# SELF-REGULATION OF FRANCHISING: THE IFA CODE OF ETHICS



HEARING

BEFORE THE

## COMMITTEE ON SMALL BUSINESS
## HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC, JUNE 30, 1994

Printed for the use of the Committee on Small Business

**Serial No. 103–92**



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# SELF-REGULATION OF FRANCHISING: THE IFA CODE OF ETHICS

THURSDAY, JUNE 30, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
*Washington, DC.*

The committee met, pursuant to notice, at 9:36 a.m., in room 2359–A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee), presiding.

Chairman LAFALCE. The Small Business Committee will come to order.

Today, our committee continues its inquiry into issues and problems of franchising. Franchising remains one of the fastest growing sectors of our Nation's economy, and an important source of new small business development. This is the ninth hearing our committee has conducted on the general topic of franchising and our committee's second hearing on the issue of self-regulation in franchising.

In the first hearing on franchise industry self-regulation in April 1993, our committee recognized a number of initiatives by the International Franchise Association (IFA), to address public concerns regarding abusive practice in franchise sales and franchise business relationships.

The most promising of these was the revision of the IFA Code of Ethics in late 1992, to provide specific industry standards for many of the practices that had been identified and addressed in State franchise legislation and in the legislation I introduced in Congress in 1992.

While the language of the 1992 IFA Code of Ethics offered weaker standards or protections than those proposed in legislation, it was significant as an acknowledgement that serious abuses were occurring in franchising, and as a starting point for meaningful discussion of appropriate standards of conduct in franchising.

Our committee's concerns, in the April 1993 hearing, centered on what appeared to be the revised code's limited applicability to franchisors generally, and the absence of compliance and enforcement procedures, even for IFA member franchisors. Our committee was given assurances that a plan for enforcement was being developed and would be implemented.

The IFA's adoption of a substantially revised Code of Ethics raises additional concern. The IFA's executive board approved the latest version of the Code of Ethics at its meeting in February, but it was not made public until May. At the time of this meeting I was given personal assurances by the new IFA chairman that the re-

form initiatives of the prior year would be continued without change.

It is also significant to note that for the first time in anyone's memory the IFA published its franchise opportunities guide this spring without including any copy of its Code of Ethics.

More significant, however, are the changes made in the code itself. Far from being technical corrections, as the IFA's general counsel has been quoted as saying in the Wall Street Journal, these changes appear to be substantial and significant. Of particular concern to me are the numerous new qualifications on the applicability and enforcement of the revised IFA code.

There at least 10 separate points in the opening paragraphs of the revised code that appear to limit its scope and applicability, and weaken potential enforcement by the IFA. Only three of these appeared in the 1992 IFA code. A number of the specific standards of the 1992 code also appear to me to have undergone substantial revision. Following its first revision in late 1992, the Code of Ethics was widely cited by the IFA to support claims that industry self-regulation could eliminate the need for new and potential restrictive legislation to protect the rights and financial interests of franchisees.

It was also offered as the basis on which the IFA sought to accommodate the potentially conflicting interest of both franchisors and franchisees within the IFA. The revisions made in the Code of Ethics raise questions regarding the IFA's continued commitment to these laudable objectives.

The purpose of our hearing today is to address these and other questions regarding the recent revision of the IFA's Code of Ethics. Why was the code revised so extensively only a year after the initial code revision? Does the revised code enhance or weaken potential protections or remedies for franchisees? Does it represent a retreat by the IFA on the issue of industry ethics and self-regulation? Does the code offer reasonable standards for assessing franchisor performance? Can the revised code provide a realistic basis for broad industry self-regulation of franchising.

We have a very capable panel of witnesses with us today who offer a variety of perspectives on these and other questions. I wish to thank the panel for their willingness to appear before the committee today. I realize that in some instances this necessitated changes in court appearance and teaching schedules. The committee appreciates these efforts and looks forward to your testimony. Whenever an effort is made to have four or five, six witnesses, there are always difficulties and there are always adjustments that have to be made; but where there is a will there is a way.

The committee also intends to leave the hearing record open for additional comment from other interested organizations. I refer in particular to the International Franchise Association, from which two principals were invited to testify but were unable to attend. Unfortunately, the IFA had no other principal available to appear in today's hearing, although we invited any other principal of that association.

The four panelists will be Mr. Eric Karp, an attorney with the law firm of Friedman, Handler & Karp of Boston, Massachusetts,

who specializes in franchise law and advises a number of national franchisee associations.

Another witness will be Mr. Michael Garner, an attorney with the New York City law firm of Schnader, Harrison, Segal & Lewis. Mr. Garner is a widely known expert on franchise law and is a past editor of the Franchise Law Journal of the American Bar Association Franchise Forum.

We also will have Dr. Robert Emerson, an Assistant Professor of Business Law and Legal Studies at the University of Florida in Gainesville. Professor Emerson is an expert in franchise law and has written a number of papers on franchisee rights and legal standards in franchising.

We will also hear from Mr. Robert Purvin. Mr. Purvin is a franchise attorney in San Diego, California, and Chairman of the American Association of Franchisees and Dealers. He has also recently published a book on franchising.

Because of bad weather in the Washington area last night, neither Mr. Karp nor Mr. Garner were able to come in last night as scheduled. They have advised us, however, that they both should be here at approximately 10 o'clock. Rather than delay the hearing, however, it is my intention to go ahead with Dr. Emerson and Mr. Purvin, and by the time they have concluded their remarks both Mr. Karp and Mr. Garner should be here to give their presentations.

I would now call upon the distinguished ranking minority member, Mrs. Meyers, for any opening statement she might have.

[Chairman LaFalce's statement may be found in the appendix.]

Mrs. MEYERS. Thank you, Mr. Chairman.

I am looking forward to hearing the witnesses that we have with us today. America's franchising system has provided opportunities to those who dreamed of building their own businesses and providing jobs who needed them. While the franchise system is not perfect, it is certainly not broken.

At its core, franchising is a contractual arrangement between free and willing individuals, just like many other commercial transactions. There are risks involved at both ends of the agreement, and there is a potential for profit at both ends. We should assume that individuals consult accountants and lawyers before signing contracts, and we should recognize that there is only so much that Government can do to protect people in their business decisions.

I believe an existing body of law currently exists which provides a comfortable level of protection for franchisees against deceptive and unfair business practices by franchisors. These protections are reinforced by the Federal Trade Commission, State laws governing franchising and State FTC's. Additionally, the International Franchise Association has established a Code of Ethics. It is this IFA Code of Ethics which we will be hearing about today.

I look forward to the witnesses' testimony and I thank them for appearing for us today, and I wonder if I could request, Mr. Chairman, if we could keep the record open for comments from the International Franchising Association.

Chairman LAFALCE. As I indicated in my opening statement, we would do precisely that.

I thank the gentlelady for her statement, and we will now go to the witnesses. It is my intention to put in the prepared testimony of all the witnesses in the record, and you may feel free to summarize it. Professor Emerson, yours is 32 pages, and it is my hope that you would summarize.

**TESTIMONY OF ROBERT W. EMERSON, ASSISTANT PROFESSOR, BUSINESS LAW AND LEGAL STUDIES, UNIVERSITY OF FLORIDA**

Mr. EMERSON. Thank you, Mr. Chairman.

One of the problems with being both a lawyer and a professor is you get a double whammy of verbosity, and you may have made a mistake telling me and the other person, who is already here, that since the other two have not yet arrived we may have a little bit more time than originally planned.

Chairman LAFALCE. If I made a mistake, I will correct it during the course of your testimony.

Mr. EMERSON. I am sure that will take place.

Mr. Chairman, Representative Meyers, and other members of the committee, my name is Robert Emerson. My background is briefly outlined in my written testimony.

This is the first time I have testified before Congress, so it seemed kind of fortuitous to me that I was looking in the *Washington Post* the very day that I found out I was being called here, and there was an article about someone who was called to testify before a subcommittee on consumer credit and insurance. It turned out that she was a 10-year-old Girl Scout called by Representative Joseph Kennedy to talk about how bank fees were gouging, and thus meaning "tough cookies," for Girl Scouts. I looked at that and I was concerned because I know, as a person who has been on stage and appears in front of big groups of students, that the two things that you cannot compete with are pets and small children. Looking around here I am grateful to see that at least maybe I still have a chance because I do not see anybody that seems to qualify in either of those areas.

But as I said, I am grateful to be here. I thank you for calling me, and I will try to keep my remarks brief.

In general, the IFA code does not enhance franchisee protections, but it also does not really weaken them, and I do not think it can do so because it is obviously not going to replace, and should not replace, existing laws. So, I think, in terms of its actual effect, the code just does not do much either way in terms of enhancing or taking away protections.

As just one example of how that IFA code should have little impact, I discussed in my written testimony IFA Code Section 4, Part 3's provision protecting the franchisee's right to form franchisee associations. Many States already do that, and such a provision is not really very controversial unless something else is included, such as a limited antitrust exemption, which I have advocated in an article published by Vanderbilt Law Review, or collective bargaining rights, which many others have proposed.

House Bill No. 2596 does more than simply what the IFA code does in terms of talking about rights of association. Section 4 of that bill requires disclosures about all franchisees that have left

the system, as well as franchisor explanations about certain terminated franchisees. I feel that those provisions, along with required disclosures related to prospective franchisor sales or other assignments of the controlling interest in a franchise system, could be very useful to both franchisees and prospective franchisees.

So, in essence, the IFA code provisions simply say what a lot of States do already. The code really does not add much of anything.

Some of the descriptions that have been added to what I refer to as the 1994 code—"the revised, revised code"— are rather self-serving. They could be misleading, and they often are incomplete. As examples, I refer in my written testimony to Code Section 4, Parts 4 through 7, which deal with termination, expiration of franchises, renewal of franchises, franchise transfers and encroachment. In all of those areas I think that perhaps the intent was a good one, but in actually going ahead and trying to describe these areas the IFA may have done better if it just had not bothered at all.

The 1994 rendition of the IFA code does not represent a significant advancement in the areas of industry ethics and self-regulation. When the code previously was revised in late 1992, there was an expressed or at least implicit promise that on matters such as enforcement more was to follow. So, I think you really had something figuratively rising high in the sky, some sort of expectation or trial balloon that was floated. Since then we have really had a dashing or puncturing or deflation of the hopes that were raised both with the 1992 code and really with the 1993 hearings that were held before this committee.

There are lots of problems that at least appeared like they might be addressed last year, which have not yet been addressed, such as the question of enforcement. From what I understand, there still has not been any enforcement—no proceedings against any franchisor—since the revised code of 1992 came out.

Discovery and time limitations have been referred to in prior testimony before this committee. So have other difficulties related to the mediation program that the IFA has announced. There are rather specific but important questions about the interpretation and effect of contractually mandated arbitration, choice of law provisions, and venue clauses. These are problems which really have not been addressed yet by the IFA.

The 1994 code is not an adequate source of franchisor practice standards. The proposals before Congress are more detailed, and they dovetail more with existing substantive regulations already found in a number of States.

In my written testimony, I discuss the fact that parties to a franchise contract are bound by the same implied duty of good faith and fair dealing found elsewhere in the law of contracts. Good faith is a well established concept. There is nothing really radical there. Yet I am troubled by what I see in the IFA code of ethics.

A franchisee should be able to expect that his or her franchisor will not somehow harm, especially if it is intentional, the franchisee's ability to enjoy the fruits of their contract. Many State legislators as well as some courts have recognized that there is more to franchise relationship law than the words in a long document—a "franchise agreement," that was drafted by the franchisor.

Franchise relationships involve more than just locating the wording of a particular clause in some very elaborate document, some form that was not negotiated but in effect was simply presented by the franchisor to the prospective franchisee. Along those lines, I would refer the committee to an article that I recently published in the North Carolina Law Review, which talks about this issue of how to evaluate clauses or standards that arise from a franchise agreement.

My opinion is that franchise relationships are dynamic. To understand the parties' present relationship in an ongoing franchise situation, one must for many terms of the original written franchise agreement look beyond what was formally agreed to at the outset of the relationship. In other words, things go on and the initial, written agreement is not in effect the final word on what that agreement —or the franchise relationship—is all about.

The IFA code in effect says, to paraphrase Dragnet's Joe Friday—and we all like Joe Friday—"Just the contract, ma'am." Well, that is usually fine, if the contract terms are expressly on point. But the 1994 code restricts good faith more broadly.

To me, it is very important that the code wording on the good faith concept should say, "expressly found in some sort of written agreement." Because it does not say that, the code fails to address the difference between express and implied terms. It seems to flat out deny a franchisee's claim about franchisor bad faith when simply a presumption against that claim, a rebuttable presumption, is I believe the more appropriate standard.

Unlike the IFA's code, proposals before Congress provide a comprehensive enforcement mechanism, as well as cover non-IFA franchisors. These are obviously two very important concerns when we are talking about regulating franchising. The bills permit a private cause of action, which even many franchisor attorneys have recognized is a necessary reform.

One last point. Groups of professionals have for a very long time been developing and refining their codes of ethics. These professionals, such as doctors, and lawyers, and accountants, and the like, with their well established codes of ethics, tend to admit that they are fiduciaries—that their first duty is to the client, or the patient, or whomever.

Franchisors admit no such fiduciary standards. I do not blame them for that. In most respects in a franchise relationship, I agree with them that a fiduciary label for most aspects of the relationship is probably inappropriate.

However, without such a fiduciary obligation to franchisees or other special duties that many professions have to the public generally—a lawyer for instance is an officer of the court, not simply a zealous advocate for the client—without those special duties as a fiduciary to the franchisee or to the public generally, franchisors are really not in a good position, one comparable to true professionals, to articulate and enforce a self-administered code of ethics in lieu of a Federal statutory framework.

Franchisors can espouse beliefs and ideals. I think that is great. I think that it is a noble effort to set sort of a floor for what franchisors should be expected to do. But as a substitute for na-

tional regulation or at least uniform State laws, I think it really will not cut the mustard.

Thank you very much for allowing me to speak.

[Mr. Emerson's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Dr. Emerson.

Our next witness will be Mr. Robert Purvin, chairman of the Board of Trustees of the American Association of Franchisees and Dealers. Mr. Purvin.

**TESTIMONY OF ROBERT PURVIN, JR., CHAIRMAN, BOARD OF TRUSTEES, AMERICAN ASSOCIATION OF FRANCHISEES AND DEALERS**

Mr. PURVIN. Thank you, Mr. Chairman. Thank you for letting me speak here today. To Congresswoman Meyers. This is an exceptional opportunity to speak on an issue that I think is extremely relevant. But before I get into it, I want to comment that I think that I was a witness at the very first hearing—I do not know how to turn off my beeper, so we are just going to listen to it beep for 30 seconds, and then continue on. It is now 7 p.m. California time.

Chairman LAFALCE. Wake-up time. We will pause while we listen to our congressional beeper.

Mr. PURVIN. I started to say before all of the beepers interrupted me that I was a witness at the very first hearing this committee held with respect to franchising in September of 1990. At that time—and I want to report this to the committee, because there have been some dramatic changes in the franchising industry that I think that the committee needs to know about—at that time, there was a panel of five—one State regulator, three franchisor representatives, and then this attorney that somehow Mr. Sagar found out in California that had been speaking about franchisee concerns with literally no power base.

In fact, I remember telling the committee that I did not want anything that I said here to be heard by any of my clients back in California. Well, they all heard it, and now I represent franchisees.

But since that time, there has been a dramatic movement toward the representation of franchisees. At that time, there was no organized voice of franchisees, no generic voice. Today, as we are here, there is not one but two major franchisee organizations that have come out of the woodwork literally in the last 3 years, largely due to the effort of this committee to bring these issues to the fore.

Combined, these two associations represent approximately 20,000 franchise businesses that are finally able to come together, and recommend to franchisees to organize themselves, to speak out on issues, and to carry forth the whole program of addressing ethics and addressing how regulation should take place.

Enough of speaking of our association. Incidently, the American Association of Franchisees and Dealers has just published a new member guide. I have a copy available for each of the committee members today and for the press that are in attendance. I put as many as I could into my suitcase, as I was leaving home to come here.

I am particularly excited to be here today, because this particular hearing gets to what I have described in my written materials as the nitty-gritty of testing the record of the franchising industry for

fairly and objectively measuring and reporting the performance of the IFA as well as the industry's record for developing and enforcing fair and equitable franchise practices.

I think that we have been talking in all of the other hearings, as I have been following the progress of the committee, about the need for further regulation, and what type of franchising law should we have. But today's hearing, in particular, really puts the industry on trial, so to speak, and investigates how the industry is truly doing in its pledge to be self-regulating.

I had thought that I was going to be last in the panel, and I planned to come on very strong. But I will come on very strong in the middle. Because I, for one, think that the record——

Chairman LAFALCE. Do you think that we could have put you on at any point where you would not have come on strong?

Mr. PURVIN. In fact, I was going to remind the Chair that I was the last witness at the hearing in 1991, and we ran out of time. You had told me if I ever came back that you were going to tack on the 7 minutes I lost at that time. I just wanted to remind the Chair. I see that a third member of our panel has joined us. So, I will leave room for Mr. Garner at the other end.

At any rate, I personally believe the record of the franchising industry to meet its own self-imposed challenge of being a self-regulated industry has been frankly quite poor.

I felt the 1992 code of ethics extended the industry's rather predictable record of complimenting itself and self-aggrandizement, and setting forth an inability to establish meaningful and stringent minimum standards of enforcement of full and equitable franchising practices. Most importantly, the old code continued the failure of the industry to enfranchise, and I use that word quite on purpose, to enfranchise franchisees.

But when I look at the new code, I see a step back. In fact, the largest change from the old code is in each section of the code, which is no longer called a code of ethics, it is now called a code of principles and standards of conduct, the major change is the addition in each section of a statement of "how well we are doing, folks;" as opposed to a recognition of a high degree of duty to protect those people who are the targets of franchising, those consumers of franchising, the franchisees.

So, when I talk about getting to the nitty-gritty, I refer to the real question at hand, can this industry truly be self-regulated.

I talk about something, and I have created something in my own mind something that I call the franchise fraud. The franchise fraud does not identify fraudulent practices or an intent to deceive. The franchise fraud is the systemic misrepresentation by the franchising industry over the past 50 years, that franchising is a safe and secure way of owning a business.

In fact, franchising has been a very successful method of business ownership for which there are some major examples. But for the 3,500 companies that sell franchises, we can probably identify less than 10 percent, probably less than a 100 of those 3,500 companies, that truly would achieve the standards of a blue chip franchise opportunity.

The vast bulk of franchisors are young companies that are riding the coat tails of the Coca-Cola's, the Budweiser's, the General Mo-

tor's, or those major companies that have set the standard of wide product acceptance that anyone would like to own a franchise of.

So, part of what I want to address is how can we eliminate the franchise fraud, how can we set fair standards. Well, the way you do it is you educate the public, and you acknowledge up front that those people who buy franchises require protection. If the industry is going to take on that challenge, it must at the very first effort accept responsibility for protecting those people who it chooses to deal with.

Indeed, in every industry that I have compared, where self-regulation has come into being—there has been fundamentally this acceptance of responsibility to protect those people who require protection.

Another thing I have noticed, and I want to turn this around to talk about what I call the criteria for self-regulation, there are four items that I see when I look at industries that Congress has seen fit to allow a degree of self-regulation.

In the first place and most importantly, in every industry I have compared that is self-regulated, there has been a mandate from Congress for that self-regulation. Not an abdication by Congress, but a mandate by Congress. There has been a law put on the books that says, "these are the standards that Congress things are important, and these are the laws that must be enforced." If we look at the securities industry, if we look at labor/management, if we look at consumer protection, there are strong laws on the books that set forth the minimum standards.

Second, Congress tells the industry that if it would like to take care of its own problems, it can. But like a parent to two feuding children, there must be a congressional admonition, "if you do not take care of the problem, Congress will."

Third, the laws I see on the books are laws that have strong teeth in them. Fourth, If the industry fails to be self-regulating, those laws provide the safety net that protects the consumer.

So, the first thing is a strong legal mandate. The second criteria for self-regulation is the recognition by the industry that seeks to be self-regulating, the recognition, as Mr. Emerson just stated, of the duties. Whether you call it a fiduciary duty or just an important duty of loyalty, of good faith, of fair dealing, the recognition that those duties are the essence of the purpose of self-regulation.

Third, there is the acknowledgement and the establishment of strong minimum standards that the industry is willing to enforce. Finally, there is the enforcement, the provision of strong enforcement of those standards.

When we look at the new IFA code, we find that none of these four criteria are present. With all due respect to Congresswoman Meyers, there is no Federal statement of franchise regulation. The Congress of the United States has not taken on, except for the bill that has now been offered by Congressman LaFalce, there is not a statement of Congress that recognizes that this part of our—economy that the IFA claims represents 35 to 50 percent of retail sales in the United States—is deserving of special recognition and a special set of rules that applies across the board to all franchisors and franchisees. So, there is not that legal mandate that we first of all look for from Congress.

Second, and this is the part that concerns me the most, there is not the recognition by the industry that the industry owes a strong set of duties to its franchisee constituents. I look at the new code of principles and standards of conduct, and what I read in it is a self-aggrandizement of an industry telling us how well they have done. Nowhere in the 2 page document of very small print, is there any statement of how much the industry owes to the franchisees, and why it is incumbent upon the industry to establish and enforce a strong set of duties.

The IFA has completely failed, in my opinion, to set forth that recognition of duties to its consumer group. This is not the case in the securities industry, which is probably the biggest example of a self-regulated industry, where the NASD has set forth investor protection as the purpose of self-regulation in that industry.

In addition to minimum standards, and in addition to the recognition of the duty, there needs to be——

Chairman LAFALCE. There you do have organizations such as SIPC, Securities Industry Protection Corporation, where they have consumer representatives that look out after the consumer, the user of the securities industry.

Mr. PURVIN. Well, even the NASD, if you read through their Code of Ethics and Responsibility from word one and right on through it, the principle is investor protection. Now, that is an industry that has decided, and whether or not its fulfilling its duty—and one thing that we are not looking at today is whether self-regulation has worked in these other industries—but the acceptance of consumer protection, the acceptance of franchisee protection is missing from the current standards.

Once you have accepted the premise that you must protect investors, however, you need to establish the standards. The current standards of conduct defers to the contractual relationship. I know that they have changed the name from Code of Ethics, but how can you set forth a set of principles or a set of ethics and say that these can be exempted by contract? Ethics are ethics, or I should say ethics is ethics. If you are going to have a code, it has to apply, and it has to apply across the board.

So, if you are unwilling to establish the standards, you are unwilling to accept the responsibility, and you are not deserving of that opportunity.

The final part of the puzzle that must be there if you are going to have effective self-regulation is you must have enforcement of that regulation. The Code of Principles and Standards of Conducts does not set forth any self-regulating teeth through which self-regulation can occur.

In my closing, I want to come back to my parent example because it is the example that I think it is the role that I would like to see Congress play. If the children are the franchisors and the franchisees within the industry that need to work out their own difficulties. If Congress wants to sort of be fed up with this, what we need for the government to do is to set forth the rules and parent-like to tell us, children, settle your differences, involve yourself in collective bargaining, involve yourself in realistic ways. But if you do not, the framework of laws will take care of the problem for you.

I am anxious for your questions, and that will conclude my prepared remarks.

[Mr. Purvin's statement may be found in the appendix.]

Chairman LAFALCE. All right, thank you very much, Mr. Purvin, for your remarks.

We will now go to Mr. Michael Garner. As I indicated earlier, he is an attorney with the New York City law firm of Schnader, Harrison, Segal & Lewis, and the past editor of the Franchise Law Journal of the American Bar Association's Franchise Forum.

Mr. Garner, please proceed.

## TESTIMONY OF MICHAEL GARNER, ATTORNEY, SCHNADER, HARRISON, SEGAL & LEWIS

Mr. GARNER. Thank you so much. Mr. Chair, honorable members of the committee, I want to thank you for the opportunity to appear here to testify with respect to the International Franchise Association's new Code of Principles and Standard of Conduct which, as Mr. Purvin noted, formerly was known as the Code of Ethics.

The fundamental issue before us today is the efficacy of self-regulation. I think the most specific inquiry is whether the Code of Principles advances self-regulation or is a retreat from the position of the Code of Ethics.

I am going to give you both a long answer and a short answer. The short answer is that the Code of Principles is a retreat from the Code of Ethics in at least three respects.

First, it states, for the most part, that if a franchisor is in compliance with applicable law, it is in compliance with the code.

Second, it states that if the franchisor is in compliance with its franchise agreement, it is also in compliance with the code.

Third, in some instances it provides that if the franchisor has a procedure for dealing with a particular problem, then it is also in compliance with the code.

Essentially what this means is that the code is drafted in a way that the IFIA imposes no higher standard of conduct upon the franchise community than exists under existing law. Now, we do have a Federal standard of disclosure in the FTC rule with respect to franchise sales, but there is no Federal standard with respect to the franchise relationship. By that I mean the issue of transfers of franchises, termination of franchises, alternative sources of supply and encroachment. There are laws at the State level, but only in less than a third of the States.

Let me now come to the long answer. Franchise relationships are complex. They are complex because they usually have a duration of 10, perhaps 20 years. Problems arise during the course of that relationship that cannot be anticipated at the outset. The relationships are complex because they deal with a very, very wide range of problems; from issues of personal liability, who is responsible for personal injuries on the franchisees' premises, to buyer or seller issues, to trademark issues and antitrust issues.

These complexities are multiplied by the fact that there is a remarkable variety of franchise relationships. We have janitorial services, we have restaurants, we have quick service restaurants, full service restaurants, video outlets, business services. The particular problems that arise in this particular industries may vary.

I would like to talk about three primary areas where franchisees are facing serious problems, to get a perspective on the issue of the new Code of Principles. There is a problem today with franchisor failure. Mr. Purvin mentioned the fact, and I agree, that most franchisors out there are kind of riding the coattails of the franchisor wave, and are now companies entering the franchise arena, or they are established companies that have decided to go into franchising as a way of expanding their product or service lines.

A lot of times I have found that these new ventures have little or no experience, and they discover that franchising is much tougher than they anticipated when they went into it. The result is that when problems come up, particularly when the franchisor is always an established business, it is all too easy for the franchisor to abandon that venture and leave the franchisees with nothing.

Let me give you the example of Union Carbide, which is one of this country's largest corporations; a corporation with some $7 billion in income per year.

They started a program a few years ago to franchise interior marble surfaces in commercial and residential buildings, and saw this as a way of extending its specialty chemicals business. So, it decided to launch a franchise program by buying expertise off the shelf. It bought a small marble care company. It hired a bunch of franchise executives and suddenly it was in the business of selling franchises.

But a few years down the road it found that the sales of franchises had not met the corporate projections. After a lengthy search, it sold the company to one of the franchisees for a song. The major problem that came out of the sale was that when it sold, it did not sell the Union Carbide name, which most of the franchisees had plunked down their money for.

In another example, a well known exercise program that has been popularized through home videos went into the franchising business; set up a subsidiary; it hired executives. Again a year or two down the road people found out that the franchising executives had basically squandered the corporate assets to the point that the corporate offices were closed by the landlord. The franchisees were left with no franchisor. They did not even have a telephone number that they could call and get an answer. That system is basically in shambles now and you have a lot of people out there who do not have the name that they purchased, who have lost their investment, who left other lines of work or employment to go into this venture, and cannot go back now.

This is a real problem, and it is not addressed by existing law and it is not addressed by——

Chairman LAFALCE. What is the name of that well-known exercise program, Mr. Garner?

Mr. GARNER. Callanatics.

It is not addressed by the IFA's code, and that is regrettable because this is an area that is a golden opportunity for self-regulation. In either of these instances an effective self-regulatory scheme and a knowledgeable expert body such as IFA could have given franchisees the opportunity to voice their concerns and possibly

have them resolved in an early stage, rather than having the franchise system collapse.

Chairman LAFALCE. If Callanatics were a member of the IFA.

Mr. GARNER. True, true.

The IFA does have the resources and the expertise to counsel faltering franchisors. It could assist them in restoring a failing system to good health. This is an area that is not addressed by existing law, and probably cannot be addressed by legislators, but it is an area where self-regulation could play a very effective role.

A second major problem in franchising today is in the area of encroachment which the IFA code euphemistically refers to as system expansion. Many franchise systems today are——

Chairman LAFALCE. That is the new——

Mr. GARNER. That is the new code.

Chairman LAFALCE. That is the revised, revised. The revised referred to encroachment. The revised, revised is system expansion.

Mr. GARNER. System expansion.

Many systems are mature today. Franchising is highly competitive and we see many franchisors effectively cannibalizing their own systems through over-expansion. Keep in mind the economics of franchising here. The franchisor has no interest in whether the franchisee is particularly profitable. The franchisor typically only has an interest in the franchisee's revenues, because it takes a royalty based on gross revenues.

We see encroachment both in blatant form, such as the installation of new units in an existing franchisee's territories, as well as in very subtle forms, such as sales of a well known restaurant product through grocery stores, or where a service is delivered through a network of franchisees, the franchisor may now make this service available in the home through home videos.

Encroachment problems are especially well suited to self-regulation because the issues are difficult. They are subtle. Again, this is an area where a knowledgeable and expert body can play a significant role.

If we go back to the example of a restaurant franchisor selling its products through grocery stores, you have the question of is that really going to impact franchisees or are they really two different lines of sales here. You always have the question in encroachment of how much impact on an existing business is enough of an impact to make a difference. This is an area were self-regulation can play a real role.

The revised, as opposed to the revised, revised Code of Ethics provided categorically that a franchisor would not open an outlet in proximity to an existing one without taking 12 specified factors into account. The new Code of Principles reiterates those factors, but also says that any program, method or procedure agreed to by a franchisor and its franchisees to resolve encroachment issues will be deemed in compliance with the code.

Effectively what that means is that a franchisor can make its own self-designed dispute resolution mechanism binding up on franchisees as part of the scheme, and that mechanism can effectively have no protection through the franchisees, but they have to agree to it. So, this is an empty solution.

An example of that is that in some systems the franchisor may agree to notify an existing franchisee of an intent to place a new unit in its locale. The franchisee has the right to protest, and the franchisor pledges to listen, but the franchisor reserves the right to make the final decision.

Again, this scenario, it is a golden opportunity for self-regulation that the IFA not only has passed up, but from which it has retreated in the new Code of Principles. You, as lawmakers, will be interested to know that encroachment legislation does exist at the State level in the automobile industry. Approximately 35 States have laws providing that when an automobile manufacturer seeks to place a new dealer in a defined proximity to an existing dealer, the existing dealer may protest, and then there is a dispute resolution to resolve that dispute. Typically under that legislation the existing dealer's protest as a matter of law enjoins the manufacturer from franchising that new dealer.

Chairman LAFALCE. About how many States have State legislation dealing with the encroachment issue?

Mr. GARNER. In——

Chairman LAFALCE. Iowa?

Mr. GARNER [Continuing.] business format franchising? I think there is a total of four or five, but they are not particularly well-drawn, effective laws. I am referring—that is the maximum number you would have.

Mrs. MEYERS. Mr. Chairman.

Is there any regulation, Federal regulation, that speaks to encroachment at all?

Mr. GARNER. No.

Mrs. MEYERS. Thank you.

Chairman LAFALCE. Please continue.

Mr. GARNER. The third area I want to talk about briefly concerns sources of supply. In most areas of franchising where products are involved, there are a lot of suppliers that can satisfy the franchisor's legitimate needs.

A franchisor that requires is franchisees to purchase for it or designated suppliers essentially creates a captive market for those products, and those products are typically available from other sources.

I mentioned Union Carbide a few minutes ago. In its franchise program, it made the claim to its franchisees that the marble treatment products it had were proprietary, and required franchisees to purchase them from it. We are in litigation with that company, and internal documents of Union Carbide show that two of the supposedly proprietary products were Red Devil Stripper and Clorox Bleach that they were buying off the shelf, relabeling and then shipping out to franchisees.

The new IFA code has a significant retreat from the Code of Ethics in this area. The Code of Ethics previously mandated that franchisor members to permit franchisees to purchase from alternative sources of supply if the franchisor's legitimate standards and needs were met.

The new Code of Principles, however, states simply that a franchisor will be deemed in compliance with the code if it is in compliance with antitrust and trade regulation laws, and the state

of antitrust law is such today that the franchisor essentially can require its franchisees to purchase all of its products from the franchisor, whether they are proprietary or not.

So, the self-regulation that the new Code of Principles articulates is really illusory and I would say this is an area where legislation on the Federal level would be appropriate.

Let me start to wrap up here by just making a few other comments on the Code of Principles. The Code of Ethics mandated that franchisors deal in good faith with their franchisees, and the new code adds the qualification that a franchisor that acts in compliance with its franchise agreement is acting in good faith.

This is a significant change because in common law the duty of good faith is really a qualification on the franchisor's——

Chairman LAFALCE. Could you please repeat that? I want to make sure that I had an opportunity to hear this.

Mr. GARNER. Sure.

The new Code of Principles has qualified the franchisor's duty to act in good faith by saying if the franchisor acts in compliance with its franchise agreement, it is acting in good faith.

Now, common law, the implied duty of good faith and fair dealing is a curb on the franchisor's contractual rights to act. So, the Code of Principles——

Chairman LAFALCE. You cannot contract away the obligation to act in good faith under common law.

Mr. GARNER. That is right. That is right. This is a kind of circular argument that the—or I should say a short circuiting argument that the IFA has essentially codified here, because it gives the franchisor free rein to exercise any contractual discretion it may have, and it is deemed in compliance with the code.

In the area of franchisee advisory councils and associations, the Code of Principles retreats from the earlier position that encouraged franchisors to foster open communication with franchisees, and it simply states that a franchisor may foster such communication by such means that the franchisor deems are most effective. So, this is just kind of left up to the franchisor. So, if it decides that sending out bulletins announcing unilateral positions is the most effective way that it can deal with its franchisees, that at least on its face would be in compliance with the code, whether the franchisees have an avenue to talk back to the franchisor or not.

The new code does take a step forward in the area of expiration of the franchise agreement by providing that the franchisor may make the decision not to renew a franchise agreement as conclusion if it is for good cause or if the franchisee is given a meaningful opportunity to sell the franchise, if it has the opportunity to operate the business under a different trade identity, or if, and this is the addition, the franchisee is permitted to realize the value of the business.

There is another backward step with respect to transfers. In that area the new code states that the franchisor shall not unreasonably refuse a franchisee's request for a transfer under certain conditions, but makes an exception for so-called personal services contracts. Now, that is a term that has a meaning in common law. The IFA code does not define it, but I would be very surprised to find just about any franchisor who would say that its franchise agree-

ments are not personal services contracts, and I think most franchise agreements in fact, recite that the franchisor is entering into it with that particular franchisee because of the special skill and qualifications of that particular franchisee.

Now, I want to make one final point. There are a lot of franchisees today that are very sophisticated. They are large public corporations out there acting as franchisees. But there are still a lot of franchisees who are mom and pop operators and a lot of franchisees who are very, very unsophisticated.

When a franchise system falters, these people lack the knowledge, they lack when resources, they lack the sophistication to even know how to begin to redress their problems. I have had groups of franchisees come to me with serious problems. I have advised them to organize, to form an association, to elect a leader. They cannot do it. They simply do not have the wherewithal to do it.

These are the people who self-regulation could really serve best by providing an accessible, low-cost forum where they could voice their concerns, and hopefully work out some problems.

In concluding, I want to emphasize first that there are a lot of franchisors who are not in need of further regulations. They are good citizens. They treat their franchisees fairly. But there are problems in franchising today, and they don't arise from evil-minded people, but from competitive stresses, from the growing pains of development. The fact that franchising is a pioneering industry, and is an pioneering venture, there are greater risks than in following the beaten path.

Self-regulation does present a golden opportunity for those who speak for the industry as a whole. It can provide mechanisms to resolve issues before they become problems. It can provide expert guidance and dispute resolution where legislation may be cumbersome or difficult. It can educate and advise instead of having the current situation in which there is too much confrontation and escalation.

Unfortunately, the IFA's Code of Principles, while it is certainly well intentioned, provides franchisors with a safe harbor and a status quo.

Thank you.

[Mr. Garner's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Garner, for your expert testimony.

I do not know what the individual looks like. I wonder if Mr. Eric Karp is in the room.

Mr. KARP. Yes, Mr. Chairman.

Chairman LAFALCE. Oh, he is. Oh, good.

Please take a seat.

Mr. KARP. Thank you, Mr. Chairman.

Chairman LAFALCE. You were obviously able to take a flight this morning.

Mr. KARP. My apologies for my tardiness, Mr. Chairman. But nature does have a way of reminding us of the limitations of our technology.

Chairman LAFALCE. That is all right. Fine.

Mr. Karp, please proceed. We have heard the other three witnesses. We have not begun a dialogue amongst the panelists or be-

tween the panel and the committee. We will upon the conclusion of your remarks.

Mr. KARP. Thank you, Mr. Chairman.

Chairman LAFALCE. When did you arrive? Who was testifying, who was testifying when you arrived? Was it Mr. Garner?

Mr. KARP. I believe Mr. Garner was concluding his remarks.

Chairman LAFALCE. All right. Dr. Emerson and Mr. Purvin had already testified.

Mr. KARP. Thank you.

## TESTIMONY OF ERIC H. KARP, ATTORNEY, FRIEDMAN, HANDLER & KARP

Mr. KARP. Mr. Chairman and members of the committee, my name is Eric Karp. I am a partner in the Boston law firm of Friedman, Handler & Karp, where I specialize in representing franchisees and franchisee associations throughout the United States.

I also appear here today as an affiliate member of the American Franchisee Association, the largest franchisee trade organization in the United States, which represents some 13,000 outlets, encompassing some 60 brands.

I want to thank you, Mr. Chairman for the opportunity to present my views to this committee concerning this vital area in franchising.

Mr. Chairman, the IFA Code of Ethics as it was originally issued in late 1992 was part of a three-point plan by the IFA to convince the Congress and the States that legislative solutions to the urgent and obvious problems in franchising were not necessary, and that this $600 billion a year industry could regulate itself.

In addition to the code, the IFA announced the creation of the National Franchise Mediation Program, and began to invite franchisees to become dues paying members of the IFA. The unspoken but irrefutable premise of the IFA's program was that there were serious problems in franchising, but that the current state of the law was not sufficient to address those areas. It is thus fair to ask whether the IFA code, either in its original version or in its newly watered down version, is intended in any way to change the legal relationship between franchisors and franchisees.

After a careful examination of both the new and the old codes, I have come to the conclusion that, to the very limited extent that the old IFA code did attempt in discrete areas to affect those legal relationships, the newly issued code has deliberate erased those limited advances.

Any analysis of this new IFA code and a comparison with the old must be placed in context in order to determine not only what changes were made, but why they were made.

In late 1992, the IFA was in a state of near panic over the filing of your disclosure, relationship and data bills, coupled with the Iowa-styled bills filed in two dozen States around the country. The IFA hurriedly published its initial code, reportedly without consulting its own membership. This was done in order to create the illusion of change, and to persuade the Congress and State legislators that franchisors could police their own.

The IFA was immediately caught in a cross-fire. The code was rightly greeted with skepticism by franchisee representatives who, while conceding the code contained some modest improvement, accurately observed that it lacked an effective enforcement mechanism and was of limited applicability.

At the same time member franchisors of the IFA complained loudly that the code had gone too far. Some franchisor attorneys began to advise their clients to insert provisions in their franchise agreement stating that the IFA code does not apply to or affect the franchise relationship. In addition, some franchisors have insisted that they do not consider themselves bound by the code and will take no steps to alter their policies and procedures to comply with it. As a result, franchisor members of the IFA demanded and got a significant rollback in the form of this newly revised code which was issued in the spring of this year.

Mr. Chairman, the new IFA code cuts the heart, however weak, out of the old code.

How so? Mr. Chairman, I have provided the committee with this comparison study, which is a line-by-line, side-by-side comparison of the new and old code so that you can judge for yourself, and I have attached this to my testimony. If you will permit me, I would like to highlight what I consider to be the nine most striking changes from the old code to the new cold.

First, on the issue of applicability. The new code contains a series of qualifications, hidden exceptions, loopholes and road blocks, making it possible for any franchisor to avoid compliance with even its watered down requirements.

Item. The new IFA code, as well as the old, applies only to a franchisor's U.S. operations, excluding the significant and expanding foreign operations of many U.S. franchisors.

Item. The code states that it only applies "generally" to franchise relationships. For example, the new code states that "Franchise relationships should be generally established by clear and unambiguous franchise agreement."

I ask you, Mr. Chairman, when would it be appropriate for a franchise relationship to not be governed by a clear and unambiguous agreement? Are there circumstances when a franchisor should be encouraged or permitted to use a vague franchise agreement?

Item. The code claims that some franchise relationships cannot be conducted in compliance with it, although it does not specify the kinds of franchise relationships that fall into this category. This gives any franchisor room to argue that if it is inconvenient to comply with the code, it need not do so.

Item. The new IFA code indicates that it must be applied with "flexibility." This flexibility will undoubtedly be exercised in favor of franchisors and not franchisees who may file complaints.

Item. The new code reaffirms the claimed right of franchisors to make unilateral amendments to franchise agreements through policy and procedure manuals and directives, thus bypassing the code entirely.

Item. All interpretations of the code are to be made by the executive committee of the IFA, whose opinion is binding. This allows the IFA to interpret the code so as to protect its member

franchisors from having to in any way adjust their systems to comply with the code.

Enforcement. As with the old code, the IFA code contains no meaningful enforcement mechanism. The new code reduces the IFA's role from investigating complaints to reviewing complaints. This presumably means that the IFA will not be permitted to seek information beyond that which a franchisor chooses to disclose in response to a complaint.

As before, the sanctions to be visited on a violating franchisor under the new code are limited to the privilege of no longer paying dues to the IFA. There is no provision in either the new code or the old for any form of redress for a franchisee whose franchisor violates the IFA code, even if the violation is willful and deliberate.

No rights created. Mr. Chairman, the new code is replete with indications that it is not intended to provide any rights to franchisees that do not exist under current law or under their franchise agreements. The new code states that its standards do not substitute for or supplement the franchise agreement; that it does not create any rights for franchisees; and that compliance with applicable law will constitute compliance with the code.

Clearly, the IFA is sending a strong signal that this code is intended to add nothing, and in fact, to preserve to the maximum extent possible the overwhelming imbalance in the legal relationship between the franchisors and franchisees.

Good faith and fair dealing. The 1992 code and the new code, to an even greater extent, seeks to squelch the only area of judge made common law that is emerging as an avenue of redress for franchisees. With repetitiveness and redundancy for emphasis, the code defines fair, honest and ethical behavior as whatever the franchisor unilaterally decrees is its responsibilities under the franchise agreement.

Although some courts have pined that the covenant of good faith and fair dealing can explain and clarify the legal rights of parties to a franchise agreement, the code attempts to head off this development by purporting to repeal these implied covenants.

This is not an attempt by franchisors to regulate their own conduct. It is an attempt to preserve their right to create and tender one-sided franchise agreements presented on a take it or leave it basis.

Franchise associations. The original IFA code encouraged franchisors to open up lines of communication to franchisees through advisory councils and other communication mechanisms. That language has been weakened to now indicate that a franchisor should foster dialogue with franchisees by such means as the franchisor determines to be most effective.

This means that if a franchisor decides that dealing or communicating with a franchisee association or an advisory council is contrary to its self-interest, it is free to refuse to deal with such a body. In addition, the code does not contain any prohibition against retaliation against franchisees for participation in such an association.

Expirations. Both the old code and the new code allow a franchisor decline to renew a franchise for good cause, or if the

franchisor lets the franchisee sell the business to a buyer, or if it lets the franchisee operate the business under a new name.

The new code adds a provision that nonrenewal is permitted if "the franchisee is otherwise permitted to realize the value of the business as distinct from the value of the expired franchise."

This puzzling provision seems to imply that if the franchisee can sell the assets of the business as opposed to the business as a going concern, then renewal can safely be denied by the franchisor. This would allow a franchisor to completely obliterate any equity the franchisee has built up.

Encroachment. The encroachment section of the old code has been euphemistically designated now as system expansion. In the old code there were 12 factors that a franchisor was required to take into account in determining whether or not to open a unit in "proximity" to another. The scope of this section has been further watered down by no longer requiring all of the factors to be taken into account. In addition, none of the factors apply unless the new unit is in "close proximity," neither terms being defined.

The new code, as well as the old, allows franchisors to balance the needs of the system as a whole, meaning the franchisor, with the interest of the franchisee whose market is encroached upon. Incredibly, this allows a franchisor to siphon off sales of one of its existing franchisees if the franchisor will benefit economically.

Encroachment is an issue in which there has been much recent litigation. Franchisors have fiercely resisted attempts to limit the extent to which they can compete against their own franchisees. The new IFA code has rolled back the very limited gains from the old. It now adds nothing to franchisee rights, nor does it attempt to set any standards of franchise or conduct in this area.

Supply sources. The original code allowed franchisees to purchase goods and services from sources other than the franchisor as long as the alternative supplier met the franchisor's quality, capacity and financial condition requirements.

The new code contains self-serving language claiming that controlling the sources of supply is necessary to police franchise system standards, and that many franchisors derive their principal revenue by selling goods to their franchisees for resale. The latter consideration is the most telling as restricting sources of supply is a prevalent and much abused way of diverting profits from franchisees to franchisors.

Here, the new IFA code has eliminated all references to the ability of franchisees to purchase from alternative sources, stating only that franchisors must comply in all respects with applicable antitrust and trade regulation laws.

Last, discrimination. The old code provided that a franchisor should not discriminate on the basis of race, color, religion, national origin, age, disability or sex. The new code inexplicably leaves out age as a protected category.

Mr. Chairman, are franchisors seeking the right to discriminate on the basis of age in violation of existing Federal law?

Mr. Chairman, if I may return for a moment to the other two parts of the IFA self-regulation proposal, I would like to make a couple of brief observations.

First, the National Franchise Mediation Program, having been rolled out more than 18 months ago, entirely misses the point. Alternative dispute resolution is certainly preferable to expensive and time-consuming litigation. However, what is needed most is not to resolve disputes that grow out of the legal vacuum created by the absence of any meaningful and effective regulation in this vast sector of our economy; but rather, to address the lack of fairness and balance in the relationship between franchisors and franchisees, and to eliminate the hodge-podge of inconsistent State laws and judicial decisions.

If we did that, there would be fewer disputes to mediate or litigate because franchisors and franchisees would have a clearer picture of what each expects from the other in the franchise relationship.

Moreover, the National Franchise Mediation Program, like the IFA code, has been largely ignored by the IFA members. According to the Center for Public Resources, which administers the National Franchise Mediation Program, only 33 franchisors out of more than 700 IFA members have signed on to the program. In addition, of the 31 franchisors represented on IFA's board of directors, only nine have signed up for the program.

Finally, the IFA's invitation to franchisees to join its association is the most disingenuous, overtly political move imaginable. The IFA spends significant efforts and resources lobbying in opposition to attempts to level the playing field through legislative initiatives at both the Federal and State level. The IFA has no intention of allowing franchisees to play a meaningful role in the formulation and implementation of its policies. If it did, the IFA code would never have been watered down to the extent that it was.

Mr. Chairman, the IFA code is nothing but smoke and mirrors. It is a blatant and cynical attempt to co-opt the growing chorus of voices calling for meaningful and effective regulation of franchise disclosure and relationships. It is time to end this digression and proceed with the real agenda, restoring balance to the legal relationship between franchisors and franchisees, and ensuring that those who work hard and play by the rules receive a fair return on their time, energy and financial investment.

Thank you, Mr. Chairman.

[Mr. Karp's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Karp. I thank all the panelists for their across-the-board excellent presentations.

I wonder if any of the panelists have any comments they would like to make in response to any of the comments that the other panelists have made, either in support or distinction. Or if any of you have thought of something that you would have liked to have said, this will be the opportunity.

Mr. EMERSON. I would like to say one thing.

Chairman LAFALCE. Dr. Emerson.

Mr. EMERSON. First of all, what everybody else has said I generally am in agreement with. As for the comment that Mr. Purvin made about setting up some sort of framework, in effect, similar perhaps to what you have in other bodies of law, such as securities law, there has been a proposal put forth by a person named Tom Murphy, who is an editor at the Continental Franchise Review. He

sent me a copy of his proposed national franchise network association. I think it is something that if we got people who are experts, sort of cross-experts in terms of they know something about, say, securities law and about the self-regulatory mechanisms that are used there in conjunction with the SEC, and yet can apply their expertise in a franchising law context, there may be some sort of fruitful discussions or results from proposals such as Mr. Murphy's.

His proposal, I believe, is grossly inadequate in terms of actually setting forth what Mr. Purvin refers to as the legal mandates or the underlying laws that you need in order to build a self-regulating mechanism. He has gone at length into how you set up the mechanism, but, as Mr. Purvin says, I do not think it is very useful until you also resolve what exactly are the laws that this mechanism is supposed to be all about.

But that is something to look at and it is something on which perhaps, if the IFA is generally interested in self-regulating mechanisms beyond simply the Code of Principles, there might be some discussion among the industry members and Congress.

Chairman LAFALCE. Good. Does anybody else have any comments?

Mr. PURVIN. Yes, Mr. Chairman.

Hearing Mr. Karp's presentation, it occurred to me that I had left out something that I felt was very important. Mr. Karp did an excellent job of comparing the old code to the new code and showing its deficiencies.

In my preparations and in my written testimony, it occurred to me that we should not confine our review to what the IFA has set forth as being the standards that need to be addressed. So, I went to the documentation of the American Association of Franchisees and Dealers, the organization that I chair, and where we have not yet established a code of ethics, but we have established something we call the Franchisee Bill of Rights. That is 15 contractual and legal protections that we think should be in every franchise relationship.

We have also promulgated something we call the eight things to look for in a franchise opportunity, and these are not legal protections so much as they are business protections that a franchisee should look at before purchasing a franchise. Such things as important as making sure that your franchisor is in business to sell goods and services to the public and not just in business to sell franchises.

I compared those 23 items, the 15 items of the bill of rights and the 8 items of the—8 things to look for, and I was rather shocked that of the 15 rights the AAFD has identified, the IFA has only addressed 6 of them in their Code of Ethics. Of the nine not mentioned, the right to same equity in the franchised business, the one right that every franchisee should enjoy is not addressed anywhere in the Standards of Principles and Code of Conduct.

Looking at the eight things to look for in a franchise opportunity, only two of the eight things to look for were addressed in the IFA's code. Such things as the right to trademark protection, which we would think would be fundamental to a franchise relationship, is not mentioned anywhere in the IFA code. The right to market protection is, but only in the context of the rights of franchisors to ex-

pand their system, not the right of franchisees to have a protected market.

There is no mention in the code of a right to support for the franchisor. There is no mention in the code to the right to training. These are things that we think of as being absolutely attendant to the franchise relationship.

It comes back to that very fundamental first step, if we are going to explore the possibility of self-regulation in this industry, and that is what this committee has already set us on the path to, what is the mandate from Congress under which any code of ethics must be structured, and I applaud again the committee's efforts in that regard. Thank you.

Chairman LAFALCE. Anybody else wish to make any comment? Dr. Emerson.

Mr. EMERSON. One other comment. With regard to Section 3 of the Code of Principles, Part 4, I am not sure if it is in the written testimony of one of the other analysts. I believe I may have mentioned the point very briefly, but I think it does deserve some recognition that the language was changed from "investigate" to "review," in terms of what an IFA executive committee or other investigative body would do with regard to a complaint.

Chairman LAFALCE. Mr. Karp mentioned that specifically.

Mr. EMERSON. I do think that is significant because the threshold then becomes much less in terms of what the IFA or whomever might do about a complaint. Simply say we have looked at it, and——

Chairman LAFALCE. There is somewhat of a difference between those two words.

Mr. EMERSON. Yes. But I applaud Mr. Karp for his fine analysis. He covered everything I saw and 10 times more in his statement.

Chairman LAFALCE. And even if the code kept the term "investigate," and even if it did not change the definition of "good faith," whatever is in the contract, which you must sign if you want a franchise, is automatically considered "ethical." And there is no enforcement mechanism, since so few of the francisors belong to the IFA. Of those franchisors who belong to the IFA, only about 500, only 33 have signed on to the National Franchise Medication Program. So, you are not left with very much. You are not left with very much at all.

About a year or so ago, under the leadership of Mr. Lynn, I was hopeful that the small step that I thought the IFA was taking by revising its code of ethics could be improved upon and expanded. It offered a glimmer of hope. I understood the inadequacy of that code revision even if it reached its maximum potential. But I thought it was at least a step in the right direction.

Clearly, this revision is a major step backwards, even leading one to suspect the good faith intentions behind the changes. I regret to have to say that. I regret also that I have not kept their feet to the fire. I think perhaps the original revision may well have been brought about because I was keeping their feet to the fire, and I have given them an opportunity now to advance. Rather than advance, they have retreated. They should not have done that.

Mr. GARNER. May I comment briefly——

Chairman LAFALCE. Yes.

Mr. GARNER [Continuing.] on the dispute resolution program?

Chairman LAFALCE. Yes.

Mr. GARNER. I have had one experience with it, and I cannot say that this is representative. I was representing a franchisee against whom the franchisor had a claim of underreported royalties, which the franchisee hotly disputed. The franchisor was one of the IFA members that has signed up for the mediation program under the Center of Public Resources.

In an effort, in an effort to resolve the issue, I was speaking with the franchisor's general counsel, who gave me a particular number that was about half of what the franchisor was asking for. We were on the verge of going into mediation, and I called him back and I said, now, I do not want to commit to this medication process and the trotting out of all of our evidence and going through discovery, whether informal or formal, with you, and spending my client's money if the mediators come back and tell us that you—that my clients owe you nothing, and you reject that result out of hand. I would like to know now before I commit my clients to do that, if the number you have given me is your bottom line regardless of what the mediators said, and if we know that we will not go into mediation.

Mr. KARP. Mr. Chairman, may I follow up just very briefly?

Chairman LAFALCE. Surely.

Mr. KARP. On the Franchise Mediation Program, if the Chairman would like to know, I have here a case report from the Center for Public Resources concerning how much work they have actually done in this area. It indicates that in the 18 months that the program has been in existence only 42 cases have been filed, and only seven of those have been resolved through their efforts.

Interestingly, Mr. Chairman, 12 out of the 42 cases involved encroachment, and that was one of the areas in which I noted that there was a significant rollback in the very limited protections that had been in effect under the old code.

As a further refinement of these statistics, I noted that on the executive committee of the IFA there are seven members and only two of their franchisors have signed up for the program. It is clearly not something that members of the IFA have in fact, embraced. None of the three points of their program have really been embraced.

Chairman LAFALCE. Yes, one has to wonder whether or not the initial revision was done out of noble motives or as a mean to deal with pressure from State and Federal legislatures.

Mr. Garner, you were the chairman of the Franchising Law Journal, is that correct?

Mr. GARNER. I was editor of the journal.

Chairman LAFALCE. Editor of it, yes. This was the American Bar Association Franchise Forum, correct?

Mr. GARNER. Correct.

Chairman LAFALCE. And that forum is predominantly made up of attorneys who represent franchisors. Is that correct, or is its membership pretty evenly split, or is it predominantly made up of attorneys representing franchisees?

Mr. GARNER. We have the results of a survey that was taken a couple of years ago, and I, frankly, cannot recall what the results on that issue were.

As a member of the—currently a member of the governing board of that body, I——

Chairman LAFALCE. Of what body? The Franchise Forum of the ABA?

Mr. GARNER. Of the Franchise Forum.

Chairman LAFALCE. Yes.

Mr. GARNER. I can say that there is a—there is certainly a widely held perception that it is predominantly franchisor-oriented, and that the governing board itself is trying to service franchisees, or attorneys who are representing franchisees, more actively, trying to make a push in that direction.

Chairman LAFALCE. It surely seems irrefutable to me that there is a void of appropriate legislation, whether that legislation should exist on a State or a Federal level. Frequently attorneys have attempted to come up with model laws. They do this either through the restatement or some other mechanism.

In the 1970's, I had extensive hearings on the issue of product liability, and I came up with a Federal uniform product liability law that I hoped would serve as a model for either adoption at the State level or by the U.S. Congress. I worked closely at that time with Professor Victor Schwartz, who was employed in both the administrations of Presidents Ford and Carter. The result was a model product liability law to be adopted by the States.

There has been very slow progress. Yesterday or the day before, I think it was yesterday, the Senate again failed to bring closure to a modicum of some Federal law dealing with that issue. I have not taken a side on the merits of this legislation, recognizing that the gestation period for the concept of a Federal uniform product liability is long. But at least there are models out there which reasonable attorneys on both side have discussed at great length.

Has there been any effort on the part of the organized bar to come up with some model legislation that could be adopted either by States or the Congress that seeks a fairer balancing of the rights of franchisors and franchisees similar to what we have attempted to do in our bills? Has the organized bar attempted to do this?

Mr. GARNER. Not to my knowledge.

Chairman LAFALCE. Is there any value in attempting to light a fire under the ABA to come up with something of this nature?

Mr. GARNER. Subject to what the general ABA by-laws and guidelines say on that type of thing, there is certainly no reason not to.

Chairman LAFALCE. Has there been any discussion of this issue within the Franchise Forum——

Mr. GARNER. No.

Chairman LAFALCE [Continuing.] of the ABA?

Mr. GARNER. No.

Mr. PURVIN. Well, actually, a few years—there has not been any effort with respect to a relationship law, but there was a model act that was—we spent a lot of time on, what, 5 years ago, that was

actually promulgated by the—I do not know what the promulgating associations——

Mr. GARNER. It was not the ABA. It was not the Forum.

Mr. PURVIN. But within the Forum we had substantial debate and discussion around that——

Chairman LAFALCE. Disclosure?

Mr. PURVIN. It was a disclosure bill, a disclosure act, and I do not think it was adopted in any State.

Chairman LAFALCE. Well, we do have State regulators who have attempted to get together and come up with some model disclosure laws. We do have a multiplicity of State franchise disclosure laws, although not in enough States. We do have the FTC disclosure, inadequate though it is. Of course, the difficulty we have is the enforcement mechanism, both at the Federal level and at the State level. So, there is tremendous need there for better legal protection, both for prospective franchisees and for existing franchisees who could benefit greatly from the disclosure to prospective franchisees.

But there is far, far, far greater need, in my judgment, for a relationship statute—for some form of fair practices law.

Mr. PURVIN. Absolutely.

Chairman LAFALCE Well, let us get back to the issue of the code. Do any of you practice internationally or have any of you done any international studies? Do other countries have codes for the franchise relationship that might be of guidance to us? For example, Canada. Does Canada have a code? Does anybody know that? Does anybody have any knowledge on that to address the issue?

Mr. EMERSON. There was a recent development, which I referred to in my written testimony, where the Canadian Franchise Association, which I assume is somewhat equivalent to our IFA, has put forth a proposal.

Chairman LAFALCE. Anybody else have any thought?

We also have countries that were formerly centrally planned economies that are being converted into market economies. There is also a tremendous opportunity there for the growth of franchising. I think the franchisors are now starting to develop that opportunity which is good. It can help tremendously. But there is also, given the vacuum of laws in those countries, an even greater potential for exploitation and frustration and disappointment.

Mr. KARP. Mr. Chairman.

Chairman LAFALCE. So I just raise that as a point for discussion.

Mr. KARP. Mr. Chairman, the reaction of many franchisees that I speak to is when they see significant efforts on the part of our government to assist that exploitation in the finest sense of the word. They wonder where the government resources are to protect their rights here at home.

Chairman LAFALCE. Sure.

Mr. KARP. Given the, for example, the incredibly low number of cases that the FTC brings, which they say is a result of——

Chairman LAFALCE. Well, the FTC has publicly stated——

Mr. KARP. Yes, Mr. Chairman, that is right.

Chairman LAFALCE [Continuing.] they do not have the capacity to enforce their own minimal disclosure requirements——

Mr. KARP. Yes, sir.

Chairman LAFALCE [Continuing.] and have called upon the Congress to create a private right of action.

Mr. KARP. Of even more concern to me with respect to the FTC is the FTC has, presumably because of their financial limitations and resource limitations, have restricted their activities to disclosure and to people entering the franchise relationship, although I believe that they have the authority to look at the relationship side of things. There is no rule dealing with franchise relationships.

Once people are in the relationship, that is when they really need protection, and that is where whatever code is applicable that governs the relationship is so very, very important.

Chairman LAFALCE. Right.

Professor Emerson, when I initially began my inquiry into the status of the franchise industry, it seemed to me that there was a paucity of data and a paucity of respectable writing in this area, circa 1991 or so. Has there been a significant development of academic attention given to the franchising industry since 1991?

Mr. EMERSON. I think there is gradually becoming more writing in academia that deals with franchising generally. I teach at a business school. I teach law at a business school, so I am aware of people in my school, for instance, who are interested in certain issues involving franchising, but most of them tend to write upon economic issues or marketing issues or the like.

My understanding, with regard to law schools, and I know some people who teach at various law schools, is that it is still relatively unusual to have any sort of course work that is specifically related to franchising. It may be discussed briefly in a business formations class or the like. So, it is relatively rare that you have, for instance, law professors who are spending a great deal of time preparing for class where they are teaching about franchising, and I think that naturally spins off in perhaps less research among academicians in law on franchising. There really are not that many people who write in the field of franchising who are not really coming at it, as are the other three panelists here, from the perspective of practicing lawyers.

In fact, that is one reason, when I came to the University of Florida, when I was trying to carve out a niche for myself, I said, "gee, this is an area where an academician would be plowing new territory." There just are not that many people who consistently write in that field, who do not have, in effect, I do not want to say, "an ax to grind," but at least a personal experience base which is leading them into the field, not simply an academic interest in the subject generally.

Chairman LAFALCE. When we began our inquiry we received many, many complaints that the typical franchise contract had been expanded, especially with appendices, additions, et cetera, to 75 pages; and that 74 of these pages may have involved a culpatation of franchisors from liability or a tremendous enumeration of franchisee responsibilities. In most instances this contract was pretty much handed down as the definitive document that had to be signed if you wanted to participate, that there was either little or no room for negotiation.

Do any of you have any comment on the present practice and tendencies?

Mr. PURVIN. Yes, Mr. Chairman. In fact, I am disappointed that Congresswoman Meyers was not here, because in her opening remarks she made reference to our commercial system as being a Nation that is based upon the freedom of contract.

Franchising is not an exemplification of the freedom of contract. It is—rather, exemplifies what we call adhesion contracts, and the adhesive nature of one body that is able to impose a contractual commitment onto a person who has no bargaining authority.

The code that is proposed by the IFA takes maximum advantage of the franchisors ability to dictate the terms of the contract, and then to say that whatever is in the contract literally replaces—becomes ethical no matter what we put in.

In point of fact the——

Chairman LAFALCE. Of course, not all franchisors have taken full advantage of this unfair bargaining position. Have not some franchisee groups even given awards to franchisors because of their balanced contract?

Mr. PURVIN. I was just going to mention, Mr. Chairman, that the American Association of Franchisees and Dealers fundamentally would like to see the industry solve its own problems. We believe that the mechanism that is best to have that happen is to give bargaining leverage to franchisees through a collective bargaining process. We have established an award called the Fair Franchising Seal for any franchising company that is willing to submit to a collective bargaining process and actually achieve an agreement that is ratified by 75 percent of the franchisees of its system.

Doing so, we believe, will lead to balanced franchise agreements. I am most proud to announce to the committee that in March of this year a company, Taco John's International, was bestowed by vote of their franchisees, by the ratification of a—after a 2-year process of negotiating an agreement and an agreement that is so fine that our association, the AAFD, has recently set forth a task force to design a model franchise agreement from the franchisee's perspective, and has offered the Taco John's agreement as such an agreement.

It is an agreement that provides protections in all of the areas that we believe are important for franchisees to be protected. It is an agreement that is so important to talk about because what it accomplished is not only a meeting of the minds, which is what we like to think of a franchise agreement doing, but a meeting of the minds between a willing buyer and a willing seller, both from equal bargaining positions, but suddenly you have an agreement that everybody bought into.

You suddenly have a franchise system that once was a warring system 3 years ago. Now in an era of good feeling where the franchisees believe in their system, believe in the contract, and believe that they have protections, and the franchisor gains not only a happy franchisee but the uniformity of a system that is so important to franchising.

So, the collective bargaining process is not only the challenge of the industry, but it is a real potential solution. I would like to see, and we have discussed with staff, I would like to see your legislation add into it, not only very strong rules to be followed but exemptions available to companies that do submit themselves to the

collective bargaining process. So, that those industries within themselves can solve their own problems.

It goes back to the analogy that I gave in my oral testimony about serving as the parent and saying if you do not come to your own solutions, we are going to find those solutions for you.

Mr. KARP. Mr. Chairman, may I echo that in the following respects. First of all, as a representative in my work with franchisee associations, one of the things that those clients ask me to do is to do a historical retrospective, if you will, of the progression of franchise agreements in a particular system. I perform analyses that are similar in format to the one that I prepared for my testimony on the code.

What I see over time across systems and across brands is an increasing complexity and an increasing one-sidedness where franchisee responsibilities are specified with increasing specificity, and franchisor responsibilities with decreasing specificity, and an increase of the use of the word discretion on the part of the franchisor.

The other thing that is a barrier to this kind of collective bargaining, which I agree would be a terrific outcome, is that most franchisees that enter into a franchise relationship have no way to know, unless they do due diligence beyond the disclosure documents, that any sort of franchisee body exists in their system. There in no requirement that that be disclosed. That is a part of your disclosure bill, but it is not the law generally.

In addition, there are only 11 States in the country that protect the right of franchisees to freely associate. Only 11 States out of 50.

Last, where the original code encouraged franchisors to use advisory councils, the new code does note, even though the IFA's own franchise relations committee issued a report in 1991 that encouraged its members to use advisory councils. The committed did a study and found that in franchise systems with 750 or more units, 95 percent had advisory councils. Yet the IFA has removed from its code the obligation to deal with advisory councils.

So, we seem to be taking steps backwards here, and getting further away from the day when franchisors and franchisees can sit down across the table, and come together and arrive at agreements that fairly balance their competing interests.

Chairman LAFALCE. Mr. Garner, earlier I asked you if the ABA's franchise forum had attempted to come up with a model for either franchise disclosure or relationship legislation for adoption at the State or Federal level. Let me ask you a different question.

Have you attempted to come up with a model franchise contract that would be fair for both the franchisor and franchisee? When I practiced law, if we wanted to buy real estate, there was a model contract. If you wanted to lease property, there was a model contract. I never involved myself in franchise law. But is there a model contract that both franchisor and franchisees can look to that has been developed by the ABA? Has the ABA at all discussed producing such a document?

Mr. GARNER. The answer to your question is no, we have not come up with a model contract. Let me comment that our primary mandate——

Chairman LAFALCE. Have you discussed doing it?

Mr. GARNER. I will come to that in one moment. Our primary mandate is to educate rather than to propose models.

Chairman LAFALCE. You could have whatever mandate you wanted to. I can think of so many model things that the ABA has come up with, and it was probably not in fulfillment of their primary mandate. But there was a need, and they decided to fill that need.

Mr. GARNER. We have a number of publications under consideration now; one or more of these may include some type of model contract. So, that is something that is—I will not say that it is necessarily in the discussion stage, but it is in the proposal stage.

Chairman LAFALCE. I think that I should appear before the ABA franchise forum at some early opportunity to make some exhortations for the members of the bar to remember that they are officers of the court, too, and have a responsibility to the public.

Mr. GARNER. You are certainly welcome.

Mr. EMERSON. Mr. Chairman, with regard to your question previously about contracts, and with regard to what Mr. Karp said about franchisee association laws, I would simply call your attention to the fact that I have written an article in Vanderbilt Law Review that deals extensively with rights of association laws, and talks about collective bargaining, and antitrust exemptions, and the like.

My conclusion has been that the first thing you need is that you do need a right of association that is guaranteed.

Chairman LAFALCE. That is in my bill.

Mr. EMERSON. It should be in there. Second, I think that before you even get to collective bargaining as a solution—and I am still not sure about that, given the fact that franchisees are not really the same as employees in a typical labor negotiating-type posture—the next step is giving an antitrust exemption for these associations. So, if a franchisor and a franchisee association choose to go into this, there would be no implication of potential legal culpability for a franchisee association entering into collective bargaining.

Chairman LAFALCE. If there is a Federal right to associate, it would seem to me that at least implicit is an exemption from any other Federal or State law.

Mr. EMERSON. If there were a Federal law on that, I think that it definitely would be a better argument for exemption than presently with only 11 States having a general right. A number of States have it—the right of franchisee association—in various industries.

The other thing that I just wanted to mention briefly in terms of the question about contracts is my article which was just published in the North Carolina Law Review. From talking to Mr. Sagar, I learned that it may be used as an extract or something in the record, if you so choose. The editors at the North Carolina Law Review say that is fine, whatever Congress wants to do with the article is fine with them.

In that article, I analyzed 100 fast food or other restaurant franchise agreements from the last couple of years. I analyzed them for a number of factors involving what kind of clauses they contained.

Now I could not obviously go into each and every agreement, and analyze every sentence's actual wording, and how egregious or not egregious it may be in terms of being one-sided. But what I did discover is compared to, say, 1971, when there was a study for Congress by some professors at the University of Wisconsin, compared to the figures on 116 fast-food franchised restaurants from back then, certainly in a number of areas—covenants against competition, venue stipulations, and a number of other areas—you definitely see an increase for the 100 that I analyzed. That is, there has been an increase in a lot of provisions that tend to favor the franchisor.

It just stands to reason. One reason I wrote the article was simply to get some empiric evidence to support what most of us would probably assume: That, for a form drafted by the franchisor, over time, as the franchisor's people get better and better at drafting agreements, and they encounter more and more problems, they are going to stick in things that favor the side that is drafting the agreement.

Chairman LAFALCE. That is one of the things that disturbed me about this latest revision of what previously had been referred as a code of ethics. It seems to me that if you are going to have a code of ethics that, above all else, it should enunciate the highest standards that you should aspire to in the industry. Or it could be, and what the first revision appeared to be, a modest step in the right direction.

But it could also be the lowest possible acceptable standard that you can get by with, or something that you could use as an affirmative defense in a lawsuit. I am fearful that that is what the latest revision probably can be best characterized as.

Let me ask another question. In my dealings with franchisees across the country so many of those dealings revealed a fear on their part in going public. They wanted to express these concerns, but they did not want to express them publicly because there could be retribution in so many countless ways. This includes both negative retributions or the suspension of any positive action that they would like to see from their franchisor in terms of expansion of the franchise.

Has that fear factor been lessened, is it about the same, or has it increased? I understand that this is nothing that we can quantify or something that we can prove. This is something for the most part that we have to rely largely upon anecdotal data and our feel for this situation.

What can you advise?

Mr. PURVIN. I am probably in a good position to relate to that, being that the American Association of Franchisees and Dealers deals with literally hundreds of franchisees on a daily basis.

Certainly, on an individual level, it has not lessened, and it has probably intensified. But what we do find is our association is really in the business of organizing franchisees that are unassociated. For every new member of our association and new system, we now have members in approximately 125 to 150 different franchise systems, we organize a trademark specific section of our association, which is in effect, a franchisee association of the franchisees of that particular system.

Most of the work of the AAFD is done by our trade sections. Once trade sections come together, and once they begin to collect their individual strength into group strength, as a group I think that you are going to see that franchisees, once they do organize, begin to find their voice. As the groups become bigger, it is just basic grassroots support.

It is the kind of grassroots support that has to happen for us to effectuate, and speak to Congress and let Congress know that we need the help that you have put on the table for us.

So, the bottom line is that at an individual level that that fear is still there, and it is pervasive. The franchisee does not have much in the way of legal rights. But everything he has is usually tied up in that franchise relationship. To lose what he has is a frightening situation.

Our association promises confidentiality on an individual level of all of the people who are members of our association. We are a direct member association. But as the groups come together, and we now have 50 active trade sections in our association in addition to five independent franchisee associations that are affiliated through our trade association council, so we have 55 different systems that are actively forming. Once they form their group, they find a voice. That voice is growing larger and larger.

Mr. GARNER. I would like to comment on your question from my experience not only in representing franchisees, but also in representing franchisors. This may throw some light on the human side of that fear question.

The franchisees are small business people who are running their own business. They know what that business is, and they have a lot to be proud of. They are the boss.

Now when they are dealing with the franchisor, particularly in medium to large systems, they are not dealing with the vice president of operations. They are dealing with somebody that I typically refer to as the district manager. This is an employee of the franchisor at the low end of the totem pole. He is in exactly the opposite position of the franchisee. Yet he or she is given the responsibility of inspecting that franchisee, showing the franchisee how to do the latest thing, or conform its system to this, that, or the other.

It is kind of a funny topsy-turvy relationship. Because you have somebody who is at the low end of the totem pole in their corporate ladder supervising somebody who is really at the top of the totem pole in their own business. This is completely lay opinion. But I think that what you find in that situation is that the district manager is insecure. So, the district manager wants a big club to make sure that those franchisees are in line.

The district manager uses inspection reports, he uses edicts, and throws his or her weight. I have seen it over, and over, and over again from both the franchisee side and the franchisor side. Believe me, as a litigator who represents franchisors, the first thing that I look for in a dispute is what did the district manager do, and is he or she still with the company, and can we keep them in the corral. Because the last thing you need is a former district manager who is off somewhere else and is inaccessible to the franchisee.

Chairman LAFALCE. I really never considered that aspect of the difficulties within the relationship. But now that you have mentioned it, I can see how important that would be. I remember when Congress made the mistake of bringing some bank examiners before it rather than the bosses of the regulatory agencies, and put the fear of God in the examiners because they had made mistakes in the exercise of their discretion by not coming out as heavily and as hard as they possibly could.

The word went out to every examiner in the country that, when in doubt as to whether or not there should be an additional $40 million of reserves, you will never be criticized for being too tough, never. You will only be criticized if you are too lenient. You will never be criticized or penalized for closing an institution. They will think you are great. But if you leave an institution open and you make one mistake, boy, you are going to be in trouble.

That contributed mightily to the problems that we experienced in my judgment in the thrift industry in 1989, 1990, or so.

Mr. KARP. Mr. Chairman, I agreed wholeheartedly with Mr. Garner's observation. It is a phenomenon that I have also observed in my practice. But what I have also observed, Mr. Chairman, is that the attitude, and ethics, and values that that district manager brings to his or her position is something that flows down from higher levels generally.

It is very seldom in my view that you find a district manager who is acting in a way that they perceive as contrary to the way that the company wants them to act. It does happen, but I think that it is an exception rather than the rule.

I also wanted to comment on your question concerning retaliation. You may have seen the spot on CBS Good Day awhile back. A client of mine, who is a leader of a national franchisee association, was at the American Franchisee Association convention and was interviewed, but he was extremely fearful about going on camera. The result was that we arranged to have him videotaped with his face obscured and his voice disguised, and not have him described either by name or by franchise system because there had already been specific instances of retaliation in that system.

So, it is something that we do see. I would say that it certainly has not lessened. I think that if anything it has increased somewhat.

I think, also, Mr. Chairman, that it is important to look at what is retaliation. It is not always something overt. It is not always a club. Very often, it is much more subtle. Bear in mind that of the 11 States that I have cited that have right to association laws, less than half, I believe, I do not have the number handy, but approximately half have antiretaliation provisions. The rest do not.

The IFA code has never had any provision that prohibits any form of retaliation direct or indirect, subtle or otherwise. One subtle form of intimidation or retaliation is when franchisors routinely demand a list of the members of the franchisee association. I cannot conceive of a rational purpose for wanting that other than that to know who is in the association, and to target them in some way.

I find with surprising consistency this demand for the membership list. In addition, this issue of the extent to which the franchisor can materially affect the franchise relationship through

policy directives, procedure manuals, and things of that nature. Very often, there is something in the franchise relationship that a franchisee can be called on if somebody wants to get technical and use a fine tooth comb.

Very often, I have seen franchisees subject to surprise quality audits, financial audits, and things of that nature, which are nominally within the right of a franchisor to conduct. There is no argument about that. But we find that very often the timing of these events quite suspicious.

Mr. EMERSON. Not to belabor the point on the right of association. But I am not really sure that if you simply pass a bill that prohibits discrimination or hindrance of free association rights, that it automatically follows that a franchisor will not argue a franchisee association committed antitrust violations—depending upon what an association did. In fact, if it is Congress' intention to give some sort of antitrust exemption, it would be more clear cut to just go ahead and do that.

You could do that without necessarily also creating a collective bargaining requirement, a Wagner Act. The way that I read right of association statutes is that they are basically setting forth simply a right against yellow dog contracts. They may not have anti-retaliation provisions, let alone antitrust exemptions or the like. You may not have as much protection as the committee assumes.

You have some protection under the Noerr-Pennington Doctrine for associational activity generally. But once you start getting into areas of concerted economic pressures on a franchisor, unless the antitrust exemption is pretty clear, I could see that it would be litigated.

Chairman LAFALCE. I think you are right.

Mr. KARP. Mr. Chairman, I do not know if the staff is aware. But on this very issue, the IFA in my view fired a shot across the bow of franchisee associations in its most recent Franchise Law Digest, in which there was an article which suggested specifically that franchisee associations are subject to antitrust exposure, simply undertaking the normal activities that franchisee associations undertake on a day to day basis.

I read the article, as I say, as a warning shot and as a way of educating in-house counsel of franchisors about another arrow in their quiver in terms of trying to diminish the effectiveness or even squash attempts to form franchise associations. So, I agree that it is a real concern, and one has been addressed already in the literature.

Chairman LAFALCE. I think that the position that I would take is, first, that the existing association in no way violate any existing antitrust laws. And, two, the Federal freedom of association provision within my bill would at least implicitly clarify that issue. Three, that explicit clarification of an existing right is probably best. Not that it is needed, but that a clarification would be helpful to make all see what—in my judgment—the existing law presently says.

Mr. PURVIN. I think that the bottom line is that there is a real opportunity for franchisors to recognize franchisee associations, and to enter into meaningful negotiations, so that we have bilateral agreements in franchising. There is a real opportunity for Congress

to encourage that process. At the same time that you are mandating what the minimum standards should be, you are encouraging franchisors and franchisees to solve their individual unique problems through a collective bargaining process, and by creating that exemption, and to encourage that process to blossom.

I do agree. I think that I read the same article that Mr. Karp was referring to. It was an open challenge to the question of whether collective bargaining could occur. I would invite the franchising industry to recognize that collective bargaining is the potential for franchising to achieve what it says, what the industry says that it wants to accomplish, if they want to move toward effective self-regulation.

Chairman LAFALCE. I want to thank all of the members of the panel. When we scheduled this hearing, this was anticipated to be a legislative day for the Congress. However, at about 11:30 or 11:45 last night we concluded all the work that we were able to do. So, today has only been a pro forma day and most Members of Congress immediately fled for the nearest airport and the earliest plane to their districts, something that I shall do very shortly. I thank you very much.

We have a request by Congresswoman Margolies-Mezvinsky to submit questions to you in writing. We will keep the record open for that and other purposes, so that you may respond.

I think that we will have to give increased attention to franchising issues. I think that we will have to schedule another hearing on other aspects of the franchise relationship, perhaps in a month or so.

The committee is adjourned. Thank you.

[Whereupon, at 11:47 a.m., the committee was adjourned subject to the call of the chair.]

# APPENDIX

**Statement of**

**REP. JOHN J. LaFALCE, CHAIRMAN**

**COMMITTEE ON SMALL BUSINESS**
**U.S. HOUSE OF REPRESENTATIVES**

**Hearing on**

**SELF-REGULATION OF FRANCHISING: THE IFA CODE OF ETHICS**

**June 30, 1994**

Today the Committee continues its inquiry into issues and problems of franchising. Franchising remains one of the fastest growing sectors of our nation's economy and an important source of new small business development. This is the ninth hearing the Committee has conducted on the general topic of franchising and the Committee's second hearing on the issue of self-regulation in franchising.

In the first hearing on franchise industry self-regulation in April 1993 the Committee recognized a number of initiatives by the International Franchise Association (IFA) to address public concerns regarding abusive practices in franchise sales and franchise business relationships. The most promising of these was the revision of the IFA Code of Ethics in late 1992 to provide specific industry standards for many of the practices that had been identified and addressed in state franchise legislation and in the legislation I introduced in Congress in 1992.

While the language of the 1992 IFA Code of Ethics offered weaker standards or protections than those proposed in legislation, it was significant as an acknowledgement that serious abuses were occurring in franchising and as a starting point for meaningful discussion of appropriate standards of conduct in franchising.

The Committee's concerns in the April 1993 hearing centered on what appeared to be the revised Code's limited applicability to franchisors generally and the absence of compliance and enforcement procedures even for IFA-member franchisors. The Committee was given assurances that a plan for enforcement was being developed and would be implemented.

The IFA's adoption of a substantially revised Code of Ethics raises additional concerns. The IFA's Executive Board approved the latest version of the Code of Ethics at its meeting in February, but it was not made public until May. At the time of this meeting, I was given personal assurances by the new IFA Chairman that the reform initiatives of the prior year would be continued without change. It is also significant to note that, for the first time in anyone's memory, the IFA published it's *Franchise Opportunities Guide* this spring without including any copy of its Code of Ethics.

More significant, however, are the changes made in the Code itself. Far from being "technical corrections", as the IFA's general counsel is quoted as saying in the *Wall Street Journal*, these changes appear to be substantial and significant. Of particular concern to me are the numerous new qualifications on the applicability and enforcement of the revised IFA Code. There are at least ten separate points in the opening paragraphs of the revised Code that appear to limit its scope and applicability and weaken potential enforcement by the IFA. Only three of these appeared in the 1992 IFA Code. A number of the specific standards of the 1992 Code also appear to me to have undergone substantial revision.

Following its first revision in late 1992, the Code of Ethics was widely cited by the IFA to support claims that industry self-regulation could eliminate the need for new and potentially restrictive legislation to protect the rights and financial interests of franchisees. It was also offered as the basis on which the IFA sought to accommodate the potentially conflicting interests of both franchisors and franchisees within the IFA. The revisions made in Code of Ethics raise questions regarding the IFA's continued commitment to these laudable objectives.

The purpose of today's hearings is to address these and other questions regarding the recent revision of the IFA's Code of Ethics. Why was the Code revised so extensively only a year after the initial Code revision? Does the revised Code enhance or weaken potential protections or remedies for franchisees? Does it represent a retreat by the IFA on the issue of industry ethics and self-regulation? Does the Code offer reasonable standards for assessing franchisor performance? Can the revised Code provide a realistic basis for broad, industry self-regulation of franchising?

We have a very capable panel of witnesses with us today who offer a variety of perspectives on these and other questions. I wish to thank the panel for their willingness to appear before the Committee today. I realize that in some instances this necessitated changes in court appearances and teaching schedules. The Committee appreciates these efforts and looks forward to your testimony.

CONGRESS OF THE UNITED STATES

House of Representatives

Committee on Small Business

Hearing

"Self Regulation of Franchising: The IFA Code of Ethics"

June 30, 1994

Written testimony of

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Written Testimony of Robert W. Emerson

## I. INTRODUCTION

Mr. Chairman, Representative Meyers, members of the Committee, and fellow witnesses and guests, thank you for giving me the opportunity to present some views on the issue of self-regulation in franchising.

I am an Assistant Professor of Business Law and Legal Studies at the College of Business Administration, University of Florida. I have taught and researched there since 1988, and the effective date of my promotion to Associate Professor is tomorrow - July 1, 1994.

I graduated from Harvard Law School in 1982 and practiced law in Baltimore, Maryland until I accepted my present position with the University of Florida. In my six years at the University, I have endeavored to make franchise law my most significant area of expertise. I have consulted with franchise attorneys and others about particular cases. In the field of franchise law, I have published several comprehensive law review articles and have published other, less "weighty" (literally!) works as well as presented numerous lectures at conferences and at universities.

One week ago, when the Chairman requested my appearance before this Committee, I was on a vacation in Maryland and thus was only able to prepare my remarks in the last few days. I trust you will understand that this written testimony is thus a bit more attenuated - and perhaps less polished - than it might have been if there had been more time.

My rather limited scope of review is focussed on the questions put to me by the Chairman in his letter inviting my appearance.[1] Those questions for which my testimony may assist the Committee are as follows:

1. Does the International Franchise Association's revised Code of Ethics (promulgated on approximately March 7, 1994, and now called the Code of Principles and Standards of Conduct) enhance or weaken potential protections or remedies for franchisees?

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[1] The Chairman asked two questions that I cannot answer: (1) "Why was the [International Franchise Association's] Code [of Ethics] revised so extensively only a year after the initial Code revision?"; and (2) "Does the IFA [International Franchise Association] have plans or procedures to enforce the [IFA's] revised Code of Ethics?"

These questions, especially the second one, are obviously significant. I am not privy to any information on these matters, however.

A leading jurist once recommended that those who eat sausages or love the law should not know how either their sausages or their laws are made. I can follow his enjoinder quite easily in that I tend to avoid sausages whenever possible and, in this case, I simply cannot talk about *how* the IFA's Code of Ethics was made. Instead, I will deal with the Code *as promulgated*.

2. Does that Code (hereinafter also referred to as the 1994 Code, the IFA Code, the revised Code, or the Code) represent a major retreat by the IFA on the issue of industry ethics and self-regulation?

3. Does the revised Code offer reasonable standards for assessing franchisor practices?

4. Does that Code provide a realistic basis for broad, industry self-regulation of franchising?[2]

## II. DOES THE INTERNATIONAL FRANCHISE ASSOCIATION'S REVISED CODE OF ETHICS ENHANCE OR WEAKEN POTENTIAL PROTECTIONS OR REMEDIES FOR FRANCHISEES?

### A. The Code Has a Limited Purpose and Effect

Please note the following about the 1994 Code:

(1) It is not intended to supplement or replace the rights or duties arising under a franchise agreement;[3]

(2) it does not specify any method for reviewing and

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[2] For purposes of better organizing my testimony, I have condensed and slightly altered the wording of the last two questions put forth in the Chairman's invitation for me to testify. These rephrased questions still serve to cover the information that the Chairman seeks.

[3] IFA Code, Section III, Part 1.

investigating complaints about alleged Code violations;[4]

(3) it is to be "applied with flexibility";[5]

(4) quasi-judicial interpretations of the 1994 Code are completely within the control of the very body that "legislated" the Code (with a separation of powers clearly absent, and with any general review procedures omitted);[6]

(5) Code violations may, "if appropriate," lead to suspension or termination of IFA membership or "other appropriate [but unspecified] action";[7] and

(6) no other compliance standards, possible punishments, or franchisee remedies are mentioned.[8]

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[4] IFA Code Section III, Part 4, replaces the word "investigate" with "review." The implication is that while a complaint under the earlier proposed Code (November 1992) would have led to some sort of active examination - a ferreting out of the facts, calling witnesses, ordering the production of documents, or other *investigative* tools - the 1994 Code of Principles and Standards of Conduct calls for a simpler, much more passive approach toward complaints (i.e., just a "review").

[5] IFA Code, Section III, Part 1.

[6] The IFA Code Section III, Part 2, refers to Code interpretation by the Executive Committee, upon consideration of the interpretations recommended by the Committee on Standards of Conduct. Nothing else is specified, except that IFA Executive Committee interpretations will be final and binding on IFA members. Complaints simply are to be "reviewed," with no standards for review delineated.

[7] IFA Code, Section III, Part 4.

[8] *See Franchising: Is Self-Regulation Sufficient?: Hearing Before the Comm. on Small Business*, 103rd Cong., 1st Sess. 32 (April 21, 1993) (statement of Gil Thurm, IFA Senior Vice President and Chief Counsel) ("Expulsion and being ostracized may be as harsh a remedy as there is"). The Wall Street Journal reports, "Since

It is, therefore, quite apparent that the revised Code cannot substantially enhance the protections or remedies for franchisees. The Code's purpose seems much narrower in scope: Simply to set forth some general standards that never impede upon the franchising parties' power to contract, standards that IFA members in fact probably already meet because these standards are so general and flexible. The Code's role is almost entirely hortatory, with the only penalty for violations being possible ouster from IFA membership.

Clearly, while the Code does not appreciably enhance franchisee protections or remedies, neither does it weaken them. That is because the Code does not replace existing laws.

One can examine some of the Code's Standards of Conduct (Section IV) to see that the standards in ten specified areas[9] are likely to have little impact. As just one example, let us review Section IV, Part 3, which states in its last sentence, "A franchisor shall not prohibit a franchisee from

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adopting its tougher posture in 1992, the IFA has taken no actual disciplinary actions against franchisers." Jeffrey A. Tannenbaum, *Focus on Franchising: Franchiser Group Alters Ethics' Code Without Fanfare*, WALL ST. J., May 9, 1994, at B2.

[9] These areas are: (1) Franchise Sales and Disclosure; (2) Good Faith Dealing; (3) Franchisor Advisory Councils and Franchisee Associations; (4) Termination of Franchise Agreements; (5) Expiration of Franchise Agreements; (6) Transfer of Franchise; (7) System Expansion; (8) Supply Sources; (9) Disputes; and (10) Discrimination.

forming, joining, or participating in any franchisee association." In an article of mine published in October 1990,[10] I discussed the eight state statutes and one state administrative regulation that effectively protect all of those states' franchisees from "yellow dog" contracts: that is, the franchisees cannot be barred from forming an association. After my article was published, one other state, Iowa, passed a franchise relationship law that provides a right of association.[11] Such rights also have been proposed at the federal level.[12]

I do not believe that the enactment of a right-of-association provision is a very controversial measure.[13] As more states pass bills regulating franchising or adding to existing regulation, we will see more such provisions.[14]

What might actually enhance a franchisee's rights would

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[10] Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VANDERBILT LAW REVIEW 1503, 1523-25 (1990).

[11] IOWA CODE §§ 523H.1-523H.17 (1993).

[12] *See, e.g.*, H.R. 2593, 103rd Cong., 1st Sess. § 3(b)(4) (1993) (proposed Federal Fair Franchise Practices Act).

[13] Criticism of recent enactments or proposals, such as the Iowa statute or the bills before Congress in the last few years, have focussed on other issues besides the franchisees' right to associate.

[14] As of four years ago, more than half of the states had a franchisee right-of-association provision covering one or more specific industries, such as automobile and gasoline dealerships. Emerson, *supra* note 10, at 1525-26 & nn.109-113.

be to require, as part of the *pre-sale* disclosures to a prospective franchisee, information about franchisee associations and advisory councils. Such a provision adds more force to existing disclosure requirements requiring the listing of some franchisees. Certainly, an association, rather than just individual franchisees,[15] might be in a better position to inform the prospective franchisee about the overall franchisor-franchisee relationship throughout the franchised system.[16] Coming at the outset of a potential relationship, the increased likelihood of early access to a franchisee *group* may redound to the benefit of franchisees as much as, or even more than, a relatively obscure right-of-association statute or IFA Code provision that speaks only to the post-sale franchisee (not potential franchisees).

In this same subject area, another possible franchisee protection would be to grant franchisee associations a limited exemption from the antitrust laws for purpose of those

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[15] The Code, at Section IV, Part 1, does provide that franchisors "shall encourage prospective franchisees to contact existing franchisees."

[16] Required disclosure of franchisee associations and advisory councils is found in an Information Circular Guide and Commentary adopted as a disclosure policy by the Canadian Franchise Association on October 27, 1993. *Canadian Franchise Association Implements Voluntary Pre-Sale Disclosure*, 13 FRANCHISE LAW JOURNAL 117 (Spring 1994). It is also found in the proposed Federal Franchise Disclosure and Consumer Protection Act. H.R. 2596, 103rd Cong., 1st Sess. § 4(a)(12)(E) (1993).

activities that parallel some of the analogous, exempted actions of labor unions. That proposal is discussed in my Vanderbilt Law Review article.[17]

B. Some of the Descriptions Added to the Code are Self-Serving, Misleading, and Incomplete

Some descriptions found in the revised Code may gloss over problems faced by franchisees. For instance, the first sentence in Code Section IV, Part 6, states, "[t]he great majority of franchise agreements grant to the franchisee a *qualified* right to transfer the franchise in connection with the sale of his or her business" (emphasis added). For many

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[17] Emerson, *supra* note 10, at 1549-60. A franchisee collective bargaining right has been proposed, either at the state or the federal level. *See, e.g., Franchising: Is Self-Regulation Sufficient?, supra* note 8, at 35 (statement of Harold Brown, franchise author and attorney) (supporting the proposed federal and New York legislation that gives franchisees not simply a right of association, but also precludes franchisors from refusing to deal with franchisees as a group); *see also* Emerson, *supra* note 10, at 1527-28 (concluding that the present right-of-franchisee-association laws simply impose upon franchisors "a negative duty to avoid interfering with membership, but no affirmative duty to communicate with the franchisee association"); H.R. 5961, 102d Cong., 2d Sess. (1992) (proposed, but unenacted, Federal Fair Franchising Practices Act, submitted by Representative James H. Scheuer). Under the Scheuer bill, a franchisor's duty to engage in collective bargaining with a representative franchisee association only would have arisen in systems in which there are more than 500 franchises outstanding or more than 300 franchisees in the United States.

My concerns about a franchise collective bargaining right are addressed in the Vanderbilt Law Review article (Emerson, *supra* note 10, at 1560-61).

franchisees, that right to transfer may be *extremely* qualified. While franchisors often have an unfettered right to assign the contract to a new franchisor,[18] by comparison almost all franchise agreements give the franchisor a right of first-refusal on a franchisee's proposed assignment to another party,[19] and nearly all expressly deny to the franchisee any right of assignment unless it first obtains the franchisor's approval.[20] The agreements often go into great detail about the terms franchisees must meet, as well as accord great discretion to franchisors wishing to deny a transfer, and the 1994 Code simply upholds the notion that any restrictions in a franchise agreement are permissible.[21]

Some IFA Code descriptions may be misleading. For instance, Section IV, Part 4, states that the termination of a franchise before it would by agreement expire "is a rare

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[18] Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees*, 72 NORTH CAROLINA LAW REVIEW 905, 914 n.20 & 970, at § B-3-b (1994) (66% of the 100 franchise agreements reviewed by the author from October 1992 to February 1993 stated that the franchisor has the right to assign the agreement to another party).

[19] *Id.* at 969, § B-3-a(1) (95% of the reviewed agreements).

[20] *Id.* at 970, § B-3-a(2) (93% of the reviewed agreements).

[21] IFA Code, Section IV, Part 6, subpart c (including as criteria that a proposed franchise transfer must meet - "the transfer provisions of the franchise agreement," but not in any way limiting what those provisions could be).

occurrence." While that may be true,[22] the franchisor's power to terminate is usually very strong, and the ability to use those strong termination powers - fairly or unfairly - is generally not softened by much of anything found in the written franchise agreement. It is this power to terminate, even more so than the actual exercise of the power, that can easily tilt the franchise relationship, any time after the franchise agreement has been signed, decidedly in favor of the franchisor. Most franchise agreements contain a statement that *any franchisee violation* is considered a material breach entitling the franchisor to terminate the franchise.[23] While all, or nearly all, franchise agreements list numerous instances of franchisee acts or omissions constituting grounds for termination,[24] relatively few franchise agreements expressly permit franchisees to terminate,[25] and they evidently include such a clause only in order to limit franchisee powers of termination to a few extreme cases of

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[22] As with a steak, the question, though, remains: How rare is "rare"?

[23] Emerson, *supra* note 18, at 970, § B-4-a (87% of the 100 reviewed agreements); *see also* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STANFORD LAW REVIEW 927, 940 (1990) (discussing typical franchise clauses).

[24] Emerson, *supra* note 18, at 971, § B-4-g (100% of the reviewed contracts specified certain franchisee conduct constituting grounds for termination).

[25] *Id.* at 970, § B-4-b (14% of the reviewed agreements).

significant contractual breaches by the franchisor.[26] Franchisors often have the option to buy the franchisee business *in toto*[27] or to purchase specific assets of the business.[28]

An example of an incomplete Code description is found in Section IV, Part 5. There, the first paragraph notes that some franchise agreements grant qualified renewal rights to the franchisee and that other agreements do not address renewal. Left out is a third category - one frequently found in the written franchise agreement: the *franchisor's* right to renew.[29]

Finally, another instance of a possibly misleading or incomplete IFA Code description occurs when Section IV, Part 7, describes territorial protection rights (rights against encroachment). The description fails to note that,

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[26] *Id.* at 970 (paragraph following § B-4-b). Periods to cure also are often far longer than comparable periods afforded to franchisees. *Id.* at 970, § B-4-b (succeeding para.) & 971, § B-4-h (succeeding para.).

[27] *Id.* at 971, § B-4-j (11% of the reviewed franchise agreements granted the franchisor an option to purchase the franchisee's business upon termination of the franchise). It is solely the franchisor's choice.

[28] *Id.* at 971, § B-4-k (54% of the reviewed franchise agreements granted the franchisor an option to purchase the franchisee's equipment upon termination of the franchise). Again, the franchisor has the discretionary powers in this area, not the franchisee.

[29] *Id.* at 970, § B-4-e (38% of the surveyed agreements provided for a franchisor option to renew).

particularly for franchisees of larger systems, (1) territorial protection rights seem to be less frequent than in previous decades,[30] and (2) a large number of franchise agreements expressly state that there is no exclusive territory.[31] (Of course, many franchisors will argue against any franchisee non-encroachment rights, no matter how small, unless the agreement contains an express, written provision detailing such a franchisee right; so the number of franchisors denying any territorial rights is far higher than the approximate one-quarter who forthrightly deny such rights in the contract form signed by the franchisee.)

## III. DOES THE 1994 CODE REPRESENT A MAJOR RETREAT BY THE *IFA* ON THE ISSUE OF INDUSTRY ETHICS AND SELF-REGULATION?

I do not believe that the revised Code represents a major retreat. The problem is that it does not represent a significant advancement. The earlier Code, promulgated in

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[30] *Id.* at 968, § B-1-a (from 1971 to 1993, among surveyed franchise agreements, the percentage of those providing an exclusive territory to the franchisee dropped from 60% to 46%).

[31] *Id.* at 969, § B-1-a(2) (25% of reviewed agreements expressly stated that there was no exclusive territory for the franchisee).

late 1992, was important, probably more for the promise implicit with its creation than for any specific provisions in it. The implied promise was that more was to follow: improvements in its enforcement mechanism, inclusion of franchisees in the decision making process, and other reforms.[32] This revised Code falls short of the promise.

The 1994 Code is only part of the picture, however. Other IFA action, or inaction, can be significant in evaluating a franchising self-regulation program. For instance, in the Committee hearing on April 21, 1993, Mr. Gil Thurm, IFA Senior Vice President and Chief Counsel, asked the Committee to "give this process [self-regulation] a chance."[33] When asked about Code enforcement, Mr. Thurm stated that it was an important issue the IFA was still working on, and that enforcement was a question about which the IFA had asked its Franchisee Advisory Council for assistance.[34] The question thus facing the Committee is: what has happened in the last fourteen months since the last hearing on this matter? A related development would be the status of the National Franchise Mediation Program announced on February 8, 1993 and

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[32] For general information on this point, *see Franchising: Is Self-Regulation Sufficient?*, *supra* note 8.

[33] *Id.* at 34 (statement of Gil Thurm).

[34] *Id.* at 32.

discussed in Mr. Thurm's testimony of April 21, 1993.[35] Obviously, the meaning and effect of Code Section IV, Part 9 (Disputes), depends greatly on what is actually taking place under this program.[36] Do mediation panels include franchisee representatives as well as franchisor representatives? Also, how has the program dealt with contractually-mandated arbitration,[37] choice-of-law provisions,[38] and venue clauses?[39]

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[35] *Id.* at 7-8.

[36] Without any contrary information on this point, I would simply echo some of the concerns raised in the prior hearing by Mr. W. Michael Garner. Mr. Garner, a noted franchise attorney, author, and former editor of the Franchise Law Journal, raised these questions about the franchise mediation program: (1) Does the program in fact serve as simply another hurdle for franchisees to surmount in order to obtain redress? (2) Does the program lead to a watering down of possible remedies - e.g., damages - that would have served to deter future misconduct, with the parties instead urged to compromise and settle a case when the case really merits a strong decision in favor of one side? (3) Does the franchisee have the discovery tools available to seek to prove difficult cases such as fraud? *Id.* at 12 & 33-34 (statement of Mr. W. Michael Garner). Use of alternate dispute resolution mechanisms (ADR) can, of course, be better for both sides than resorting to courtroom litigation, but ADR is no panacea.

[37] Alternate proceedings, such as arbitration, may be compelled in some instances. Emerson, *supra* note 19, at 973, § C-2-c (31% of 100 surveyed agreements contained clauses requiring arbitration of franchisor-franchisee disputes). State franchise statutes occasionally require judicial consideration of a claim rather than contractually-mandated arbitration, but the Supreme Court has found that the Federal Arbitration Act (9 U.S.C. §§ 1-2 (1988 & Supp. 1993) preempts such state laws. Soler Chrysler-Plymouth, Inc. v. Mitsubishi Motors Corp., 473 U.S. 614 (1985) (upholding a contractual clause requiring that a car dealer's complaint be arbitrated in Japan); Southland Corp. v. Keating, 465 U.S. 1, 10-11 (1984) (stating that the only grounds for not enforcing an arbitration clause were (1) the clause is unjust *and* does not concern a transaction "involving commerce," or (2)

## IV. DOES THE *IFA* CODE OFFER REASONABLE STANDARDS FOR ASSESSING FRANCHISOR PRACTICES?

The IFA Code is an inadequate source of franchisor practice standards. The proposals before Congress are more detailed, and they dovetail more with existing substantive regulation already found in a number of states.

The treatment of good faith may serve as an example of the Code's inadequacy. The second sentence of Section IV, Part 2, provides that "the good faith obligation does not supersede, enlarge or diminish the rights and obligations contained in an agreement." This statement should include the

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allegedly the arbitration clause itself, not simply the overall franchise contract, was induced by fraud). (Recent Congressional bills have proposed that, despite a contractual mandate of arbitration, parties be entitled to a court action for damages or equitable relief when claims concern alleged violations of the new, proposed federal act. *See, e.g.*, H.R. 2593, 103rd Cong., 1st Sess. § 7(d)(2) (1993) (the proposed Federal Fair Franchise Practices Act).)

[38] The proposed Federal Fair Franchise Practices Act contains a provision essentially negating contractual choice-of-law provisions that "deprive a franchisee of the application and benefits of this Act or of any federal law or the law of the state in which the franchisee's principle place of business is located." H.R. 2593, 103rd Cong., 1st Sess. § 6(c)(1) (1993).

[39] Emerson, *supra* note 18, at 973, § C-2-b (62% of the reviewed agreements contained a venue stipulation).

word, "expressly." In other words, the good faith obligation does not supersede, enlarge, or diminish the rights and obligations *expressly* contained in a franchise agreement.[40]

Parties to a franchise contract are bound by the same implied duty of good faith and fair dealing found elsewhere in the law of contracts.[41] On various topics, such as training

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[40] *See, e.g.*, Devery Implement Co. v. J.I. Case Co., 944 F.2d 724, 728 (10th Cir. 1991) (holding that an implied covenant of good faith and fair dealing cannot be applied "so as to write the termination-at-will provision out of" a franchise contract); UNIFORM FRANCHISE AND BUSINESS OPPORTUNITIES ACT § 201, 7A U.L.A. 118 (Supp. 1993) (stating that a franchise agreement "imposes on the parties a duty of good faith in its performance and enforcement," but, at Comment 3 to § 201, limiting the duty to those instances in which it would not "add to or override substantive provisions of a [franchise] contract"); *accord* Flint Davis v. Sears, Roebuck and Co., 873 F.2d 888 (6th Cir. 1989); Cloverdale Equip. Co. v. Siomon Aerials, Inc., 869 F.2d 934 (6th Cir. 1989) (restricting the good faith standard to only those cases in which a party acted in bad faith while negotiating the original franchise agreement, not simply cases involving alleged, subsequent bad faith); Rosenberg v. Pillsbury Co., 718 F. Supp. 1146 (S.D.N.Y. 1989). *But see* B.P.B. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp., 799 F. Supp. 1250 (D. Mass. 1991) (concluding that the franchisor's prior failure to enforce certain credit provisions meant that its sudden withdrawal of the franchisee's inventory financing may have breached an implied covenant of good faith and fair dealing, even though the written agreement between the parties expressly permitted such an abrupt withdrawal).

[41] Dunkin' Donuts of Am., Inc. v. Minerva, Inc., 956 F.2d 1566, 1569-70 (11th Cir. 1992). The Restatement (Second) of Contracts § 205 (1981), the Uniform Commercial Code § 1-203 (1989), and a majority of jurisdictions all recognize that every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 (1980) (providing an appendix which contains cases indicating jurisdictions that explicitly recognize a general obligation of good faith in every contract at common law).

The duty of good faith and fair dealing limits either party's

of franchisees, court interpretations may vary considerably.[42] The common law covenants of good faith and fair dealing, though, are not as amorphous as one might, at first blush, believe. The burden of proof is on a franchisee-plaintiff to show that the franchisor-defendant acted in bad faith. When a franchise agreement contains nothing expressly on point, many courts have refused to let the franchisor do as it wished. In the 1991 case of *Scheck v. Burger King Corp.*,[43] for example, the court permitted a franchisee to go to trial on its claim that the franchisor had breached an implied covenant of good faith and fair dealing by opening another franchised restaurant just two miles away from the

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use of discretionary powers or other advantages over the other party, but this implied limit may be contradicted - in effect, overturned - by a directly contravening express term in the contract.

[42] *See, e.g.*, Fox v. Dynamark Sec. Centers, Inc., 885 F.2d 864 (table of unreported decisions), 1989 WL 106802, at *3 (4th Cir. 1989) (denying franchisor's argument that the franchise agreement's reference to "training" was met by any training, even inadequate training); Chico's Pizza Franchise, Inc. v. Sisemore, Bus. Franchise Guide (CCH) ¶ 8041 (E.D. Wash. 1983) (finding that franchisor Chico's had provided only minimal support and had even abandoned some express terms of the contract, such as the bulk buying program; noting, however, that the franchisees had earned profits for several years and only complained after their businesses started to lose money, and thus finding the support services marginally adequate and not violative of any implied duties).

[43] 756 F. Supp. 543 (S.D. Fla. 1991).

franchisee's location.[44] The court recognized that a contract includes not only its written provisions, but also terms and matters that are implied at law.[45] According to the court, although the franchise contract explicitly denied the franchisee any territorial rights, the franchisor had no right to open additional franchises without taking into account their effect on the nearby franchisee.[46] An implied covenant of good faith and fair dealing means, the court held, that *franchisees rightfully can expect the franchisor to refrain from destroying the franchisees' ability to "enjoy the fruits of the contract."*[47] (This same concept involving "the fruits

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[44] *Id.* at 545. The court granted summary judgment to the franchisor on all other theories advanced by the franchisee: breach of (1) an implied contract created by promissory estoppel, (2) an implied non-competition agreement, and (3) the Massachusetts Consumer Protection Act. *Id.* at 545, 550.

[45] *Id.* at 548.

[46] *Id.* at 549. This same reasoning was adopted in Burger King Corp. v. Weaver, 798 F. Supp. 684, 689 (S.D. Fla. 1992), in which the court noted that just because the franchise agreement failed to grant the franchisee an exclusive area or other express area rights did *not* somehow authorize the franchisor to place additional, competing franchises on any site it wanted.

[47] *Scheck*, 756 F. Supp. at 549 (emphasis added); Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 728 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980); Burton, *supra* note 41, at 373 (contending that good faith consists of actions within the reasonable contemplation of the parties when the contract was formed, while it is bad faith when a party exercises its discretion to recapture opportunities foregone upon contracting); Rochelle Buchsbaum Spandorf et al., *Implications of the Covenant of Good Faith: Its Extension to Franchising*, FRANCHISE L.J., Fall 1985, at 3,5 (stating, "the good faith covenant requires that each party act in a manner consistent with the contract's purpose," and - since

of the franchise contract" is found in the proposed Federal Fair Franchise Practices Act.)[48]

Analysis under common law contract principles may, for purposes of evaluating the parties' good faith, consider a franchisor's subjective intent. The concept of good faith naturally encompasses the manner in which parties actually have used the powers created by their agreement. For instance, one problem that has received little attention is the franchisee's response to a franchisor that, due to financial troubles or for any other reason, cuts back on the assistance it provides the franchisee. If, for example, a nationwide diet center chain teeters on the edge of insolvency and thus falls far short of its past performance, how may franchisees, individually or collectively, respond? Unfortunately for franchisees, their options may be rather limited. Most franchise agreements provide little or no relief if a franchisor fails to meet its duties.[49] Instead,

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economic profit is the main reason for entering a franchise contract - a franchisor should not take any "action that precludes profitable operation of a franchise").

[48] H.R. 2593, 103rd Cong., 1st Sess. § 5(a) (1993).

[49] Anthony G. Covatta, *Aspects of Systemwide Discontent: Learning to Live Together, Avoiding Divorce*, 12 FRANCHISE L.J. 33, 55 (1992) (comparing the franchise agreement to a one-sided prenuptial contract, and stating that while the franchisor is protected by a 75-page contract listing franchisee duties, the franchisee's hopes are pinned upon the franchise *relationship* - there is little for the franchisee to

the typically comprehensive, lengthy contract serves mainly to protect the franchisor by listing and detailing numerous *franchisee* responsibilities and by empowering the franchisor to control the franchisee.[50]

Many state legislatures have already recognized that there must be more to franchise relationship law than the words in a franchise agreement drafted by the franchisor. The law certainly takes note of those terms, and - again - the express wording cannot be overcome merely by spouting the words, "good faith"; but franchise relationships do involve more than just locating the wording in a lengthy document. The relationships suggest a complex web of dynamic activity and dependency - something so fluid and informal that an initial, static, one-sided document cannot adequately manage it all. That is why there are substantive, statutory laws

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embrace in the written agreement itself).

[50] *See generally* Harold Brown, *Franchising: Punitive Damages and Contractual Arbitration*, 209 N.Y.L.J. 3, 29 (Jan. 28, 1993) (speaking of adhesion contracts, an "absence of equal bargaining power," and the unfair provisions that "overbearing franchisors [insert] in their contracts" against the franchisees' interests); Robert L. Purvin, Jr., *Comments on Proposed Federal Regulation of Franchising*, 12 FRANCHISE L.J. 12, 12 (1992) (noting attorney Purvin's Congressional committee testimony that he "had never written or read a franchise agreement that [he] would recommend a franchisee sign"); *Minority Franchising: Is Discrimination a Factor?: Hearing Before the Comm. on Small Business*, 103rd Cong., 1st Sess. 9 (June 30, 1993) (statement of Representative Kweisi Mfume) ("in many respects [the franchise relationship] is the old master-slave relationship all over again").

regulating the post-purchase relationship between franchisor and franchisee in over one third of the states.[51] These laws are most notable for: (1) requiring the franchisor to provide franchisees notice and a period to cure before terminating or declining to renew franchises, and (2) restricting the franchisors' rights of termination or nonrenewal to decisions made for "good cause."[52] Substantive laws also regulate many other aspects of the franchise relationship by affording

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[51] *See* ARK. CODE. ANN. § 4-72-201 to 4-72-210 (1987); CAL. CORP. CODE §§ 31,000-31,516 (West 1977 & Supp. 1993); CAL. BUS. & PROF. CODE § 20,000 (West 1987 & Supp. 1993); CONN. GEN. STAT. § 42-133E (1992); DEL. CODE ANN. tit. 6, § 2551 (1975 & Supp. 1992); FLA. STAT. § 817.416 (West 1976 & Supp. 1993) (limited to prohibitions on the making of intentional misrepresentations in connection with the sale of a franchise); HAWAII REV. STAT. § 482E (1992); Illinois Franchise Disclosure Act of 1987, Ill. Laws, P.A. 85-551, ILL. REV. STAT., ch. 121 1/2, paras. 1701-1744 (Smith-Hurd Supp. 1992); IND. CODE §§ 23-2-2.5-1 to 23-2-2.5-51 (Burns 1989 & Supp. 1992); IOWA CODE ANN. §§ 523H.1-523H.17 (Supp. 1992); MICH. COMP. LAWS §§ 445.1501-445.1546 (West 1989 & Supp. 1992); MINN. STAT. ANN. §§ 80C.01-80C.30 (West 1986 & Supp. 1993); NEB. REV. STAT. §§ 87-401 to 87-410 (1987 & Supp. 1992); N.J. STAT. ANN. §§ 56:10-1 to 56:10-15 (West 1989 & Supp. 1991); S.D. CODIFIED LAWS ANN. §§ 37-5A-1 to 37-5A-87 (1986 & Supp. 1992); TENN. CODE ANN. §§ 47-25-1501 to -1511 (Supp. 1992); VA. CODE §§ 13.1-557 to 13.1-.574 (Michie 1989 & Supp. 1992); WASH. REV. CODE §§ 19.100.010-19.100.940 (1989); WIS. STAT. ANN. §§ 135.01-135.07 (West 1989 & Supp. 1992). The District of Columbia, Puerto Rico, and the Virgin Islands also have substantive franchise legislation: D.C. CODE ANN. §§ 29-1201 to 29-1208 (Supp. 1991); P.R. LAWS ANN. tit. 10, §§ 278-278d (1978 & Supp. 1989); V.I. CODE ANN. tit. 12A, § 132 (1982).

[52] The proposed Federal Fair Franchise Practices Act has a similar "good cause" section. H.R. 2593, 103rd Cong., 1st Sess. § 3(b)(2) (1993).

greater protection to franchisees on the theory that an imbalance exists in the relationship.[53]

The last sentence of IFA Code Section IV, Part 2, is particularly troubling because its effect may be to leave nothing for "good faith," that is, to render the good faith concept a nullity. Far better than the Code's bald statement that franchisors acting in compliance with the terms of their franchise agreement are acting "fairly and in good faith" would be a sentence saying that such franchisors are "*presumed to be* dealing with the franchisee fairly and in good faith."[54]

Ordinary contract law principles such as the parol evidence rule may make it quite difficult to contradict or add

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[53] For example, substantive laws may prevent a franchisor from unfairly discriminating among franchises, from unreasonably prohibiting the transfer or assignment of a franchise, from failing to repurchase items upon termination or non-renewal, or from interfering with the free association among franchises. *See* W. MICHAEL GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE §§ 10:30, 10:34, 10:39 & 10:43 (1993) (describing and citing the state statutes in these areas); *see also* Emerson, *supra* note 10, at 1511 & nn.27-28 (describing and citing the statutes in 16 states that regulate the substance of the franchising relationship and that bar some or all of the above practices as well as other activities).

[54] IFA Code, Section IV, Part 2 (italicized words added by Robert W. Emerson). Under this approach, there would be a rebuttable presumption which the franchisee-plaintiff might overcome.

to the wording of a contract.[55] There generally is a high standard of proof required to win a fraud case.[56] The parties enter into a relationship by signing what is usually a long, complex, rather one-sided document.[57] All three factors (contract law principles, burdens of proof, the bias of most franchise agreements) are important reasons why, in many states, there are substantive, franchise laws superseding the usual rights of contract.[58]

## V. DOES THE *IFA* CODE PROVIDE A REALISTIC BASIS FOR BROAD, INDUSTRY SELF-REGULATION OF FRANCHISING?

### A. National Legislation Is Better

Proposals before Congress provide a comprehensive enforcement mechanism as well as cover non-IFA franchisors,

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[55] *See, e.g.*, Traumann v. Southland Corp., Bus. Franchise Guide (CCH) ¶ 10,250 (N.D. Cal. 1993) (holding that the parol evidence rule barred the introduction of evidence of the franchisor's presale statements and thus, effectively, killed the franchisee-plaintiffs' fraud claims); *but see* Scott v. Minuteman Press Int'l, Inc., Bus. Franchise Guide (CCH) ¶ 10,344 (N.D. Cal. 1993) (permitting parol evidence to prove fraudulent inducement to enter into a franchise agreement).

[56] Generally, the standard is "clear and convincing evidence," a much higher level of proof than the ordinary measure: mere preponderance of evidence.

[57] *Supra* notes 49-50 and accompanying text.

[58] *See supra* notes 51-53 and accompanying text.

thus resolving two problems with the IFA framework. The 1994 Code seems to be simply a hortatory document: Encouraging good behavior, but imprecise about exactly what good (or bad) behavior is and, even when the franchisor's conduct clearly is inappropriate, not really doing much about it.[59]

As Representative Meyers stated at the April 21, 1993 hearing of this Committee, "Self-regulation is only the first line of defense."[60] It could constitute "an early warning device"[61] that might permit mediation or other lower cost efforts at amelioration. The bottom line, though, is that there must be something beyond the Code to which aggrieved parties can turn. In the area of disclosure law, even leading *franchisor* attorneys have noted that a private, federal right of action is needed.[62] A number of states already provide a

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[59] In fact, because of court interpretation of the antitrust laws, the IFA - as a private association without any governmental mandate - may not be able to exercise stronger enforcement powers without risking a successful suit by a disgruntled franchisor.

[60] *Franchising: Is Self-Regulation Sufficient*, *supra* note 8, at 3 (statement of Representative Jan Meyers).

[61] *Id.* at 12 (statement of W. Michael Garner).

[62] Even franchisor lawyers who have strongly condemned most proposed regulations tend to agree that a private right of action is long overdue. *See, e.g.*, Richard M. Asbil, *Franchise Commentary*, 12 FRANCHISE L.J. 1, 9 (1992) (stating, "why not let existing laws provide remedies [including] a private right of action?"); H. Bret Lowell, *Comments on Federal Franchise Disclosure and Relationship Bills*, 12 FRANCHISE L.J. 10, 11 (1992) (noting that a private right of action "is surely an idea whose time has come").

private cause of action for damages based upon franchisor statutory violations.[63]

In the last few years the Federal Trade Commission (FTC) appears to have performed as well as could be expected, given its limited resources and the glut of complaints, in the area of FTC Franchise Rule enforcement.[64] Nonetheless, the FTC process "can be slow" (some cases take several years to

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[63] *See, e.g.*, CAL. BUS. & PROF. CODE § 80,037 (West 1977 & Supp. 1993); CONN. GEN. STAT. ANN. § 42-133g (West 1987); DEL CODE ANN. tit. 6, § 2553 (1975 & Supp. 1993); MISS. CODE ANN. § 75-24-57 (1992 Supp.); MO. ANN. STAT. § 407.410.2 (Vernon 1990 & Supp. 1992); N.J. STAT. ANN. § 56:10-10 (West 1989 & Supp. 1991).

Rescission can arise from a franchisor's failure to register under state law. *See, e.g.*, My Pie Int'l, Inc. v. Debould, Inc., 687 F.2d 919 (7th Cir. 1982) (applying Illinois law to rescind a franchise agreement). A number of states provide for a private right of action, often including the remedy of rescission, based upon the franchisor's violation of the franchise laws. CAL. CORP. CODE §§ 31,300-31,301 (West 1977 & Supp. 1993); HAW. REV. STAT. § 482E-9 (1992); Illinois Franchise Disclosure Act of 1987, Ill. Laws, P.A. 85-551, ILL. REV. STAT., ch. 121 1/2, para. 1726 (Smith-Hurd Supp. 1992); IND. CODE § 23-2-2.5-27 (Burns 1989 & Supp. 1992); MD. ANN. CODE art. 56, § 365(b) (1988 & Supp. 1992); MICH. COMP. LAWS § 445.1531 (West 1989 & Supp. 1992); MINN. STAT. ANN. § 80C.17, subd. 1 (West 1986 & Supp. 1993); N.Y. GEN. BUS. LAW § 691(1) (McKinney 1984 & Supp. 1993); N.D. CENT. CODE §§ 51-19-12 (1989 & Supp. 1991); R.I. GEN. LAWS § 19-28-9 (1989); S.D. CODIFIED LAWS ANN. § 37-5A-83 (1986 & Supp. 1992); VA. CODE ANN. § 13.1-571 (Michie 1989 & Supp. 1992); WASH. REV. CODE ANN. § 19.100.190 (1989); WIS. STAT. ANN. § 553.51 (West 1989 & Supp. 1992).

[64] *See, e.g., General Accounting Office Report: FTC Franchise Rule Enforcement*, Bus. Franchise Guide (CCH), Supp. Report No. 163, at 7 (July 23, 1993).

resolve)[65] and "potentially meritorious cases may not get investigated or litigated."[66] A Government Accounting Office study concluded that permitting a private cause of action "would have addressed a long-standing criticism of the current law's limitations."[67] The Federal Franchise Disclosure and Consumer Protection Act[68] would rectify this problem.[69]

B. The Law Must Recognize that the Franchise Relationship Is Dynamic: To Understand the Parties' Present Relationship One Must, For Many Terms of the Original, Written Franchise Agreement, Look Beyond What Was Formally Agreed to at the Outset of the Relationship[70]

If a franchisor-franchisee dispute were to arise over fees, intellectual property, or other set terms such as insurance requirements or arbitration and venue stipulations, the parties' franchise agreement typically would reflect a full accord reached before the contract started; therefore,

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[65] *Id.* at 3 & 5.

[66] *Id.* at 3.

[67] *Id.* at 8.

[68] H.R. 2596,, 103rd Cong., 1st Sess. (1993).

[69] *Id.* at § 7 (section setting forth a private right of action).

[70] For more on this point, *see* Emerson, *supra* note 18; Hadfield, *supra* note 23.

the written terms could stand alone. Franchisees and franchisors, however, tend to have legitimate expectations about their franchise relationship that often go far beyond the terms specified in their written agreement. If the parties later disagree about other terms - ones dependent upon an ongoing series of judgments by the franchisor - then concepts of fairness and rationality would run counter to any naive notions of a completed franchise contract necessitating no judicial or statutory refinements. Without the good faith doctrine, other judicial standards based on simple fairness, or statutory intervention in the franchise relationship, a franchisor can point to contractual clauses giving it - among other things - nearly total, unfettered power to restrict a franchisee's competition, to assign the franchisor's rights and duties but bar any franchise transfers by the franchisee, and even to terminate or not renew the franchise.

Most franchisees realistically expect far more than what the written document promises. A court that reads the franchise contract literally will adequately interpret and apply some provisions, but must adopt a wholly different approach to other clauses or else violate the "spirit" of the

franchise agreement.[71]

C. The IFA Code Is Distinct from True, Professional Codes of Ethics

The IFA's attempt to enunciate and thereby improve standards for franchisors is commendable. The 1994 Code serves a useful purpose not as a substitute for existing law, nor as a means to prevent future regulation, but as an ongoing expression of the ethical concerns of the IFA's membership. As such, the Code remains subject to future refinements.

The IFA Code should stand apart from the law. While ethics, fair play, behaving honorably, and the like are concepts certainly important in law *and* ethics, the fact that the two (ethics and law) are closely related does not mean that they should be viewed as synonymous. The IFA Code puts forth what a "good" franchisor, according to its own community

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[71] That is why the added language in the Code, Section III (Compliance and Enforcement)), Part 1, is so troubling. Buried within that paragraph is the following sentence:

> The principles and standards of conduct contained in the Code do not substitute for or supplement the franchise agreements between IFA members and their franchisees or create any rights for franchisees of IFA members (emphasis added).

In effect, the IFA says that the written franchise agreement is the franchise relationship, period. This often ignores business reality and, I believe, renders the IFA Code of Ethics simply a series of somewhat self-serving descriptions and occasional, presumably unenforceable (at least in court) admonishments.

standards, should or should not be doing. It has a relatively low aspiration level, but at least it represents a recognition of certain fundamental, albeit general, principles.

The IFA Code may not readily translate into a criminal enforcement or civil litigation tool. It is not at all clear that it should serve such a purpose. Instead, again, it should serve simply as what it appears to be: an exhortatory document reflecting the moral sensibilities of the IFA franchisor community. To use it broadly as a shield against pending regulation is to discredit what might otherwise work well, if given a narrower purpose (i.e., as a sort of IFA "position paper").[72]

Genuinely self-regulating bodies are few in number. Their scope of self-regulation is rather narrow and, it seems, shrinking. Groups of professionals, such as lawyers and doctors, have had centuries to develop and re-develop the standards that are so familiar to members of the profession and, indeed, the public.[73]

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[72] In that narrower context, publication and adherence to the Code could signal what attorney Garner seeks: franchisor commitment, a "change in attitude." *Franchising: Is Self-Regulation Sufficient?*, *supra* note 8, at 85 (written testimony of W. Michael Garner).

[73] Certainly the notion of a Hippocratic oath is known to many patients, and few clients have no notion of the ethical duties (confidentiality, service as a zealous advocate, etc.)

Professionals with well-established codes of ethics, such as attorneys, admit that they are fiduciaries. Their first duty, therefore, is to the client or patient. Also, lawyers have a recognized duty to society, as they are "officers of the court," beholden as licensed members of the bar.

Franchisors admit no such standards. They have fought, quite successfully, attempts by courts or legislatures to label them fiduciaries - even if the labeling was intended for just limited purposes.[74] The IFA's effort to provide greater ethical clarity and oversight for member franchisors is certainly appropriate, but - without the constraints that true professionals feel (the fiduciary obligation to clients or patients; the special duties to the public generally) the IFA Code can easily be viewed, correctly so, as a document reflecting just one side's view of the franchise relationship.

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that govern attorneys.

[74] Such a limited fiduciary status is proposed in my North Carolina Law Review article. *See* Emerson, *supra* note 18, at 922-26 & 933-42. A more limited form of fiduciary relationship is found in the proposed Federal Fair Franchise Practices Act. H.R. 2593, 103rd Cong., 1st Sess. § 5(c) (1993).

## V. CONCLUSION

I disagree with the basic premises of the revised Code: That franchisor-franchisee relations are entirely contractual, that the limits of that contract are found within the wording of a franchisor-crafted form. There is more to a franchise relationship than the literal wording of an agreement. Many courts and legislatures have recognized the need to go beyond simply the written document, to look at the relationship as it develops over time, and to recognize public policy interests in protecting franchisees and potential franchisees.[75]

While the Code is a good attempt to set minimal ethical standards for IFA members, it does not cover the entire franchising community. A national, uniform law would be a distinct improvement.[76] It need not set forth much, if anything, more than the statutory and case law standards already found in many states. By making these standards apply

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[75] For more on this point, see Emerson, *supra* note 18.

[76] Because state legislatures often differ about which relationships to regulate, which key elements will define the relationship, and which relationships should be exempt, a lack of uniformity has arisen among the various state statutes. The task of determining coverage under the various state laws is formidable, owing not only to the statutory maze, but also to the large body of regulations, advisory opinions, and informal administrative practices used to interpret these statutory provisions. PHILIP F. ZEIDMAN ET AL., FRANCHISING: REGULATION OF BUYING AND SELLING A FRANCHISE, 34 C.P.S. (BNA), at A-85 (1983).

to all, a national law would benefit not only franchisees and prospective franchisees, but that law should, over time, lead to greater legal certainty and predictability. The result would be better business planning, thus serving the long-term interest in growth and prosperity that both franchisors and franchisees share.

Thank you.

Robert W. Emerson

CONGRESS OF THE UNITED STATES

House of Representatives

103rd Congress

Committee on Small Business

Hearings on

Self Regulation of Franchising:

The IFA Code of Ethics

June 30, 1994

Written Testimony of W. Michael Garner

Honorable members of the Committee, I want to thank you for the opportunity to appear here today before you to testify with respect to the International Franchise Association's new Code of Principles and Standards of Conduct, a document that was formerly called the IFA's Code of Ethics.

The fundamental issue this Committee is facing is the efficacy of self-regulation in franchising; the specific inquiry today is whether the Code of Principles advances self regulation or is a retreat from the position of the Code of Ethics.

I am going to give you both a short answer and a long answer. The short answer is that the Code of Principles is a retreat from the Code of Ethics in three respects: First, it states for the most part that if a franchisor is in compliance with applicable law, it is in compliance with the Code. Second, it states that if the franchisor is in compliance with its franchise agreement, it is in compliance with the Code. Third, in some instances it states that if the franchisor has a procedure for dealing with a problem, it will be in compliance with the Code. What this means is that the Code is drafted in such a way that the IFA imposes no higher standard of conduct upon the franchise community than existing law. And although we have a federal standard of disclosure in connection with franchise sales, laws

regulating the franchise relationship -- transfers, termination, alternative sources of supply and encroachment -- exist, if at all, in less than a third of the states.

Now for the long answer. Any franchise relationship is complex; it is complex because, first, it is usually a long-term relationship and problems arise over the long term that are not anticipated at the outset. It is complex because it deals with the entire panoply of the legal aspects of a business relationship -- from buyer-seller issues to trademark licensing to antitrust issues and liability for personal injury. These complexities are multiplied by the startling variety of franchise relationships that exist today -- from janitorial services to video outlets to restaurants to business services.

Today, the legal challenges facing franchising usually arise with respect to existing franchise relationships. In my experience, there are three primary areas where franchisees are facing serious problems:

-- First, there is the problem of franchisor failure. Franchising has proven to be such a success that established companies as well as entrepreneurs have gotten into franchising as a way of exending their product lines and expanding their businesses. But they frequently find, that with little or no experience, becoming a franchisor is a daunting experience and rarely a business venture that can be purchased "off the shelf." The result is that when problems arise, particularly when the franchisor already has an established business, it is all to easy to abandon the venture and leave the franchisees with nothing.

Union Carbide, for example, started a program a few years ago to franchise the care of interior marble surfaces in commercial and residential businesses. It saw the venture as a way of building its specialty chemicals sales, and the concept itself was sound. It tried to launch a franchise program by buying the expertise off the shelf: it purchased a small marble-care company, and hired franchising executives from existing franchisors. But four years into the project, it found that sales of franchises had not met corporate projections, and after a lengthy search sold the system to one of the franchisees. A major issue there was that in selling the system, it did not sell the right to use the Union Carbide name, which had been a major inducement for most of the franchisees.

In another example, a well-known exercise program, popularized through home videos, went into the franchising business by setting up a subsidiary and hiring purportedly competent managers. A year or two down the road, the managers had squandered the assets of the company to the point that the corporate offices were shut down by the landlord. The franchisees were left without as much as a telephone number they could call for answers to their questions.

I point out this area as a problem because it is a real problem that is not addressed by existing law and is not addressed by the IFA's Code. It is, however, a golden opportunity for self-regulation. In either of these instances, an effective self-regulatory scheme by a knowledgeable body such as IFA could have

given franchisees the opportunity to voice their concerns and possibly have them resolved at an early stage, before collapse or sale of the franchise systems. IFA has the resources and the expertise to counsel faltering franchisors and assist in restoring a faltering system to good health. It is not an area that existing law addresses, and is probably not an area that the law could effectively address.

A second major area of problems in franchising today is in the area of encroachment, or in the euphemistic terms of the Code, "System Expansion." Because many franchise systems are mature, and because franchising is highly competitive, we see today in some instances that franchisors may effectively cannibalize their own systems through over-expansion. This problem, generally known as encroachment, can take many forms. A franchisor may franchise or install a company-owned unit in a location that is so close to an existing unit that it deprives the existing franchisee of the economic incentive to continue in business. The franchisor may deprive existing franchisees of revenue by expanding into secondary service or product lines -- such as selling the franchisor's restaurant food products in a grocery store, or offering services that were previously offered solely through franchised outlets to "at home" customers through home videos.

The problems of encroachment are particularly well suited to self-regulation because they raise difficult and subtle issues that could effectively be addressed by a knowledgeable, expert body such as the IFA. For example, if a restaurant franchisor offers

its well-known products through grocery stores, will those sales in fact deprive restaurant franchisees of income? And if so, how much of an impact should such sales have in order to have an effect on the franchise system? What's the proper remedy? Should the franchisor be barred from expanding its product line or should franchisees perhaps be given a portion of the grocery revenues?

The old IFA Code of Ethics provided categorically that a franchisor would not open an outlet in proximity to an existing outlet without taking into account 12 factors that would protect the interests of both the franchisor and franchisee. While the new Code of Principles reiterates these factors, it also adds that any program, method or procedure agreed to by an franchisor and its franchisees to resolve encroachment issues will be deemed in compliance with the Code. What this means, effectively, is that a franchisor may make its own dispute-resolution mechanism binding upon franchisees as part of the franchise scheme, and that mechanism can effectively have no protections for franchisees at all. For example, in some systems, the franchisor agrees to notify existing franchisees of its intent to place a new unit in their locale; if the franchisee protests, the franchisor agrees to conduct an study of the impact of the placement upon the franchisee; but the franchisor retains the right to put in the new unit, regardless of the outcome of the study.

Again, this is an area that is a golden opportunity for self-regulation that the IFA not only has passed up, but from which it has retreated in its new Code of Principles. As lawmakers, you

will be interested to know, as you probably do, that encroachment legislation does, however, exist at the state level in the automobile industry. Approximately 35 states have laws providing that when an automobile manufacturer or importer seeks to place a new dealer in a defined proximity to an existing dealer, the existing dealer may protest. Usually, this legislation provides that the existing dealer's protest automatically bars the manufacturer from installing the new dealer until the equities of the issue can be adjudicated -- by either a court or administrative body that takes into account a number of factors set forth in the legislation.

A third area in which there are problems in franchising concerns sources of supply. In many if not most areas of franchising, there are myriad suppliers available that can satisfy the franchisor's legitimate business, trademark and proprietary needs. A franchisor that requires its franchisees to purchase from it or from designated suppliers essentially creates a captive market for these products -- which frequently are available from other sources. You will recall that I mentioned Union Carbide a few moments ago. It made the claim to its franchisees that its marble treatment products were proprietary -- available only from the franchisor -- and required franchisees to purchase those products from it. Well, internal documents of the Union Carbide subsidiary that was franchising show that two of those supposedly proprietary products were Red Devil Stripper and Clorox bleach -- products that the franchisor was buying from third parties, then

relabeling with its own name.

The new IFA Code retreats most significantly from the Code of Ethics in this area. The Code of Ethics previously mandated its franchisor members to permit franchisees to purchase from alternative sources of supply if the franchisor's legitimate standards and needs were met. The Code of Principles, however, retreats from this position and states simply that a franchisor will be deemed in compliance with the Code if it is in compliance with antitrust and trade regulation laws. This mandate, however, is essentially a paper tiger. Under existing law, except in unusual circumstances, a franchisor can require a franchisee to purchase all of its products -- proprietary or not, at any price -- without running afoul of the antitrust laws. This is indeed an area in which self-regulation has provided an illusory solution; it is also an area where legislation, on a federal level, would be appropriate.

I want to make a few more observations on the Code of Principles before concluding.

The prior Code of Ethics mandated that franchisors deal in good faith with their franchisees. The new Code adds the qualification that a franchisor that acts in compliance with its franchise agreement is acting in good faith. This is a significant change. At common law, the duty of good faith qualifies the discretion a franchisor may have to act under a contract. For example, if the agreement gives the franchisor the discretion at any time during the relationship to require franchisees to upgrade

their facilities, the implied duty of good faith would curb the exercise of that discretion by saying that any upgrade requirements would have to be reasonable. By adopting the position that a franchisor is deemed to be acting in good faith if it is in compliance with its agreement, the Code gives the franchisor the "out" of saying that any exercise of discretion -- reasonable or not -- is in compliance with the contract.

In the area of franchisee advisory councils and associations, the Code of Principles retreats from the prior position -- which encouraged franchisors to foster open communication with franchisees -- and states flatly that a franchisor may foster such communications by such means that the franchisor determines are most effective. Thus, the issue of communication is left up to the franchisor.

The new Code does take a step forward in the area of expiration of a franchise agreement by stating that a franchisor may make the decision not to renew a franchise agreement at its conclusion if it is for good cause, or if the franchisee is given a meaningful opportunity to sell the franchise; if the franchisee is given the opportunity to operate the business under a different trade identity; or if -- and this is the addition -- the franchisee is permitted to realize the value of the business.

The IFA, however, took a step backward with respect to transfers. The new Code states that a franchisor shall not unreasonably refuse a franchisee's request for a transfer under certain conditions, but makes an exception for so-called "personal

services contracts." While this has a meaning at common law, the Code does not define it, and franchisees should be concerned that a franchisor will deem any franchise to be a personal service contract.

A final point: Although there are many franchisees today that are sophisticated business persons -- indeed many franchisees are themselves major corporations operating hundreds of franchises -- we still have many, many franchisees who are unsophisticated individual operators. It has been my experience that when the franchise system is visited with troubles, oftentimes these small franchisees lack the knowledge, resources, sophistication and leadership to even know how to begin to redress their problems. They may simply vanish. Yet, these are the franchisees that self-regulation could serve best, by providing an accessible, low-cost forum in which they could voice their concerns and -- hopefully -- work out their problems.

In conclusion, I want to emphasize first, that there are many franchisors who are not in need of further regulation -- either self regulation or government regulation. They are responsible citizens who treat their franchisees fairly. On the other hand, there are problems in franchising: problems that arise not from evil-minded franchisors but from the competitive stresses of industry, from the growing pains of development, from the fact that franchising is a pioneering industry, and as in any pioneering venture, there are greater risks than in following the beaten path.

Self-regulation does present a golden opportunity to

those who speak for the industry as a whole. Self regulation can provide mechanisms to resolve issues before they become problems; to provide expert guidance and dispute resolution where legislation may be cumbersome or difficult; to educate and advise instead of to confront and escalate. Regretfully, the IFA's Code of Principles, while certainly well-intentioned, provides franchisors with the safe harbor of the status quo.

Thank you.

**TESTIMONY**

**ERIC H. KARP**

**THE IFA CODE OF ETHICS**

**U.S. HOUSE SMALL BUSINESS COMMITTEE**
**WASHINGTON, D.C.**

**June 30, 1994**

Mr. Chairman and members of the Committee:

My name is Eric H. Karp. I am a partner in the Boston law firm of Friedman, Handler & Karp where I specialize in representing franchisees and franchisee associations throughout the United States.

I thank you for the opportunity to present my views to this Committee concerning this vital issue in the franchising arena.

Mr. Chairman, the IFA Code of Ethics, as it was originally issued late in 1992, was part of a three point plan by the IFA to convince the Congress and the States that legislative solutions to the urgent and obvious problems in franchising were not necessary and that this $600 Billion industry could regulate itself. In addition to the Code, the IFA announced the creation of the National Franchise Mediation Program and began to invite franchisees to become dues paying members of the IFA.

The unspoken but irrefutable premise of the IFA's program was that there were serious problems in franchising but that the current state of the law was not sufficient to address those issues.

It is thus fair to ask whether the IFA Code, either in its original version or in its newly watered down version, is intended to in any way change the legal relationship between franchisors and franchisees.

After a careful examination of both the new and the old Code, I have come to the conclusion that to the very limited extent that the old IFA Code did attempt in discrete areas, to affect those legal relationships, the newly issued Code has deliberately erased those limited advances.

Any analysis of the new IFA Code and a comparison with the old must be placed in context in order to determine not only what changes were made but why they were made.

In late 1992, the IFA was in a state of near panic over the filing of your Disclosure, Relationship and Data Bills, coupled with Iowa style bills filed in two dozen states around the country.

The IFA hurriedly published its initial Code, reportedly without consulting its membership. This was done in order to create the illusion of change and to persuade the Congress and State Legislatures that franchisors could police their own.

The IFA was immediately caught in a cross-fire. The Code was rightly greeted with skepticism by franchisee representatives who, while conceding that the Code contained some modest improvements, accurately observed that it lacked an effective enforcement mechanism and was of limited

applicability. At the same time, member franchisors of the IFA complained loudly that the Code had gone too far. Some franchisor attorneys began to advise their clients to insert provisions in their Franchise Agreements stating that the IFA Code does not apply to or affect the franchise relationship. In addition, some franchisors have insisted that they do not consider themselves bound by the Code and will take no steps to alter their policies and procedures to comply with it.

As a result, franchisor members of the IFA demanded and got a significant roll-back in the form of this newly revised Code which was issued in the Spring of this year.

Mr. Chairman, the new Code cuts the heart, however weak, out of the old Code.

How so?

I have prepared a Comparison Study of the 1992 IFA Code and the 1994 IFA Code of Principles and Standards of Conduct which I have attached to my Testimony.

Allow me to highlight the most striking changes and their significance.

**1. Applicability**

The new Code contains a series of qualifications, hidden exceptions, loopholes and roadblocks, making it possible for any franchisor to avoid compliance with even its watered down requirements.

- The new IFA Code, as well as the old, applies only to a franchisor's US operations, excluding the significant foreign operations of many US franchisors.

- The Code states that it only applies "generally" to franchise agreements. For example, the new Code states that "franchise relationships should generally be established by clear and unambiguous franchise agreements." I ask you, Mr. Chairman, when would it be appropriate for a franchise relationship to not be governed by a clear and unambiguous agreement? Are there circumstances when a franchisor should be encouraged or permitted to use a vague franchise agreement?

- The Code claims that some franchise relationships cannot be conducted in compliance with it, although it does not specify the kinds of franchise relationships that fall into this category. This gives any franchisor room to argue that if it is inconvenient to comply with the Code, it need not do so.

- The new IFA Code indicates that it must be applied with "flexibility". This flexibility will undoubtedly be exercised in favor of franchisors and not franchisees who may file complaints.

- The new Code reaffirms the claimed right of franchisors to make unilateral amendments to Franchise Agreements through policy and procedure manuals and directives, thus bypassing the Code entirely.

- All interpretations of the Code are to be made by the Executive Committee of the IFA, whose opinion is binding. This allows the IFA to interpret the Code so as to protect its member franchisors from having to in any way adjust their systems to comply with the Code.

**2. Enforcement**

As with the old Code, the new IFA Code contains no meaningful enforcement mechanism.

The new Code reduces the IFA's role from investigating complaints to reviewing complaints. This presumably means that the IFA will not be permitted to seek information beyond that which a franchisor chooses to disclose in response to a Complaint.

As before, the sanctions to be visited on a violating franchisor under the new Code are limited to the privilege of no longer paying dues to the IFA. There is no provision, in either the new Code or the old, which provides any form of redress for a franchisee whose franchisor violates the IFA Code, even if the violation is willful and deliberate.

### 3. No Rights Created

The new Code is replete with indications that it is not intended to provide any rights to franchisees that do not exist under current law or their franchise agreements.

The new Code states that its standards do not substitute for or supplement the franchise agreement, that it does not create any rights for franchisees, and that compliance with applicable law will constitute compliance with the Code. Clearly the IFA is sending a strong signal that this Code is intended to add nothing and in fact to preserve, to the maximum extent possible, the overwhelming imbalance in the legal relationship between franchisors and franchisees.

### 4. Good Faith and Fair Dealing

The 1992 IFA Code, and the new Code to an even greater extent, seeks to squelch the only area of judge-made common law that is emerging as an

avenue of redress for franchisees.

With repetitiveness and redundancy for emphasis, the Code defines fair, honest and ethical behavior as whatever the franchisor unilaterally decrees is its responsibilities under the Franchise Agreement. Although some courts have opined that the covenant of good faith and fair dealing can explain and clarify the legal rights of parties to a Franchise Agreement, the Code attempts to head off this development by purporting to repeal these implied covenants.

This is not an attempt by franchisors to regulate their own conduct. It is an attempt to preserve their right to create and tender one-sided franchise agreements presented on a take it or leave it basis.

### 5. Franchisee Associations

The original IFA Code encouraged franchisors to open up lines of communication to franchisees through franchisee advisory councils and other communication mechanisms. That language has been weakened to now indicate that a franchisor should foster dialogue with franchisees by such means as the franchisor determines to be most effective. This means that if a franchisor decides that dealing with a franchisee association is contrary to its self-interest, it is free to refuse to deal with such association. In addition, the Code does not contain any prohibition against retaliation against franchisees for participation in such an association.

### 6. Expirations

Both the old and new Code allow a franchisor to decline to renew a franchise for good cause, or if the franchisor lets the franchisee sell the business to a buyer or if it lets the franchisee operate the business under a new name.

The new Code adds a provision that non-renewal is permitted if "the franchisee is otherwise permitted to realize the value of the business (as distinct from the value of the expired franchise)". This puzzling provision seems to imply that if the franchisee can sell the assets of the business, as opposed to the business as a going concern, then renewal can safely be denied. This would allow a franchisor to obliterate any equity the franchisee may have built up.

### 7. Encroachment

The encroachment section of the old Code has been euphemistically designated now as System Expansion. In the old Code there were 12 factors that a franchisor was required to take into account in determining whether or not to open a unit in "proximity" to another. The scope of this section has been further watered down by no longer requiring all of the factors to be taken into account. In addition, none of the factors apply unless the new unit is in "close proximity".

The new Code as well as the old allows the franchisor to balance the needs of the system as a whole (meaning the franchisor) with the interests of the franchisee whose market is encroached upon. Incredibly, this allows a franchisor to syphon off the sales of one of its existing franchisees if the franchisor will benefit economically.

Encroachment is an issue on which there has been much recent litigation. Franchisors have fiercely resisted attempts to limit the extent to which they can compete against their own franchisees. The new IFA Code has rolled back the very limited gains from the old; it now adds nothing to franchisee rights nor does it attempt to set any standards of franchisor conduct in this area.

### 8. Supply Sources

The original Code allowed franchisees to purchase goods and services from sources other than the franchisor as long as the alternative supplier met the franchisor's quality, capacity and financial condition requirements.

The new Code contains self-serving language claiming that controlling the sources of supply is necessary to police franchise system standards and that many franchisors derive their principal revenue by selling goods to their franchisees for resale. The latter consideration is the most telling, as restricting sources of supply is a prevalent and much abused way of diverting profits from

franchisees to franchisors.

Here, the new IFA Code has eliminated all references to the ability of franchisees to purchase from alternate sources, stating only that franchisors must comply in all respects with applicable anti-trust and trade regulation laws.

**9. Discrimination**

The old Code provided that a franchisor should not discriminate on the basis of race, color, religion, national origin, age, disability or sex.

The new Code inexplicably leaves out age as a protected category. Are franchisors seeking the right to discriminate on the basis of age in violation of existing federal law?

Mr. Chairman, if I may return for just a moment to the other two parts of the IFA self-regulation proposal, I would like to make a couple of brief observations.

First, the National Franchise Mediation Program, having been rolled out more than 18 months ago, entirely misses the point.

Alternative dispute resolution is certainly preferable to expensive and time consuming litigation. However, what is needed most is not to resolve disputes that grow out of the legal vacuum created by the absence of any meaningful and effective regulation in this vast sector of our economy, but rather to address the lack of fairness and balance in the relationship between

franchisors and franchisees and to eliminate the hodge podge of inconsistent state laws and judicial decisions. If we did that, there would be fewer disputes to mediate or litigate because franchisors and franchisees would have a clearer picture of what each expects from the other in the franchise relationship.

Moreover, the National Franchise Mediation Program, like the IFA Code, has been largely ignored by the IFA's members. According to the Center for Public Resources, which administers the National Franchise Mediation Program, only 33 franchisors out of more than 700 IFA members have signed on to the program. In addition, of the 31 franchisors represented on the IFA's Board of Directors, only 9 have signed up for the program.

Finally, the IFA's invitation to franchisees to join its association is the most disingenuous, overtly political move imaginable. The IFA spends significant efforts and resources lobbying in opposition to attempts to level the playing field through legislative initiatives at both the federal and state level. The IFA has no intention of allowing franchisees to play a meaningful role in formulation and implementation of its policies. If it did, the IFA Code would never have been watered down to the extent that it was.

Mr. Chairman, the IFA Code is nothing but smoke and mirrors. It is a blatant and cynical attempt to co-opt the growing chorus of voices calling for meaningful and effective regulation of franchise disclosure and relationships. It is time to end this digression and proceed with the real agenda: Restoring

balance to the legal relationship between franchisors and franchisees and ensuring that those who work hard and play by the rules receive a fair return on their time, energy and financial investment.

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Before the Committee on Small Business
United States House of Representatives

"Self Regulation in the Franchising Industry:
The IFA Code of Ethics"

June 30, 1994

Written testimony of
Robert L. Purvin, Jr.,
Chairman, Board of Trustees
American Association of Franchisees
and Dealers

Mr. Chairman:

It gives me great pleasure to return before this Committee to participate in your ongoing review of the franchising industry. The subject of today's hearing, the ability of the franchising industry to be self-regulating, is more than appropriate. Frankly, the topic for discussion gets down to the "nitty-gritty" of testing the record of the franchising industry for fairly and objectively measuring and reporting its performance, as well as the industry's record for developing and enforcing fair and equitable franchise practices. Without mincing words, thus far the industry's record on both counts has been very poor.

The IFA's 1994 edition of its Code of Principles and Standards of Conduct merely extends the industry's predictable record of self aggrandizement, of an inability to establish stringent minimum standards and enforcement of fair and equitable franchising practices, and most importantly, of the failure to "enfranchise" franchisees.

But more than the opportunity to expose the franchising industry's poor record for self-regulation, I am most pleased to alert the Committee to the promising signs of strength and emerging market power of franchised business owners, and emerging signs of a long overdue counter balance in franchising--a counter balance that in my view would never have catalyzed were it not for the efforts of this Committee and the proposal for federal laws to combat franchise fraud and abusive practices.

The Progress of the AAFD Since My Last Appearance.

When I first addressed this Committee in September of 1991, the American Association of Franchisees and Dealers was no more than the dream of a handful of franchisees and franchisee "victims" who saw an urgent need for a generic trade association of franchised business owners. We called ourselves an association of "EEs," the unrepresented troops of franchised business owners who

those who speak for the industry as a whole. Self regulation can provide mechanisms to resolve issues before they become problems; to provide expert guidance and dispute resolution where legislation may be cumbersome or difficult; to educate and advise instead of to confront and escalate. Regretfully, the IFA's Code of Principles, while certainly well-intentioned, provides franchisors with the safe harbor of the status quo.

Thank you.

felt abused and without any meaningful voice, defense or remedy against the powerful lobbies of franchisors.

The franchising industry had successfully painted itself as, in the words of its then Code of Ethics, "...the best opportunity for individuals who are seeking to enter into business for themselves by providing a framework for a mutually beneficial business relationship." When I appeared before you in 1991, I could only report from instinct that the industry was not as represented. Beginning with your early hearings, the stories relating what Debra Bollinger referred to as "The Dark side of franchising" have emerged. Franchisees have begun to recognize that abuse is widespread. More importantly, franchisees are beginning to realize that there is strength in numbers, and that by banding together, meaningful legal protection from franchisee abuse can be achieved.

The American Association of Franchisees and Dealers came into existence in late May of 1992, some eight months after that first hearing, with about 10 lonely members. I appear before you today in my capacity of Chairman of the oldest and (we believe) the largest generic direct member franchisee association in the United States. The AAFD is a multi-faceted trade association dedicated to promoting market and negotiating power and leverage for franchised business owners. We are dedicated to balancing the franchising market place, to educating franchisees and the public to both good and bad franchising practices, and to providing fair and equitable solutions for problems in the industry, including fair and appropriate regulation of the franchising industry.

The AAFD now counts several thousand direct members, representing 10,000 to 12,000 franchised outlets. We have members in well over 100 different franchise systems, including more than 50 trademark specific sections actively forming. The AAFD has a principal objective of creating an effective collective bargaining unit for every franchise system in the United States, and our Trademark Specific Sections, the backbone of our association, is the primary vehicle for helping franchise systems to organize and bargain effectively with their franchisors.

Through our legislative and legal support systems, the AAFD monitors and works to improve the legal system. We seek to expose unfair and abusive practices, and to reward exemplary practices in franchising. In March of this year the AAFD awarded its first ever Fair Franchising Seal to Taco John's International, a company that turned franchisee discord to praise and national recognition by negotiating an exemplary franchise agreement with its independent franchisee association and achieving greater than an 80% satisfaction rating with its franchisees.

I am pleased to leave with the Committee copies of the AAFD's new Member Guide, published this month, which details the expansive growth and services offered by our Association. The success we have enjoyed would never have been achieved had it not been for the

efforts of this committee and the leadership of your Chairman.

The Franchise Fraud

Mr. Chairman, as the Committee may be aware, I have recently published a book entitled, The Franchise Fraud. In a very real sense, my book addresses the very subject of this hearing. The Franchise Fraud is a defined term in my book--it is the false representation by the franchising industry that franchising *per se* is a safe and secure means of owning a business. The Franchise Fraud perpetuates the myth that franchising is a protective industry with promotes and protects the interests of franchisees. Rather, my book describes franchising in terms of the maxim "Power corrupts and absolute power corrupts absolutely!"

The premise of my book was well exemplified by the IFA's old Code of Ethics, a document that extolled the claimed virtue and honor of franchising, even while paying lip service to the establishment of standards. The new IFA Code of Principles and Standards of Conduct goes beyond the old Code in its praise of current franchising practices, and continues the industry tradition of failing to take responsibility for obvious industry abuses.

The premise of my testimony today is that the new IFA Code is the ultimate expression of The Franchise Fraud, the blatant misrepresentation of an industry that has many flaws, a serious market imbalance, and has demonstrated complete failure to establish meaningful minimum standards and practices backed by any serious enforcement effort.

The Essential Criteria for Self-Regulation

Even a cursory review of those industries which have been accorded some degree of self-regulation demonstrate glaring conflicts with the IFA effort at developing either a Code of Ethics or a Code of Conduct.

Looking at the Securities Industry, Airlines, and Labor-Management relations (all segments of our economy that have been accorded some degree of self-regulatory control), we find that the industry regulation is invariably aimed at protecting the unprotected. These industries have been accorded to responsibility for policing themselves only once they have accepted the mandate that their industries owe a high standard of ethical duties to some unprotected group that is vulnerable to abuse by the respective industry in question.

The securities industry has accepted the critical importance of investor protection and confidence, as have the airlines recognized the importance of safety, and so on. Compare the IFA's Code which is replete with protection for franchisors and self-aggrandizement relative to the benevolent order of franchising. Literally nowhere is there a recognition of, and acceptance of responsibility for, the ultimate protection of the rights of

franchisees. Indeed, nowhere is there a list of rights due to franchise owners which are deserving of protection.

The IFA Code is more concerned with praising franchising than it is with setting minimum standads of conduct. Each section of the Code sets forth a principal right of franchisors, and frames the code around the franchisor's rights. In doing so, the IFA has entirely missed the point of self-regulation to self police the rights of those targeted by the industry and who are most susceptible to abuse by fraudulent and unfair practices.

The Franchisee Bill of Rights

The AAFD has promulgated a "Franchisee Bill of Rights," including 15 contractual and/or legal protection every franchisee should receive from the franchisee relationship. The AAFD has also published "Eight Things to Look For in a Franchise," which describes business considerations which distinguish fair and recommended franchise opportunities. Both the "Franchisee Bill of Rights" and the "Eight Things to Look For in a Franchise" are appended to this testimony. Together these statements suggest the kinds of protection that a Code of Ethics and Standards of Conduct should enforce.

Without repeating the Bill of Rights, 9 of the 15 claimed rights are completely ignored by the IFA Standards, including the all important right to some form of equity in the franchised business, any acknowledged duty of care, loyalty or diligence, the right to trademark protection, training, support, marketing assistance, or the right to local dispute resolution. The six categories that are addressed by the IFA Code, which include market protection, disclosure, right of association, renewal and termination rights, and post-termination competition, all are dealt with essentially from the perspective of protecting franchisor interests.

The AAFD's eight criteria for franchise selection present principles of equitable franchise practices from the franchisee perspective, including the franchisors emphasis in selling goods and services to ultimate consumers (and not just selling franchises), the dedication of the franchisor to its franchise system, the promotion and recognition of independent franchisee associations with negotiating authority, the willingness to disclose earnings and earnings data, and respect for the franchisee bill of rights. Only one of these important criteria is even addressed by the IFA Code, which encourages a franchisor to merely provide communication with franchisees *within the franchisors sole discretion.*

The IFA's failure to even address principal franchisee concerns, let alone deal with these concerns fully and fairly (involving franchisees in the codification process), underscores the failure of the franchising industry to understand and accept the responsibility of self-regulation.

The Failure of the IFA Code to Regulate.

While I view the revised IFA Code as a step back from accepting responsibility for the fair treatment of franchisees, previous Codes were little better (and wholly inadequate from the franchisees perspective). Simply stated, the IFA has not yet accepted responsibility to protect franchisees with stringent rules of conduct. Moreover, the IFA has never created meaningful enforcement apparatus, sufficient to give teeth to the rules that have been put in place. In fact, after 22 years in franchising, I am not aware of any instance of IFA rule or Code enforcement, even by censure of a member. Rules, weak or strong, are meaningless without some modicum of enforcement.

The Role of Government in Self-Regulated Industries.

The IFA has promoted self-regulation in lieu of government mandated standards of conduct and practices. Such carte blanche authority to self-regulate would be absolutely unprecedented. Indeed, every "self-regulated" industry known to this witness has legal standards defined by legislation and Congressional mandate. When an industry is given authority to regulate itself, the authority of law invariably prescribes the minimum standards the industry must maintain in order to retain the right of self-regulation.

Thus the securities industry is charged with the responsibility to enforce the protections mandated by the Securities Act of 1933, and the Securities Exchange Act of 1934. Other industries have been delegated the authority to enforce legally enacted mandates. Much the same way as a parent lays down the law in advising warring siblings to "settle your differences, or I will settle them for you," most laws that delegate regulation to industries carry a similar warning.

Self-regulation should not mean government abdication of strict rules for franchise conduction. Rather, self-regulation should be no more than allowing the industry to police itself in upholding legally mandated protection for franchisees. Even such authority must be earned by the acceptance of the franchising industry of the essential rights of owning a franchise business. Until the industry is ready to accept this responsibility, and until franchisees are truly included in the regulating process, self-regulation will not be a viable alternative to government mandated franchisee protection.

Respectfully submitted,

Robert L. Purvin, Jr.
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and Dealers

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