, 4615 (June 2, 1980).

93. It is estimated that there are about 1200 franchisors and about 460,000 franchisees. However, less than 100 franchisors account for more than 75% of the franchise sales activities. The remaining franchisors are small to medium sized enterprises.

ties for sale in a state, since most states provide for registration by coordination where a registration statement is filed under the 1933 Securities Act. Moreover, effective February 25, 1980, the SEC adopted Rule 242 which permits corporate issuers to raise $2 million in a six-month period without registration, though in most cases a disclosure statement must be given to purchasers.[94] If the issuer adopts the Rule 242 format, he will still have to comply with state securities laws which may require registration. However, even if the issuer does not qualify for an exemption from the state registration requirements, the disclosure statement he will prepare pursuant to Rule 242 will contain most of the information required to register under most state securities acts.

It seems that franchising regulation has been adopted from the point of view of protecting a consumer (the franchisee). However, if a consumer protection point of view is adopted by the regulators, they will lose sight of the fact that for many franchisors, franchising is a method of raising capital. Such franchisors should not face more costly regulation than other small businessmen who are trying to raise capital. These changes in the regulation of securities sales may result in providing a simpler process for raising investment capital than for raising capital by franchising. The costs to small businesses of complying with franchise regulation should be considered especially with the Federal Trade Commission's entry into franchising regulation. As stated by Anthony Pierno the former Commissioner of Corporations of California:

> The goal in preparing franchise legislation, as the goal in drafting any regulatory law, should be to achieve the type of regulation that will bring about the necessary amount of protection to the investor at a minimum cost to the taxpayer, and with a minimum burden on legitimate enterprises. It is easy to draft a law that merely regulates; it is far more difficult to draft a law that regulates well and within the foregoing guidelines . . .[95]

FEDERAL TRADE COMMISSION REGULATION OF FRANCHISING

On October 21, 1979, the Federal Trade Commission's Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (FTC Rule) became effective.[96] This rule is designed to insure that prospective

94. 17 C.F.R. 230.242 (1980).
95. 44 L.A. BAR BULL. at 535 (Sept. 1969).
96. FTC Rule, *supra* note 2, at § 436 *et. seq.*

franchisees receive certain information so that they can make informed decisions prior to entering into the franchise relationship. Additional information must be furnished to the franchisee if any claims are made by the franchisor about actual or potential earnings.[97] Copies of the proposed franchise agreement must also be furnished to the franchisee. Unlike the state disclosure rules, the FTC's rule does not require registration, approval or the filing of any documents with the FTC.

The FTC rule makes it an unfair or deceptive act or practice within Section 5 of the Federal Trade Commission Act[98] for any franchisor or franchise broker:

(a) to fail to furnish to a prospective franchisee at the prescribed time a written disclosure statement containing information concerning twenty specified areas (this portion of the rule also requires the updating of the disclosure statement quarterly);[99]

(b) to make oral, written, or visual representations to a prospective franchisee which state a specific level of sales, income, or profit for that prospective franchisee, unless a number of conditions are met;[100]

(c) to make oral, written, or visual representations to a prospective franchisee which state a specific level of sales, income or profits of existing outlets of the franchised business, unless a number of conditions are met;[101]

(d) to fail to provide certain disclosure information if representations to a prospective franchisee concerning his potential sales, income, or profit are being made;[102]

(e) to make any oral, written, or visual representation for general dissemination which states or suggests a specific level of sales, income or profit, either actual or potential, for existing or prospective outlets, unless certain conditions are met;[103]

(f) to make any claim or representation which is contradictory to the information required to be disclosed;[104]

(g) to fail to furnish the prospective franchisee with a copy of the franchise agreement and any related agreements within a prescribed time before execu-

97. *Id.* at § 436.1(b).
98. 15 U.S.C. § 45 (1978).
99. 16 C.F.R. § 436.1(a) (1980).
100. *Id.* at § 436.1(b).
101. *Id.* at § 436.1(c).
102. *Id.* at § 436.1(d).
103. *Id.* at § 436.1(e).
104. *Id.* at § 436.1(f).

tion;[105]

(h) to fail to return any funds or deposits which the franchisor has disclosed are refundable.[106]

The list of unfair practices demonstrates the areas of particular concern to the FTC. The goal is to assure that the franchisee, before he is contractually obligated, receives relevant information about the franchisor, the franchise business, and the cost and terms of the franchise. This is quite similar to the securities regulation disclosure goal and to the requirements imposed by state disclosure statutes concerning franchising.[107] In addition, the FTC rule demonstrates the concern that the regulators have over earnings claims being made to prospective franchisees.[108] The rule neither requires nor prohibits earnings claims to be made. However, claims to prospective franchisees of potential earnings, past earnings performance, or earnings claims made in the media must meet certain conditions.[109] There must be a reasonable basis for the claim and the franchisor must have the evidence to support this claim in his possession.[110] In addition, the claim must be relevant to the prospective franchisee's geographical location.[111] If these conditions are met, earnings claims may be made, provided that the franchisee receives a separate disclosure statement providing information about the earnings claim.

Basically, the regulatory format adopted by the FTC is quite similar to that of the states which have adopted the disclosure format of regulation. Indeed, the FTC has determined that a disclosure statement which meets the requirements for a Uniform Franchise Offering Circular (UFOC), which were adopted by the Midwest Securities Commissioners Association in 1975, may be furnished to a franchisee in satisfaction of the FTC's disclosure requirement.[112]

Pursuant to the FTC Rule, the disclosure statement must be given to all prospective franchisees and, in some circumstances, to existing franchisees who extend or renew the term of their franchise within a particular time frame. It must be given at the earlier of the first "personal meeting" or the "time for making of

105. *Id.* at § 436.1(g).
106. *Id.* at § 436.1(h).
107. *See* text accompanying notes 67-82 *supra.*
108. *See generally Statement on Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 43 Fed. Reg. 5968495 (1978).
109. 16 C.F.R. § 436.1(b) (1980).
110. *Id.*
111. *Id.*
112. *See Final Guides, supra* note 27, at § D.

disclosures."[113] These terms are defined in the rule.[114] A personal meeting is a face-to-face meeting between a prospective franchisee and a franchisor or its representative which is held for the purpose of discussing the sale, or possible sale, of a franchise. Thus, a franchisor should defer the first personal meeting until it is prepared to provide the required disclosure. It should use the mail or telephone to attempt to qualify a possible franchisee before meeting with the prospect. The term "time for making of disclosures" means ten days prior to the execution of the franchise agreement or other agreement, or the payment of any consideration by the franchisee. Thus, if there is no earlier personal meeting, the disclosure statement must be given at least ten days before execution of the agreement or any payment.

This requirement is stricter than the Illinois Act which requires that the disclosure statement be given seven days prior to execution of the franchise agreement or payment of any consideration.[115] This understandable conflict between a state requirement and a federal requirement presents a good setting to discuss the question of pre-emption. The FTC rule provides:

> By taking action in this area, the Federal Trade Commission does not intend to annul, alter, or affect, or exempt any person subject to the provisions of this part from complying with the laws or regulations of any State, municipality, or other local government with respect to franchising practices, *except to the extent that those laws or regulations are inconsistent with any provision of this part, and then only to the extent of the inconsistency. For the purposes of this part, a law or regulation . . . is not inconsistent with this part if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by this part.* Examples of the provisions which provide protection equal to or greater than those provided by this part include laws or regulations which require more complete record keeping by the franchisor or the disclosure of more complete information to the franchisee.[116]

Based on this definition of pre-emption, a franchisee in Illinois must be given the disclosure statement ten days prior to execution or to the payment of any consideration by the franchisee, since the Illinois requirement of seven days is inconsistent with the FTC rule and less protective of the franchisee. Thus the FTC rule

113. 16 C.F.R. § 436.1(b)(3) (1980).
114. *Id.* at § 436.2.
115. ILL. ANN. STAT. ch. 121 1/2, § 704(2) (Smith-Hurd Supp. 1980-81).
116. 16 C.F.R. § 436.3 n.2 (emphasis added).

adopts an approach which is different from federal securities regulation which specifically provides that the states maintain concurrent power to regulate securities activities.[117] The blue-sky regulations exist as an additional and separate layer of securities regulation. By neither pre-empting state franchise regulation nor allowing the states totally concurrent power, the FTC has introduced additional complexity into the regulatory scheme. On the one hand the FTC has announced that disclosures required by the UFOC format provide protection to prospective franchisees which is equal to or greater than that provided by the Rule and, therefore, those state disclosure requirements are not inconsistent with the Rule.[118] However, in order to relieve the franchisor from the requirement of preparing two disclosure statements, one for states which have adopted the UFOC and one for the FTC, the FTC has announced that it will permit the UFOC to be used in lieu of the disclosure statement required by the FTC Rule.[119] The Commission still retains the power to determine whether the UFOC requirements have been met independent of any state determination.[120] Therefore, a situation could arise when a state had determined that the disclosure statement met the UFOC requirement but where the FTC disagreed and the FTC could bring an action under the Federal Trade Commission Act. Also, since the FTC does not defer to the state in enforcement, it may bring an action simultaneously with the state regulatory authorities for disclosure violations.

To cover the situation where the franchisor plans to offer a franchise in a state which has not adopted disclosure type regulation, the Rule provides that the franchisor may use the UFOC format if he has registered in a state adopting the UFOC.[121] In that case, the cover page requirements of the FTC Rule apply and certain state-specific disclosures must be modified. Similarly, if the franchisor plans to offer a franchise in a state which has not adopted disclosure type regulation and if the franchisor is not then registered in a state adopting the UFOC format, the franchisor may still use the UFOC to satisfy the FTC disclosure requirements, provided that the FTC cover page format is used and that certain requirements of the FTC Rule concerning timeliness of the information are met.[122] The third possible situation arises if a

117. 15 U.S.C. § 77 (1971).
118. *See Final Guides*, supra note 27, at § D.
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*

franchisor plans to offer a franchise in a state which has disclosure requirements but which has not adopted the UFOC format. In that case each state disclosure requirement would have to be compared with the FTC rule and only those not inconsistent with the FTC rule would be applicable. This could be a complex task. It would have been much simpler to provide that if a state did not adopt the UFOC format then the FTC rule would govern the disclosure requirements.[123]

Because of the preemption system outlined in the FTC rule and since the FTC rule does not impose substantive requirements on franchisors, almost all substantive requirements imposed by a state will have to be complied with since they will provide protections in addition to those of the FTC Rule. Thus a complete analysis of each state's franchise law must be made to determine the requirements imposed on the franchisor. This may raise not only preemption questions but also conflict of law problems. Assume the following: Suppose state A requires that if a franchisee wishes to assign his franchise, the franchisor must either accept the transferee or repurchase the franchise at a price to include the good will generated by the franchisee. Suppose state B which is the principal place of business of the franchisor permits the franchisor to disapprove any assignment of the franchise. Suppose state A is a UFOC state and that the franchisor discloses that it reserves the right to disapprove any assignment of the franchise and that the franchise agreement states that the law of state B applies, will the franchisor be able to deny a franchisee's assignment? The FTC rule has no substantive standard concerning the assignability of a franchise, so there will not be any preemption of state law in this area. However, even though the franchisor in state B is in compliance with the UFOC rule and the FTC rule, his disclosure with respect to assignability may be ineffective in state A, if that state feels that in order to protect its franchisees it must apply its franchise law notwithstanding the contractual choice of law clause.[124] Thus a franchisor planning to do business in a number of states has the burden of knowing all of the states' substantive as well as disclosure rules.

This also presents some very practical drafting problems. Once an attorney has drafted a UFOC and registered a franchise in a UFOC state, the tendency is to assume that this Circular will be

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123. For a good discussion of the interrelationship of the FTC Rule and state disclosure laws *see* BUSINESS FRANCHISE GUIDE (CCH) ¶7502 (1980).

124. *See* R&R Associates of Connecticut, Inc. v. Deltona Corp., BUSINESS FRANCHISE GUIDE (CCH) ¶7525 (D. Conn. 1980).

able to be used in another UFOC state. However, if the states' substantive laws differ, for example, different termination or assignment rules, the Circular will have to be redrafted to take into account these state differences. This also may require that the franchise agreement itself will have to be changed. In addition, the client will have to have a fairly sophisticated system to keep track of the different circulars and franchise agreements as well as to categorize the different renewal dates and other reporting requirements that the different states impose.

Both the FTC and the Midwest Securities Commissioners have prepared extensive guidelines to help in the preparation of the disclosure statement.[125] Each required disclosure item is explained and an example of appropriate disclosure is set forth. This will greatly simplify the attorney's task. However, it also will lead to boiler-plate type disclosure and may result in attorneys doing a less detailed job.[126] It is important that counsel keep in mind that these are guidelines only. The particular state statute should be carefully reviewed since the statute creates the disclosure requirements. Further, there are differences in requirements even among those states which have adopted the UFOC.

BUSINESS OPPORTUNITIES AND THE NEBRASKA SELLER-ASSISTED MARKETING PLAN ACT

Most of the state disclosure laws regulate only the offer or sale of franchises. They do not cover the offer or sales of business opportunities which generally are defined as situations where an offeror directly or indirectly provides goods or services to, secures retail outlets for, and requires a payment from the purchaser.[127] The common example of business opportunity ventures are vending machines and rack jobber routes. The FTC Rule does cover the offer of business opportunities.[128] This means that though a state may not regulate business opportunity ventures, the FTC Rule will have to be complied with. If the seller of a business opportunity

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125. *See*, BUSINESS FRANCHISE GUIDE (CCH) ¶5793-5828 and ¶6200-6262 (1980).

126. Black, *supra* note 23, at 426 n.84 states:

> In several recent state court actions in states which have franchise regulation laws, franchisors who failed to provide franchisees with the disclosure statements required by state law have interpleaded franchisor's counsel for failing to advise them of the need for disclosure. Since numerous other franchisees may share similar dissatisfaction to that which prompted the suit, the suits may be disastrous for franchisor's counsel. A similar claim for failure to advise a franchisor of the need to satisfy the disclosure requirements of the rule also appears possible.

Id.

127. *See, e.g.*, 16 C.F.R. § 436.2(a).

128. *Id.*

fails to provide the disclosure information required by the FTC rule, he will be subject to an action brought by the FTC. It is unclear whether private actions under the FTC Act may be maintained.[129] However, many states have so-called "little FTC Acts." These acts typically provide for actions by private parties[130] and permit state courts to consider FTC interpretations of "unfair or deceptive acts or practices" in determining what constitutes a violation of the state's "little FTC Acts."[131] Therefore, a failure to give the purchaser of a business opportunity venture the disclosure statement required by the FTC Rule could be a violation of the state's "little FTC Act" and might result in a private cause of action being brought by the purchaser.

Though Nebraska did not choose to adopt the disclosure/registration format for regulating franchises, it did adopt this format to regulate business opportunity ventures when, in 1979, it enacted the Seller-Assisted Marketing Plan Act.[132] This Act is designed to provide protection to the purchaser of a seller-assisted marketing plan by requiring that the seller of such a plan provide a written disclosure statement,[133] a written information sheet,[134] and a written contract to the prospective purchaser[135] and also file this information with the Nebraska Department of Banking & Finance.[136] The Act also includes certain substantive regulation by prohibiting certain contractual terms in the agreement between the purchaser and the seller of a seller-assisted marketing plan.[137]

The definition of a seller-assisted marketing plan is very broad. An offer to sell any product or service which requires the purchaser to pay more than $500 to the seller at any time within six months from the time the purchaser commences his operation constitutes a seller-assisted marketing plan, if the seller solicits the purchaser and represents that there is a market for the product or

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129. *Compare* Guernsey v. Rich Plan of the Midwest, 408 F. Supp. 582 (N.D. Ind. 1976) (granting a private cause of action) *with* Holloway v. Bristol-Myers Corp., 485 F.2d 986 (D.C. Cir. 1973) (denying such relief).

130. *See, e.g.*, FLA. STAT. ANN. § 501.211 (Supp. 1980); NEB. REV. STAT. § 59-1609 (Cum. Supp. 1978).

131. The Florida statute specifically provides that "due consideration and great weight shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to § 5(a)(1) of the Federal Trade Commission Act" in determining what constitutes an unfair trade practice under the state statute. FLA. STAT. ANN. § 501.204 (Supp. 1980).

132. NEB. REV. STAT. 59-1701 *et. seq.* (Supp. 1979).

133. *Id.* at § 59-1732.

134. *Id.* at § 59-1734.

135. *Id.* at § 59-1741.

136. *Id.* at § 59-1724.

137. *Id.* at § 59-1726.

service.[138] This definition is broader than the Nebraska Franchise Practice Act's definition of a franchise and is broader than the FTC Rule's definition of a business opportunity. The bizarre result would appear to be that though the Franchise Practice Act would, on initial inquiry, appear to cover franchising relationships, a franchisor in Nebraska could be subject to both disclosure and substantive regulation by virtue of the Seller-Assisted Marketing Plan Act and the substantive regulation of the FPA. However, the Seller-Assisted Marketing Plan Act excludes from the definition of seller-assisted marketing plans, among others, any transaction in which the seller has complied with the FTC Rule.[139] Thus, if the transaction fits within the FTC Rule's definition of a franchise or a business opportunity, the FTC disclosure rules apply. Unfortunately, some of the substantive provisions of both the Seller-Assisted Marketing Plan Act and the Nebraska Franchise Practice Act will apply since they are not preempted by the FTC rule.

One can only assume that the Nebraska legislature was not sure whether the FTC Rule would be adopted and, therefore, it passed the Seller-Assisted Marketing Plan Act. There was a period during 1979 when the Seller-Assisted Marketing Plan Act was in effect and the FTC Rule was not in effect. With the adoption of the FTC Rule, the significance of the Seller Assisted Marketing Plan Act is greatly diminished. It applies to those business relationships which fit within the definition of a seller-assisted marketing plan but do not fit within the FTC Rule's definition or for some reason are exempt from the FTC Rule. However, because of the breadth of the Seller-Assisted Marketing Plan Act's definition of a seller-assisted marketing plan, all those having distributor or dealer arrangements should check the Act's provision to determine whether the Act may be applicable to their system of distribution. Though the preamble to the act does not appear to intend to cover typical dealer arrangements, the definition of a seller-assisted marketing plan in the Act may be broad enough to reach them. The Act has been structured to have an all encompassing definition and then a series of exclusions from the definition, but because of the exclusions and the passage of the FTC Rule, it will probably have limited applicability at least with respect to its disclosure and filing provisions.

CONCLUSION

The 1970s demonstrated a need for more extensive regulation

138. *Id.* at § 59-1703.
139. *Id.* at § 59-1715 to -1722.

of franchising where many abuses had occurred. There appears to be little doubt that regulation was and is necessary. However, the early years of this decade should be used to reassess the regulatory effort.

Nebraska's reassessment of its regulation of the franchising relationship should result in repeal of the Nebraska Franchise Practice Act. The enactment of the FTC rule will provide prospective Nebraska franchisees with the information necessary to make a reasoned decision. If the legislature would amend the Nebraska Consumer Protection Act[140] to provide that violations of the FTC rule, as interpreted by the courts, will be considered an unfair trade practice under the Consumer Protection Act, Nebraska franchisees would have a method to enforce the FTC rule in the Nebraska courts. Such a regulatory format would also make it easier for franchisors to do business in Nebraska. They would have to comply with the disclosure provisions of the FTC rule and they would know that violations of the rule would subject them to suit in Nebraska under the Consumer Protection Act.

As interpretations of the FTC rule by the staff and by the courts develop, it is to be hoped that a fairly clear guide will develop which will make planning and compliance readily available to those who make the effort. If the legislature believes that additional protection should be afforded franchises in the termination, renewal and assignment of franchise areas, I suggest that they adopt the approach taken in the proposed California legislation. Such an approach makes the rules quite clear and franchisors will know what will be required of them should they wish to offer franchises in Nebraska. Any substantive legislation should adopt the definition of the term "franchise" used in the FTC rule. That definition seems as good as any of the others and it will be subject to continued interpretation and analysis which may crystalize in a short period of time.

Likewise, I suggest that the Nebraska Seller-Assisted Marketing Plan Act be repealed. The FTC rule covers business opportunity ventures. Thus, Nebraska offerees of business opportunities will be provided extensive disclosure. Furthermore, the definition of a business opportunity in the FTC rule adequately encompasses the types of activities of concern to the Nebraska legislature.[141] Moreover, the Nebraska Seller-Assisted Marketing Plan Acts' very broad definition and series of exceptions to the definition seems

140. *Id.* at § 59-1601 *et. seq.* (Cum. Supp. 1978).

141. See statement of legislative intent in NEB. REV. STAT. § 59-1701 (Supp. 1979).

much more complex than is necessary. By amending the Consumer Protection Act, as previously suggested, private and administrative action could be taken against offerors of business opportunity ventures who fail to comply with the FTC rule. If the legislature believes that certain substantive regulation is necessary in addition to requiring disclosure, it should determine what practices it wishes to prohibit and clearly specify them.

At the national level, the reassessment of the regulatory activities should result in a uniform offering circular acceptable for compliance with the FTC rule and with each state adopting a registration disclosure format. I believe that if this cannot be accomplished through cooperative effort that Congress should preempt the field with respect to the disclosure format.[142] The disclosure requirement presently imposed by the states and by the FTC are very similar. It seems difficult on any cost-benefit basis to justify two separate systems. Likewise, a uniform set of guidelines for preparing the disclosure statement should be adopted from the existing state and federal guidelines. Moreover, this uniform offering circular should only have to be renewed on a calendar year basis, for example, within three months after the end of the prior calendar year, unless material changes have occurred during the year. In this way franchisors will be able to analyze a uniform set of guidelines and prepare an offering circular which will be adequate in any state and, absent material changes, will not have to be renewed for a year. Additionally, a uniform rule on the use of earnings projection should be adopted and be applicable for purposes of FTC and state disclosure compliance. It seems wise to permit projections to be used and to prescribe the format, rather than to prohibit them, since it appears that this type of information will always be sought by the prospective franchisee. It is better to permit the franchisee to receive this information in a prescribed form rather than force franchisors to evade the law and orally give information which is prohibited.

The states should be able to continue to decide whether they wish to require a registration and filing procedure. Indeed, if the states wish to adopt a form of merit regulation and substantive requirements, they will be free to do so. It is probably merely a hope, given the political realities, that these requirements could also become uniform. However, some concern should be demonstrated for the small businessman who is attempting to expand

142. Limited preemption in the securities disclosure area has been suggested in the proposed Federal Securities Code. See ALI, PROPOSED FEDERAL SECURITIES CODE § 1904 (Proposed Official Draft 1978).

through franchising. Limited offering exemptions which have been used in the securities laws may not be appropriate given the special concern we have for a prospective franchisee who may part not only with his money but who also may leave a career to embark on this new venture. However, the regulation should be streamlined and made uniform whenever possible so that the franchisor's costs of entering the franchise field are not made so high as to leave this arena to big business.