

**THE FTC'S FRANCHISE RULE: TWENTY-THREE  
YEARS AFTER THE PROMULGATION**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
COMMERCE, TRADE, AND CONSUMER PROTECTION  
OF THE  
COMMITTEE ON ENERGY AND  
COMMERCE  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED SEVENTH CONGRESS  
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## THE FTC'S FRANCHISE RULE: TWENTY-THREE YEARS AFTER THE PROMULGATION

TUESDAY, JUNE 25, 2002

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON ENERGY AND COMMERCE,  
SUBCOMMITTEE ON COMMERCE, TRADE,  
AND CONSUMER PROTECTION,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Walden, and Rush.

Staff present: Ramsen Betfarhad, majority counsel; Brendan Williams, legislative clerk; and Jonathan J. Cordone, minority counsel.

Mr. STEARNS. Good morning, everybody. I am pleased to welcome all of you to the Commerce, Trade, and Consumer Protection Subcommittee hearing on the FTC Franchise Rule. I wish to thank the witnesses for appearing before the committee and look forward to their testimony.

The FTC Franchise Rule mandates a pre-sale disclosure of certain material facts by a franchisor to a prospective franchisee. The rule was promulgated in 1979 and has not changed since. A lot can and does change in 23 years. During the past 23 years, communism has all but vanished. Global trade has expanded exponentially and the Internet has evolved from a mere curiosity to an everyday business necessity. Yet the Franchise Rule, the rule that regulates one of the fastest growing and most important fields of private enterprise, franchising, employing more than 8 million Americans and accounting for \$1 trillion in retail sales, has not changed since its inception in 1979.

As time and circumstances have changed many argue that through creative and sometimes not so creative interpretation of the 1979 rule, franchisors have avoided disclosing important facts and practices to prospective franchisees, creating cause for consternation years later when both the franchisee and the FTC are powerless to effectively address them. To its credit the Commission began the process of reviewing and amending the rule in 1997. Nevertheless, the review process has yet to reach its fruition and yield a new Franchise Rule more responsive to today's business reality.

Meanwhile, since 1993, 15 States have adopted the Uniform Franchise Offering Circular, UFOC, according greater protection to franchisees resident in those States over those offered by the

Federal rule. The UFOC to a great extent came about because many States concluded that the Federal Franchise Rule was outdated and therefore less effective.

Today my colleagues will hear testimony from the Commission as to its review efforts and its proposed amendment to the rule. We will also hear proposed amendments offered by others, most of which share the objective of harmonizing the FTC Franchise Rule disclosure requirements with those of the UFOC.

I commend those efforts. I strongly encourage that the Commission undertake its review and amending of the rule on an expedited timetable. I also support the promulgation of a separate rule for business opportunity franchises, as they pose substantially different questions and challenges than business format franchises. Amending the rule so that it better serves its intended purpose, protection of perspective franchisees through pre-sale disclosure of the pertinent facts about the franchise is one thing, enforcing the rule is something different.

The Commission reports that since the rules promulgation in 1979 it has brought over 200 franchise and business opportunity cases under both the Rule and Section 5 of the FTC Act. Meanwhile, just in the period 1993 to 1999 the Commission received nearly 4,000 complaints. The question that I have for the Commission is why so few prosecutions?

Finally, as members we are typically approached by aggrieved franchisees, be they friends, constituents, with some degree of frequency. Most of the issues that trouble these franchisees arise post-sale or after the signing of the franchise contract and, as such, don't implicate the disclosure requirements of the FTC Franchise Rule. For example, many franchisees have complained about the renewal and supply sourcing policies, whether the franchisor is required to buy all supplies from the franchisor or its designee.

Now I have had that experience myself having franchises in which I have to buy everything from the franchisor, and then pretty soon I end up buying the installation by the franchisor. Moreover, the franchisees identify encroachment as yet another contentious problem. Where a new franchisee was assigned a franchise territory they encroached on a preexisting franchisee's territory.

Holiday Inn sells you a franchise. You have a Holiday Inn, and pretty soon right next to it goes a Crown Plaza. They are upscale, and right next to it goes their budget hotel. And so here you thought you had a franchise with Holiday Inn, you find you have two competitors side by side, a low end and a high end. You go to the book to look where your property is and the three properties are there together and you thought you had it.

Or they give you a franchise and they tell you that there will not be a franchise within 5 miles of your property. And lo and behold, the rules change and they say, Mr. Stearns, we have done a study which shows we are now putting another Howard Johnson right within 3 miles of your Howard Johnson. And then I say to them, well, that is not fair because you told me I was going to have this. And they say, well, our rules changed because the population density changes and that means, Mr. Stearns, we are putting another Howard Johnson within 3 miles of you and there is nothing in the

contract that says we can't do this. And so, lo and behold, another franchise Howard Johnson.

It might be my friend at Chamber of Commerce, at the Kiwanis, who sits with me at lunch who suddenly is my strong competitor, and he is a brand new property, I am an older property and he is now within 3 miles and, lo and behold, he takes my business.

So I am well aware of some of those things. But these are clearly post-sale issues not under our jurisdiction. I can complain, can't do anything about it. Nevertheless, I wonder to what extent can these post-sale problems be avoided and lessened with a better disclosure rule. Some will argue that post-sale problems cannot be effectively addressed by any disclosure rule. That may be true—still the Commission should strive to promulgate a new Franchise Rule that better informs a prospective franchisee of some of the challenges such as encroachment and renewal that he or she may face post-sale. You can't get too much information. The person that comes in should be more careful and that is his, the whole caveat emptor as a franchisee. You have to assume a certain level of risk. So you can't be a cry baby after you sign the contract and say I want all these rules changed, because you are a big boy, you are putting up your own money and you have to decide if you want to go ahead with this.

If the Federal Franchise Rule is not made more effective, more responsive to problems that plague franchisor-franchisee relationships today, then the call by some for a Federal law governing aspects of post-sale relationship will not subside. After all, in the past Congress has enacted post-sale relationship statutes applicable to the largest industries within the franchising world, the auto and gasoline retailing. So we have those exception. We are not suggesting that we do that, but we do bring up at this hearing that we have these post-sale relationship statutes in place. So we are not suggesting it, but I think from the point of information and from my colleagues they should realize that these statutes do apply to auto and gasoline retailing.

So that is my opening statement, and with that I am pleased to have an opening statement from the ranking member who is taking Mr. Towns' place, Mr. Rush.

[The prepared statement of Hon. Clifford Stearns follows:]

PREPARED STATEMENT OF HON. CLIFFORD STEARNS, CHAIRMAN, SUBCOMMITTEE ON  
COMMERCE, TRADE, AND CONSUMER PROTECTION

Good morning. I am pleased to welcome all of you to the Commerce, Trade and Consumer Protection subcommittee's hearing on the FTC Franchise Rule. I wish to thank the witnesses for appearing before the committee and look forward to their testimony.

The FTC Franchise Rule mandates a pre-sale disclosure of certain material facts by a franchisor to a prospective franchisee. The Rule was promulgated in 1979 and has not changed since. A lot can and does change in 23 years. During the past twenty-three years, communism has all but vanished, global trade has expanded exponentially, and the internet has evolved from a mere curiosity to an everyday business necessity. Yet the Franchise Rule, the rule that regulates one of the fastest growing and most important fields of private enterprise (franchising) employing more than 8 million Americans and accounting for \$1 trillion in retail sales, has not changed since its inception in 1979.

As the times and circumstances have changed, many argue that through creative and sometimes not so creative interpretation of the 1979 rule, franchisors have avoided disclosing important facts and practices to prospective franchisees creating cause for consternation years later, when both the franchisee and the FTC are pow-

erless to effectively address them. To its credit the Commission began the process of reviewing and amending the Rule in 1997. Nevertheless, the review process has yet to reach its fruition and yield a new franchise rule more responsive to today's business realities. Meanwhile, since 1993, fifteen states have adopted the Uniform Franchise Offering Circular (UFOC) according greater protections to franchisees resident in those states over those offered by the federal rule. The UFOC, to a great extent, came about because many states concluded that the federal Franchise Rule was outdated and therefore less effective.

Today, we'll hear testimony from the Commission as to its review efforts and its proposed amendments to the Rule. We'll also hear of proposed amendments offered by others, most of which share the objective of harmonizing the FTC Franchise Rule disclosure requirements with those of the UFOC. I commend those efforts. I strongly encourage that the Commission undertake its review and amending of the Rule on an expedited timetable. I also support the promulgation of a separate rule for business opportunity franchises as they pose substantially different questions and challenges than business format franchises.

Amending the Rule so that it better serves its intended purpose: protection of prospective franchisees, through the pre-sale disclosure of pertinent facts about the franchise is one thing. Enforcing the Rule is something different. The Commission reports that since the Rule's promulgation in 1979, it has brought over 200 franchise and business opportunity cases under both the rule and section 5 of the FTC Act. Meanwhile, just in the period 1993-99, the Commission received nearly 4000 complaints. The question that I have for the Commission is: why so few prosecutions?

Finally, as members, we are typically approached by aggrieved franchisees, be they friends or constituents, with some degree of frequency. Most of the issues that trouble those franchisees arise post-sale or after the signing of the franchise contract and as such don't implicate the disclosure requirements of the FTC Franchise Rule. For example, many franchisees have complained about the renewal and supply sourcing policies (whether the franchisee was required to buy all supplies from the franchisor or its designee) of their respective franchisors. Moreover, the franchisees identify encroachment as yet another contentious problem—where a new franchisee was assigned a franchise territory that encroached on a pre-existing franchisee's territory. These are clearly post-sale issues. Nonetheless, I wonder to what extent can these post-sale problems be avoided or lessened with a "better" disclosure rule. Some will argue that post-sale problems cannot be effectively addressed by "any" disclosure rule. That may be true. Still, we, specifically the Commission, should strive to promulgate a "new" Franchise Rule that better informs a prospective franchisee of some of the challenges, such as encroachment and renewal, that he/she may face post-sale. If the federal franchise rule is not made more effective, i.e., responsive to problems that plague franchisor-franchisee relations today, then the call by some for a federal law governing aspects of post-sale relationship will not subside. After all in the past Congress has enacted post-sale relationship statutes applicable to two of the largest industries within the franchising world: the auto and gasoline retailers.

Mr. RUSH. Thank you, Mr. Chairman. Thank you for holding this hearing on the FTC's Franchise Rule. There are important questions about how this 23-year-old rule affects the industry it regulates, as well as the efficiency of the administrative processes at the FTC. The FTC began its review of the Franchise Rule in April 1995. However, noticed rule changes were proposed in 1997. That rule, however, remains unaltered even until today.

Now, after 7 years the FTC first sought public comment regarding amendments to the rule. Now the Commission tells us that it will release a staff report, a staff report, I remind you, not even a proposed final rule, by early 2003. I hope the Commission can tell us a little bit more today about these deliberations and shed some light on the significant delay.

The substance of the Franchise Rule also raises important questions. The relationship between franchisees and franchisors is unique among American businesses. As franchising becomes more prevalent in our Nation's economy, the nature of that relationship



should be explained more closely and examined much more closely by the FTC and by the Congress.

Are franchisees consumers of a product made by franchisors? If so, should they receive additional consumer protections enforced by the FTC? Or are they merely business partners whose relationship is more appropriately governed by State contract law? And most importantly, are potential franchisees adequately informed about the nature of this relationship and the pitfalls that they may face?

Today we will be hearing from representatives on both sides of the issue as well as the FTC and State Attorney General. I look forward to hearing their views as our subcommittee begins its inquiry into the franchise industry.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. STEARNS. Thank you. Mr. Shimkus for an opening statement.

Mr. SHIMKUS. Thank you, Mr. Chairman, and the benefits of small business and job creation is indisputable. However, we have all read and heard horror stories over the years of small business people buying into franchises and then running into a bait and switch problem. Franchising has become a major engine in economic growth in our country and around the world. With as many as 8 million Americans employed by franchises, it is important to ensure that franchisors abide by a code of fairness and truthfulness in dealing with their franchisees.

The GAO issued a report in July 2001 on the FTC regulation of franchising. Among its findings were that complaints by franchisees to the FTC had risen dramatically and that 92 percent of these complaints are specifically about the post-sale relationship. However, the FTC repeatedly complained of a lack of resources and authority to address the post-sale relationship issues.

I look forward to today's hearing and the panel's report and views on what the Federal Government's role should be in regulation of franchising and what can be done to improve the FTC's franchising rule. Again, I thank Chairman Stearns for holding this important consumer protection hearing, and with that, Mr. Chairman, I yield back the balance of my time.

Mr. STEARNS. I thank my colleague.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. CHARLES F. BASS, A REPRESENTATIVE IN CONGRESS  
FROM THE STATE OF NEW HAMPSHIRE

Mr. Chairman, I thank you for holding this hearing. I am pleased the Subcommittee has the opportunity to revisit the issue

With 8 million Americans employed by franchises, the FTC franchise rule is one that affects a significant segment of the population. Given that the commission has been collecting comments since 1997 and that the rule was promulgated 23 years ago, it is timely to consider this disclosure rule again in light of more recent legislation and business trends.

These relationship issues regarding policy disclosure, FTC regulation, enforcement and even corporate governance may require renewed consideration and deliberation and I look forward to today's testimony.

I yield back to the Chairman.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON  
ENERGY AND COMMERCE

Thank you, Mr. Chairman, for calling this hearing today on the Federal Trade Commission's Franchise rule. It has been some time since this Committee examined

the guidelines set forth in the Rule, and so I am pleased we have two distinguished panels here today to bring us up to speed.

The "franchise" is one of this country's most successful business relationships. Franchise systems continue to provide the widest possible entrepreneurial opportunities for citizens of this country. Today, with more than 75 industries operating within the franchising format, franchise companies are major contributors in the development of the management and technical skills that help to produce an experienced work force and to support the economic vitality of this country. There are hundreds of thousands of people who have succeeded in this country by investing in franchises—from McDonald's restaurants, to Hilton hotels, to 7-11 convenience stores.

As with any other business relationship, however, franchise relationships have certainly had their share of problems. In order to prevent abuses, the FTC implemented the Franchise Rule in 1979 to ensure that the parties to any franchise agreement received pre-sale disclosures of important franchise information. Today, every U.S. franchisor must disclose certain information to prospective franchise buyers so both parties can enter into an agreement having made informed business decisions.

To the Commission's credit, the rules have not changed substantially since they were first implemented. But, as Mr. Beales, our witness from the FTC, will tell us today, the Franchise Rule covers both franchises and so-called business opportunity enterprises. In a business opportunity, the promoter promises to provide the buyer with equipment, such as vending machines, used to sell products or services.

It is in the area of "business opportunities" that the FTC is receiving an increasing number of complaints. Of the 170 cases the FTC brought in 2001 under the Commission's Franchise Program, a startling 148 of those were business opportunity scams. I am heartened to see the FTC, as the agency empowered to protect consumers against schemes designed to separate people from their money, is taking aggressive enforcement steps to address the growing problems seen in this area.

Since the Franchise rule has been in place for 23 years, it is about time the Commission took a fresh look and considered appropriate amendments. I understand that the FTC is currently in the process of making amendments to the Franchise Rule to reflect changes in the marketplace and to further increase the pre-sale disclosures. I look forward to hearing about these proposed changes and the impact they will have for both franchisees and franchisors.

I thank our witnesses for appearing here today and, again, I thank the Chairman for holding this hearing. Thank you.

Mr. STEARNS. We welcome our first witness, Mr. Howard Beales, Director of the Bureau of Consumer Protection in the FTC. Mr. Beales has been before us before. We welcome you, and we look forward to your opening statement.

**STATEMENT OF J. HOWARD BEALES III, DIRECTOR, BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION**

Mr. BEALES. Thank you, Mr. Chairman. It is always a pleasure to be here, and thank you also to the members of the subcommittee. I am pleased to be here today to discuss the FTC's Franchise Rule. The written statement that I have submitted represents the views of the Federal Trade Commission. My oral statement and responses to questions are my own and not necessarily those of the Commission or any individual Commissioner.

The Franchise Rule seeks to facilitate informed decisions and to prevent deception in the sale of franchises. Rather than regulate the substance of the terms controlling the relationship, the rule requires franchisors to provide prospective franchisees with material information that they need prior to the sale. As you know, the rule works in conjunction with section 5 of the FTC Act, which prohibits unfair and deceptive practices. The Commission aggressively investigates and prosecutes violations of the Franchise Rule and section 5 against franchisors and business opportunity sellers. To date the

Commission has brought over 200 such law enforcement actions, involving over 640 entities and individuals.

I am pleased to tell you that just last week the Commission announced the filing of over 70 new cases by the FTC, the Department of Justice and our State partners in a FTC coordinated sweep against fraudulent business opportunities and related scams. The majority of the FTC's franchise related actions have targeted business opportunities.

As you know, the Franchise Rule generally covers two different types of business arrangements, franchises and business opportunity ventures. Although the Commission receives few franchisee complaints alleging fraud, deception or substantive rule violations by franchisors, the same cannot be said of business opportunity sellers. Many business opportunities are outright scams that disappear shortly after taking consumers money.

Unfortunately, compliance with the Franchise Rule by business opportunity sellers is low. This fact is amply demonstrated by the analysis of our complaint data base contained in the Commission's prepared testimony. We receive far more consumer complaints about the sale of business opportunities than we receive about traditional franchises. The complaint data also indicate that unlike complaints about traditional franchises, business opportunity fraud is a leading cause of consumer injury.

The same pattern is evident when we examine the number of complaints about particular sellers. Although we often receive large numbers of complaints about a single business opportunity scam, we rarely receive complaint from more than one franchisee about the same franchisor. Accordingly, the Commission continues to focus much of its Franchise Rule enforcement resources on prosecuting business opportunity frauds.

Finally, as the subcommittee is aware, the Commission is in the process of updating the Franchise Rule. In 1999, the Commission published a notice of proposed rulemaking which sets forth the text of a proposed rule. Among other things, the proposal would review the rule in four material respects. It would focus exclusively on franchise issues so that business opportunities would be handled in a separate rulemaking.

Second, the proposal would revise the Franchise Rule along the model of the uniform franchise offering circular guidelines.

Third, the proposal would update the rule to address franchise disclosures made via the Internet.

Finally, the proposal would provide prospective franchisees with more information about the state of the franchise relationship.

We are hopeful of forwarding a staff report to the Commission, which would be the next stage in this process, at some point in the fall. That staff report would then be subject to public comment under the FTC's procedures.

Mr. Chairman, the FTC greatly appreciates the opportunity to testify, and I would be happy to answer any questions that you or members of the committee may have.

[The prepared statement of J. Howard Beales III follows:]

PREPARED STATEMENT OF J. HOWARD BEALES, III, DIRECTOR, BUREAU OF CONSUMER PROTECTION, FEDERAL TRADE COMMISSION

Mr. Chairman, I am J. Howard Beales, III, the Director of the Federal Trade Commission's Bureau of Consumer Protection.<sup>1</sup> On behalf of the Commission, I appreciate this opportunity to provide information to the Subcommittee on franchising and the Commission's enforcement of the Franchise Rule.<sup>2</sup> As you know, the Commission promulgated the Franchise Rule in the late 1970s, and since that time has rigorously enforced its provisions. Since the Franchise Rule was enacted, the Commission has brought over 200 franchise and business opportunity cases against over 640 entities and individuals. Indeed, just last week, the Commission announced its seventh joint law enforcement sweep in this field. Together with the Department of Justice and our state partners, we have filed over 70 cases against business opportunities and related schemes, the most prevalent and persistent problem in Franchise Rule enforcement.

The FTC's mission is to protect American consumers by taking action against unfair or deceptive acts or practices and by promoting vigorous competition. To that end, the Commission enforces the Federal Trade Commission Act ("FTC Act"), which prohibits unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.<sup>3</sup> The FTC Act also empowers the Commission to prescribe rules that define with specificity acts or practices that are unfair or deceptive.<sup>4</sup> One such rule is the Commission's Franchise Rule.<sup>5</sup> Today, I will describe the Franchise Rule and the Commission's enforcement history. I will then discuss franchise relationship issues and the Commission's ongoing rule amendment proceeding.

#### I. BACKGROUND

##### A. *The Franchise Rule Provides Important Information And Prohibits Deceptive Practices*

When the Commission promulgated the Franchise Rule in the 1970s, the Commission determined that prospective franchisees needed certain critical information from franchisors. Without adequate information, prospective franchisees risked serious economic injury as a result of misrepresentations or omissions of material facts about the franchise business under consideration. Prevalent deceptive practices included the misrepresentation of: (1) the nature of the franchise; (2) the range of goods and services, such as supplies, equipment, and training, to be provided as part of the franchise package; (3) the value and profitability of the franchise; and (4) the franchisor's financial stability and prior experience.<sup>6</sup>

The Franchise Rule seeks to facilitate informed decisions and to prevent deception in the sale of franchises by requiring franchisors to provide prospective franchisees with material information prior to the sale. Specifically, the Franchise Rule requires franchisors to make material disclosures in five categories: (1) the nature of the franchisor and the franchise system; (2) the franchisor's financial viability; (3) the

<sup>1</sup>The views expressed in this statement represent the views of the Commission. My oral statement and responses to any questions you may have are my own and are not necessarily those of the Commission or any Commissioner.

<sup>2</sup>Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. Part 436. The Commission also enforces over 30 rules governing specific industries and practices, for example: the Funeral Rule, 16 C.F.R. Part 453, which requires funeral providers to give consumers accurate price lists that itemize goods and services offered; and the Telemarketing Sales Rule, 16 C.F.R. Part 310, which defines and prohibits deceptive telemarketing practices and other abusive telemarketing practices.

<sup>3</sup>15 U.S.C. § 45(a).

<sup>4</sup>15 U.S.C. § 57a.

<sup>5</sup>In many respects, franchisees are not ordinary consumers. For example, the Magnuson-Moss Warranty Act defines "consumer" as "a buyer...of any consumer product." In turn, it defines "consumer product" in relevant part as "any tangible personal property which is distributed in commerce and which is normally used for personal, family, or household purposes." 15 U.S.C. § 2301. Similarly, the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7001 *et seq.* defines "consumer" as "an individual who obtains, through a transaction, products or services which are used primarily for personal, family, or household purposes..." *Id.* at § 7006. Franchisees, in contrast, do not just buy products, but invest in a business system. Indeed, several states have held that franchisees are not "consumers" entitled to protection under state general consumer protection statutes. *E.g., West Coast Franchising Co. v. WCV Corp.*, 30 F. Supp. 2d 49 (E.D. Pa. 1998); *Sparks Tune Up Centers v. Addison*, Civ. No. 89-1355, 1989 U.S. Dist. LEXIS 7413 (E.D. Pa. 1989)(applying Ohio law). This view, however, is not universal. *See, e.g., Hofsettler v. Fletcher*, 905 F.2d 897 (6th Cir. 1988); *Deerman v. Fed. Home Loan Mortg. Corp.*, 955 F. Supp. 1393 (N.D. Ala. 1997); *LJS Co. v. Marks*, 480 F. Supp. 241 (S.D. Fla. 1979).

<sup>6</sup>*See* Franchise Rule Statement of Basis and Purpose, 43 Fed. Reg. 59,614, 59,624-632 (Dec. 21, 1978).

costs involved in purchasing and operating a franchised outlet; (4) the terms and conditions that govern the franchise relationship; and (5) the names and addresses of current franchisees who can share their experiences within the franchise system, thus helping the prospective franchisee to verify independently the franchisor's claims. In addition, franchisors must have a reasonable basis and substantiation for any earnings claims made to prospective franchisees, as well as disclose the basis and assumptions underlying any such earnings claims.

*B. The Franchise Rule Covers Sales Of Franchises And Business Opportunity Ventures*

The Franchise Rule generally covers two different types of business arrangements: franchises and business opportunity ventures. Franchises typically involve retail outlets that bear the franchisor's trademark and follow the franchisor's business operations model, such as fast-food restaurants, hotels, and automotive repair shops. These are commonly known as "business-format" franchises.<sup>7</sup> Business opportunities, on the other hand, often do not entail a trademark or detailed business plan. In a business opportunity, the promoter typically promises to provide the buyer with equipment that is used to sell products or services to the public, such as vending machines, rack displays, pay phones, or medical billing software. The business opportunity promoter also frequently promises to find the buyer a market for the products or services sold by securing locations or accounts for the equipment used in the business, such as placing vending machines or rack displays in airports or bowling alleys, or providing the names of doctors seeking medical billing assistance.

*C. Fifteen States Also Have Franchise Disclosure Laws*

The FTC is not the only governmental entity to address pre-sale disclosure of franchise information. In addition to the FTC, 15 states require pre-sale disclosure in franchise sales in the form of a Uniform Franchise Offering Circular ("UFOC").<sup>8</sup> In many respects, the UFOC Guidelines' required disclosures are substantially similar to those of the Franchise Rule. Both formats, for example, require a description of: (1) the franchisor and its business; (2) prior litigation and bankruptcies; (3) initial and ongoing fees; (4) franchisor and franchisee obligations and other terms of the franchise contract; (5) restrictions on sales; and (6) rights to renew and terminate the franchise. In addition, both formats require substantiation of any earnings claims, statistics on existing franchisees, a list of franchisee references, and audited financial statements.<sup>9</sup>(3) computer system requirements; and (4) the names and addresses of former as well as current franchisees.

Because a UFOC is accepted by both the states and the FTC, the UFOC Guidelines have effectively become the national franchise disclosure standard.

## II. FRANCHISE RULE ENFORCEMENT

The Franchise Rule has the force and effect of law, and it may be enforced through civil penalty actions in federal courts.<sup>10</sup> The FTC Act authorizes courts to impose civil penalties of not more than \$11,000 per compliance violation. In addition, the Commission may seek to obtain preliminary and permanent injunctive relief (including the full range of equitable remedies) in federal court.<sup>11</sup> Such actions often result in monetary redress made to injured consumers.

To date the Commission has brought over 200 law enforcement actions under the Franchise Rule and Section 5 of the FTC Act against franchisors and business opportunity ventures, involving over 640 entities and individuals. Many of those actions have been against well-known franchise systems. For example, the Commis-

<sup>7</sup>The Franchise Rule also covers "product franchises," in which the franchisee typically distributes products manufactured by the franchisors, such as automobile dealerships. See Franchise Rule, Final Interpretive Guides, 44 Fed. Reg. 49,966, 49,966-967 (Aug. 24, 1979).

<sup>8</sup>These states are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, Michigan, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Twelve of these states review and approve franchisors' UFOCs before they can be used in the state. In order to reduce franchisors' compliance burdens, the Commission will accept a UFOC in lieu of a franchise disclosure document.

<sup>9</sup>The UFOC Guidelines, however, focus exclusively on franchise sales; business opportunities are regulated to varying degrees in 22 states. The UFOC Guidelines also contain more expansive disclosures than the Franchise Rule. For example, the UFOC Guidelines require the disclosure of: (1) regulations specific to the industry in which the franchisee will conduct business; (2) litigation or a bankruptcy involving a franchisor's predecessor;

<sup>10</sup> 15 U.S.C. § 45(m)(1)(A).

<sup>11</sup> 15 U.S.C. § 53(b).

sion brought suit against Minuteman Press, a national printing franchisor.<sup>12</sup> That case, which involved a six-month trial, resulted in a settlement in which the defendants paid over \$3 million in consumer redress.

#### *A. Distinctions Between Business-Format Franchisors And Business Opportunity Sellers*

Our law enforcement experience shows that business-format franchising has matured since the promulgation of the Franchise Rule in the 1970s.<sup>13</sup> Many franchise systems today are established, well-respected, household names.<sup>14</sup> While there is no question that fraud may occur in the sale of some franchises, the Franchise Rule's pre-sale disclosure requirements provide valuable information to help protect against fraud. Where Rule violations occur, it is mostly among small, start-up franchisors who may not be well-versed in the Franchise Rule's disclosure requirements.<sup>15</sup> As a result, the Commission receives few franchisee complaints alleging fraud, deception, or substantive Rule violations by business-format franchisors.

Unfortunately, the same cannot be said of business opportunity sellers. Many business opportunities are outright scams that disappear shortly after taking consumers' money. Compliance with the Franchise Rule by business opportunity sellers is low. A 2001 Staff Review of the Commission's Franchise Program reported that the Commission brought 170 franchise or business opportunity cases against 330 entities and 305 individuals between 1993 and 2001.<sup>16</sup> Of the 170 cases, 148 were against business opportunity schemes.<sup>17</sup> Commission actions have involved, for example, the deceptive sale of vending machine<sup>18</sup> and rack display<sup>19</sup> opportunities;

<sup>12</sup> *FTC v. Minuteman Press, Int'l*, Civ. No. CV-93-2496 (DRH)(E.D.N.Y. 1993). See also, e.g., *FTC v. Car Wash Guys, Int'l, Inc.*, Civ. No. 00-8197 (C.D. Cal. 2000); *FTC v. Tower Cleaning Sys., Inc.*, Civ. No. 96-58-44 (E.D. Pa. 1996); *U.S. v. Tutor Time Child Care Sys., Inc.*, Civ. No. 96-2603 (N.D. Cal. 1996); *FTC v. Indep. Travel Agencies of Am. Assoc.*, Civ. No. 95-6137-CIV-Gonzalez (S.D. Fla. 1995); *FTC v. Mortg. Serv. Assoc.*, Civ. No. 395-CV-1362 (AVC) (D. Conn. 1995); *U.S. v. Jani-King Int'l, Inc.*, Civ. No. 3-95-CV-1492-G (N.D. Tex. 1995).

<sup>13</sup> Since the promulgation of the Franchise Rule and the UFOC Guidelines in the 1970s, no additional state has sought to adopt franchise disclosure regulation. Indeed, several states, including Michigan, Wisconsin, and Indiana, have eliminated routine review of UFOC filings.

<sup>14</sup> The franchise legal community is also well-organized. For example, the American Bar Association's Forum on Franchising has nearly 600 members. Franchisors are also represented by the International Franchise Association ("IFA") and the National Franchise Council. Franchisees are represented by various groups including the IFA, American Franchise Association, and American Association of Franchisees and Dealers. In addition, we have recently seen the growth of franchisee councils and independent franchisee associations that represent franchisee interests, such as the National Franchise Association (the association of Burger King franchisees).

<sup>15</sup> In such instances, the FTC staff may recommend that the alleged violation be addressed through a referral to the National Franchise Council ("NFC"), a private industry group comprised of a limited number of select franchise systems, mostly in the hotel and food industries. Franchisors who agree to be referred to the NFC's Alternative Law Enforcement Program receive Franchise Rule compliance training, compliance monitoring, and in, some instances, participate in mediation of franchisee complaints. This approach to addressing minor, non-fraudulent violations of the Franchise Rule is consistent with the goals of the Small Business Regulatory Fairness Enforcement Act, 5 U.S.C. § 601, *et seq.*, which, among other things, requires agencies to consider reducing or waiving civil penalties in appropriate circumstances.

<sup>16</sup> Bureau of Consumer Protection Staff, Franchise and Business Opportunity Program Review 1993-2000 (June 2001) ("Staff Review") at 33. A copy of this Staff Review is available at the Commission's Web site at: <http://www.ftc.gov/bcp/reports/franchise9301.pdf>.

<sup>17</sup> Similarly, in its 2001 audit of the Commission's Franchise Program, the General Accounting Office ("GAO") found that, between 1993 and 2000, the Commission staff opened 332 franchise and business opportunity investigations, the overwhelming majority of which involved business opportunities. GAO, Federal Trade Commission Enforcement of the Franchise Rule (July 2001) ("GAO Report") at 13-15. See also Appendix V: Information on Business Opportunity and Franchise Court Cases Filed by FTC During 1993-2000, *id.* at 49-64.

<sup>18</sup> See, e.g., *FTC v. Pathway Merch., Inc.*, Civ. No. 01-CIV-8987 (S.D.N.Y. 2001); *FTC v. Hi Tech Mint Sys, Inc.*, Civ. No. 98 CIV 5881 (S.D.N.Y. 1998); *U.S. v. PVI, Inc.*, Civ. No. 98-6935 CIV-Ferguson (S.D. Fla. 1998); *FTC v. Telecard Dispensing Corp.*, Civ. No. 98-7058-CIV (S.D. Fla. 1998); *FTC v. Hi Tech Mint Sys., Inc.*, Civ. No. 98-CIV-5881 (N.D.N.Y. 1998); *FTC v. Vendall Mktg. Corp.*, Civ. No. 94-6011-HO (D. Or. 1994); *FTC v. Vendorline, Inc.*, Civ. No. 2:92-cv-129-WCO (N.D. Ga. 1992). See also FTC News Release: FTC Announces Operation "Vend Up Broke" (Sept. 3, 1998)(FTC and 10 states announce 40 enforcement actions against fraudulent vending business opportunities).

<sup>19</sup> See, e.g., *U.S. v. QX Int'l*, Civ. No. 3:98CV453-D (N.D. Tex. 1998); *FTC v. Carousel of Toys*, Civ. No. 97-8587 CIV-Ungaro-Benages (S.D. Fla. 1997); *FTC v. Urso*, Civ. No. 97-2680 CIV-Ungaro-Benages (S.D. Fla. 1997); *FTC v. Infinity Multimedia, Inc.*, Civ. No. 966671CIV-Gonzalez (S.D. Fla. 1996); *FTC v. Andrisani*, Civ. No. 93-6511 (S.D. Fla. 1993). See also FTC News Release: Display Racks for Trade-Named Toys and Trinkets are the Latest in Business Opportunity Fraud Schemes (Aug. 5, 1997)(FTC and eight states file 18 enforcement actions against sellers of bogus business opportunities that use trademarks of well-known companies).

pay telephones,<sup>20</sup> fax,<sup>21</sup> and Internet access<sup>22</sup> ventures; 900-number telephone schemes;<sup>23</sup> and medical billing opportunities.<sup>24</sup> Almost all of these cases involved the making of false or unsubstantiated earnings representations in violation of the Rule and most alleged that the promoter failed to provide prospects with any disclosures whatsoever.

In addition to violating the Franchise Rule, business opportunity sellers also frequently engage in a myriad of deceptive acts and practices in violation of Section 5 of the FTC Act in order to lure unsuspecting consumers to invest. For example, business opportunity sellers often disseminate false earnings projections and make false promises of exclusive market territories. In addition, they often use shill references or false testimonials to create the impression that their opportunity is safe and profitable. Typically, they also misrepresent the availability or profitability of locations for vending machines or other equipment used in the business; misrepresent their prior success; misrepresent assistance to be provided to the purchaser; and misrepresent the nature of their products or services.<sup>25</sup>

#### *B. The Commission's Law Enforcement Efforts Track Consumer Complaint Data*

The Commission's law enforcement efforts described above track the breakdown of complaints the FTC receives. Overwhelmingly, the complaints the Commission receives involve the sale of business opportunities. The Commission's staff analyzed 4,512 franchise and business opportunity complaints in the Commission's Consumer Information System ("CIS") database between 1993 and June 1999. Of the 4,512 complaints, 3,392 complaints—more than 75%—clearly involved business opportunities. An additional 832 complaints were against companies that did not appear on known lists of franchisors and most likely were business opportunities as well.<sup>26</sup> Only 6% of the complaints pertained to traditional franchise arrangements. Complaints were lodged against 949 business opportunity sellers, but against only 197 franchisors.

Injury to individual consumers resulting from business opportunity fraud is also among the highest levels of injury we see in consumer protection. The staff's analysis of complaint data between 1993 and June 1999 shows that more than 650 consumers each reported losses of at least \$10,001. An additional 631 consumers each reported losses of between \$5,001 and \$10,000, and 621 between \$1,001 and \$5,000.<sup>27</sup> Indeed, injury from business opportunity fraud consistently ranks among the top 10 product/service categories in the Commission's database based upon amount paid, often resulting in consumer losses of over \$1 million each month.

For these reasons, the Commission continues to focus much of its Franchise Rule enforcement and consumer educational resources<sup>28</sup> on combatting business opportunity fraud. Indeed, since 1995, the Commission has joined with the Department of Justice and state consumer protection agencies to bring seven joint law enforcement sweeps covering a variety of business opportunity ventures. The most recent

<sup>20</sup> See, e.g., *FTC v. Advanced Pub. Communications Corp.*, Civ. No. 00-00515 CIV-Ungaro-Benages (S.D. Fla. 2000); *FTC v. Ameritel Payphone Distrib., Inc.*, Civ. No. 00-0514 CV-Gold (S.D. Fla. 2000); *FTC v. ComTel Communications Global Network, Inc.*, Civ. No. 96-3134-CIV-Highsmith (S.D. Fla. 1996); *FTC v. Intellipay, Inc.*, Civ. No. H92-2325 (S.D. Tex. 1992).

<sup>21</sup> See *FTC v. Fax Corp. of Am., Inc.*, Civ. No. 90-983 (D. N.J. 1990).

<sup>22</sup> See *FTC v. Hart Mktg Enter.*, Civ. No. 98-222-Civ-T-23E (M.D. Fla. 1998). See also *FTC v. FutureNet, Inc.*, Civ. No. CV-98-1113 GHK (BQRx) (C.D. Cal. 1998); *FTC v. TouchNet, Inc.*, Civ. No. C98-0176 (W.D. Wash. 1998).

<sup>23</sup> See, e.g., *FTC v. Bureau 2000 Int'l, Inc.*, Civ. No. 961473DT(JR) (C.D. Cal. 1996); *FTC v. Genesis One Corp.*, Civ. No. CV961516MRP(MCX) (C. D. Cal.1996); *FTC v. Innovative Telemedia, Inc.*, Civ. No. 968140 CIVFerguson (S.D. Fla. 1996).

<sup>24</sup> See, e.g., *FTC v. Medicor LLC*, Civ. No. CV01-1896 (CBM) (C.D. Cal. 2001); *FTC v. Vaughn William, III*, Civ. No. 00-01083 (C.D. Cal. 2000); *FTC v. Data Med. Capital, Inc.*, Civ. No. SACV991266 AHS (C.D. Cal. 1999); *FTC v. Nat'l Consulting Group, Inc.*, Civ. No. 98 C 0144 (N.D. Ill. 1998); *FTC v. Marquette, Inc.*, Civ. No. 1:95-CV-1749-RLV (N.D. Ga. 1997); *U.S. v. Island Automated Med. Serv., Inc.*, Civ. No. 95-1110-CV-T-17(A) (M.D. Ga. 1995).

<sup>25</sup> Staff Review at 37-39.

<sup>26</sup> *Id.* at 4-9.

<sup>27</sup> *Id.* at 17 (Chart C.5). The level of actual injury is probably much greater. Our review found that 727 business opportunity purchasers did not disclose how much they believed was lost through their investment. See *Id.* (Chart C.6).

<sup>28</sup> In addition to law enforcement, the Commission has engaged in numerous consumer educational efforts to spread the word about business opportunity and related frauds. For example, the Commission's Office of Consumer and Business Education ("OCBE") has generated nearly 20 brochures and alerts on various business opportunities and related schemes (multi-level marketing, pyramids, work-at-home schemes). In fiscal year 2000 alone, OCBE distributed 169,120 printed copies of these materials and received 374,787 hits on its online versions. Staff Review at 61.

of these sweeps occurred just last week—Operation Busted Opportunity, which targeted over 70 business opportunity and related schemes.

The Commission will continue to work with its law enforcement partners to protect consumers from such frauds.

### III. FRANCHISE “RELATIONSHIP” ISSUES

One area of franchising that has received widespread attention in recent years is the nature of franchise relationships. The Franchise Rule requires the disclosure of material information concerning the sale of a franchise. It does not, however, regulate the substance of the terms that control the relationship between franchisors and franchisees. The Commission believes that the market is the best regulator of franchise sales, provided that prospective franchisees have full and complete disclosure of material information with which to conduct a due diligence investigation of the franchise offering.

Nonetheless, we are aware that some franchisees, franchisee trade associations, and franchisee advocates have raised concerns about franchise relationships. Their concerns do not involve allegations of deception or fraud in the sale of franchises. Rather, they assert that the underlying relationship between franchisor and franchisee is often unfair, with the franchisor dictating the terms under which the franchisee will conduct business, often allegedly resulting in significant financial losses. Among other issues, franchisees have complained about: (1) lack of protected territories and encroachment by franchisors into their market location; (2) obligations to purchase supplies or inventory from specified providers, even if comparable items are available at cheaper prices from alternative suppliers; and (3) renewal of franchise agreements on restrictive or more onerous terms.<sup>29</sup>

#### A. *The Commission Lacks Complaint Data that Would Indicate Franchise Relationship Disputes Are a Prevalent Problem*

Although the Commission does not doubt that individual franchisees may have experienced abuses in their relationships with franchisors, the Commission is unaware of any evidence that relationship issues are prevalent throughout franchising. As a preliminary matter, we do not know the exact number of franchisees in the United States. In its 2001 report on the Franchise Rule, the GAO stated that there are more than 320,000 franchised units in the United States.<sup>30</sup> Accordingly, we can reasonably assume that there are hundreds of thousands of franchisees. Yet, FTC complaint data for the period 1993 through June 1999 show that only 288 franchisees filed complaints with the Commission. Of these, 134 contained insufficient information to determine any specific allegation. Of the remaining 154 complaints, 141 raised post-sale issues involving 102 companies.<sup>31</sup> It appears that franchisees in about 95% of the approximate 2,500 franchise systems operating in North America<sup>32</sup> did not file a single relationship complaint with the Commission during nearly seven years.<sup>33</sup> Moreover, the vast majority of companies that were the subject of a franchise complaint generated only a single complaint. For example, 91 companies generated only one complaint each, while only one company generated more than five complaints. In short, complaints to the Commission rarely present a pattern of law violations by business-format franchise systems.<sup>34</sup>

<sup>29</sup>The Franchise Rule (as well as the UFOC Guidelines) addresses each of these issues through pre-sale disclosure. See 16 C.F.R. § 436.1(a)(13)(territorial protections); § 436.1(a)(10) (required suppliers); § 436.1(a)(11)(revenue received by franchisor from required suppliers); § 436.1(a)(15)(renewal and termination conditions).

<sup>30</sup>GAO Report at 5.

<sup>31</sup>See *Id.* at 22.

<sup>32</sup>See Bond’s Franchise Guide (1998 ed.) at 9, 25 (estimating there are 2,500 American and Canadian franchisors).

<sup>33</sup>The complaint data noted above do not necessarily represent an exact accounting of all correspondence that was submitted to the Commission during the relevant time period. As noted in the Staff Review, complaint data prior to 1997, especially telephone calls, were not routinely captured in a centralized database. This changed in 1997, when the Commission created the Consumer Response Center, which standardized Commission complaint handling. For these reasons, data submitted to the Commission after 1996 is the most complete. Nonetheless, the CIS data analyzed in the Staff Review are the single best source of complaint information available to the Commission both before and after 1997. See Staff Review at 4.

<sup>34</sup>It is possible that franchisees may have complained to state agencies. However, as noted below, the GAO found that the states contacted during its audit did not have readily available and statistically reliable data on the extent and nature of franchise relationship problems. Also, to the extent that states contribute data to the Commission’s Consumer Sentinel database, franchisee complaint information to the states would have been included in the complaint data analyzed by the Commission’s staff.



The lack of relationship complaints in business-format franchising is consistent with the findings of the GAO. After conducting an inquiry into the scope of franchise relationship issues, the GAO concluded:

The extent and nature of franchise relationship problems are unknown because of a lack of readily available, statistically reliable data—that is, the data available are not systematically gathered or generalizable. According to FTC staff, data FTC has collected, while limited, suggest that franchise relationship problems are isolated occurrences rather than prevalent practices. Franchise trade association officials pointed to indicators or anecdotal information to support their views regarding franchise relationship problems, but they were not aware of any statistically reliable data on the extent and nature of these problems. Likewise, none of the nine states we contacted—eight of which have franchise relationship laws—had readily available, statistically reliable data on the extent and nature of franchise relationship problems.<sup>35</sup>

*B. Franchise Relationship Issues Are Determined by State Contract Law*

Franchise relationship issues are generally governed by the private contractual relationship between the franchisor and franchisee. To the extent that there are contract disputes, these are appropriately resolved under applicable state law. As noted above, the Franchise Rule is designed to ensure that franchisees have time to review all material terms and conditions of the franchise relationship, and an opportunity to seek legal, accounting, and marketing advice as well as the opportunity to speak to both former and current system franchisees before entering into a franchise agreement.

It has been suggested by some that the Commission could use its unfairness authority to address franchise relationship issues. However, the Commission's unfairness authority is limited. Economic injury to franchisees alone is insufficient. Section 5 of the FTC Act provides that the Commission does not have the authority to declare an act or practice unfair unless it meets three specific criteria: (1) the act or practice causes or is likely to cause substantial injury; (2) that is not outweighed by countervailing benefits to consumers or to competition; and (3) is not reasonably avoidable.<sup>36</sup>

Even where there is substantial injury to franchisees, the second and third criteria must be met. Franchise systems, like all businesses, are influenced by ordinary market forces, and franchisors may want franchise agreements that maximize their ability to respond quickly to market changes. Therefore, a franchisor's choice of contract terms and conditions is often based upon some economic rationale that is designed to benefit consumers and/or the system's existing franchisees. The benefits flowing from these contractual terms may outweigh complaints or allegations of "oppression" by individual complainant-franchisees.

Further, the Commission would be required to establish that contractual provisions that prospective franchisees voluntarily read, agreed to, and signed are not reasonably avoidable. This would be difficult because, under the Franchise Rule, prospective franchisees receive a disclosure document at least 10 business days before they are required to sign the franchise agreement. Presumably, every prospective franchisee also has the opportunity to review the franchise agreement before signing, seek legal, accounting, and marketing advice, as well as to speak to both former and current system franchisees. In short, it would not be appropriate for the Commission to second-guess a prospective franchisee's wisdom in signing a particular franchise agreement, as long as the prospective franchisee is forewarned about the legal consequences of his or her actions.

#### IV. RULEMAKING

As the Subcommittee is probably aware, the Commission is in the process of updating the Franchise Rule.<sup>37</sup> In 1999, the Commission published a Notice of Proposed Rulemaking ("NPR"), which set forth the text of a proposed revised Rule. Among other things, the proposal would revise the Rule in four material respects. First, it would focus exclusively on franchise issues. In the NPR, the Commission

<sup>35</sup> GAO Report at 4 and 21.

<sup>36</sup> This definition of unfairness was codified by Congress in the 1994 amendments to the FTC Act at 15 U.S.C. § 5(n). See also *Orkin Exterminating Co.*, 108 F.T.C. 263, *aff'd Orkin Exterminating Co. v. FTC*, 849 F.2d 1354, *reh'g denied*, 859 F.2d 928 (11th Cir. 1988), *cert. denied*, 488 U.S. 1041 (1989).

<sup>37</sup> The rule amendment process began with a review of the Rule in 1995, 60 Fed. Reg. 17,656 (April 7, 1995), and was followed by the publication of an Advance Notice of Proposed Rulemaking in 1997, 62 Fed. Reg. 9,115 (February 28, 1997), and a Notice of Proposed Rulemaking in 1999, 64 Fed. Reg. 57,294 (October 22, 1999).

proposed that business opportunities be addressed in a separate rulemaking procedure that would focus narrowly on appropriate disclosures and, more importantly, on prohibitions necessary to prevent persistent fraud in that area. Second, the proposal would revise the Franchise Rule along the UFOC Guidelines model. This would reduce inconsistencies between federal and state disclosure laws and reduce compliance burdens. Third, the proposal would update the Rule to address new technologies, in particular the sale of franchises through the Internet. Fourth, the proposal would provide prospective franchisees with more information about the state of the franchise relationship. While specific complaints by franchisees are relatively few, as noted above, there remains considerable support among franchisee associations and franchisee advocates for greater disclosure of information from which a prospective franchisee can assess the quality of the relationship he or she will be entering.

The next step in the rule amendment process is the publication of a staff report that analyzes the record to date and offers specific recommendations for further fine-tuning of the NPR proposal. Because the rulemaking is ongoing, we cannot, at this time, comment on any substantive aspect of the proposed rule or its implementation. Nonetheless, we note that several NPR proposals, if ultimately adopted by the Commission, would give prospective franchisees expanded information with which to assess the franchise offering and the relationship between the franchisor and franchisee. For example, these proposals would: (1) alert prospective franchisees about the availability of the Commission's Consumer Guide to Buying a Franchise, which contains advice on how to read a disclosure document; (2) increase franchisors' disclosures about prior litigation with franchisees; (3) warn prospective franchisees about the consequences of purchasing an unprotected territory and not to rely on unauthorized financial performance information; and (4) make available information about franchisor-sponsored and independent franchisee associations.

#### V. CONCLUSION

Based upon the Commission's two decades of experience in enforcing the Franchise Rule, it is clear to us that deceptive business opportunity sales, rather than business-format franchise sales, remains a persistent cause of significant injury to American consumers. The Commission will continue to dedicate significant law enforcement resources to targeting this problem, as well as consider promulgating a separate business opportunity trade regulation rule that will prohibit specific practices that often underlie fraudulent business opportunity schemes.

Thank you for this opportunity to describe for the Committee the Commission's Franchise Rule program. I will be pleased to respond to your questions.

Mr. STEARNS. I thank you, Mr. Beales. It is interesting, I don't even think most franchisees know that they can even complain to the FTC. And how do you get the word out? I mean how are people to know that you are an agency to complain to before they sign their contracts, not post-contract?

Mr. BEALES. Well, we do a fair amount of general promotion of our complaint number, which is 1-877-FTC-HELP, as just sort of general promotion for all sorts of complaints, and we clearly get large numbers of business opportunity complaints.

Mr. STEARNS. No, I know that.

Mr. BEALES. Simply not from franchisees. We also, a lot of the complaints in our data base come from other organizations. We have tried to negotiate complaint sharing arrangements with other law enforcement entities and with other regulators so that when, for example, for many Better Business Bureaus, if a complaint goes to the Better Business Bureau, that complaint also is automatically entered into our data base.

So we try to reach out to get complaints. But there also may be, are many complaints that don't come to us or that don't go anywhere.

Mr. STEARNS. I think that is what happened. You know, like in Florida, if you sign a realtor contract for a home or you sign a realtor contract for renting of an apartment, there is a little box close

to your signature that says that if you have any concern or questions call the Consumer Affairs of Florida, Department of Commerce. Do you think something like that should apply before you sign a franchisee agreement, that there should be some kind of regulation that says in the event that you are not happy, that we will go ahead—I mean, you can call the FTC, you know, just to notify the franchisee that he doesn't have to run to a lawyer and sue because that is what most of them want to do and most of these folks don't have the money to sue? So, you know, is it possible that you need to get the word out a little bit better?

Mr. BEALES. Well, in the disclosure document that is given to franchisees prior to the sale, there is a reference to the FTC that identifies us as the place to complain.

Mr. STEARNS. With a phone number. With a toll free number?

Mr. BEALES. I don't know if the phone number is there or not. I would have to check as to whether the disclosure specifically includes that.

Mr. STEARNS. There is not a specific box that they can focus on. It just says you can contact the Federal Trade Commission. Federal Trade Commission is not known to most small business people. Who knows where, what, what it is. For all intents and purposes it could be in Afghanistan. I mean they just don't even know. I have got here my staff showing—it says franchisor, Pizza Hut, Incorporated. Information for a prospective franchisee is required by the Federal Trade Commission. But it doesn't necessarily say that in the event that you want to complain—Okay. The Federal Trade Commission, Washington, DC. Okay, well, just something to think about.

Mr. BEALES. One of the things that is in the proposed rule, in the proposed changes is some changes in that identification of the FTC and, among other things, what those changes would do to direct prospective franchisees to our consumer education materials that are available both in hard copy and on our Web site which would presumably also help to identify us as the place to complain because you can, in fact, go back to that Web site and complain.

Mr. STEARNS. And the Federal Trade Commission is a huge government agency. It would be better to say the Federal Trade Commission, Consumer Protection, so when they call they have a specific number that goes right to the people and not through the computer operated things that says dial 3 for this and dial 4 for that.

Mr. BEALES. Right.

Mr. STEARNS. And the GAO, the GAO in its July 2000 report noted that of the 79 investigation files closed between 1997 and 1999, only two contained notes explaining why they were closed, and the question is why? So—

Mr. BEALES. Well, what the practice had been, and frankly, as I looked at the GAO report, which was one of the first things I handled when I came to the FTC, I thought they had a good point, that we should do a better job of documenting the reasons that we are closing investigations. What the practice had been, and often is, as we develop a sweep is we may open an investigation of a potential target that would be part of a sweep of franchises and business opportunities and then refer that case to another enforcement partner, so that somebody else actually brings the case. And what we

would do in this case is we would have opened it, but then we fairly promptly close the investigation. What we were not doing was documenting the reasons for closing or the fact of the referral, and we are doing that now.

Mr. STEARNS. Okay. You mentioned in your opening statement about most of the business deceit has been promulgated in the business opportunity offerings and that you are looking at rule-making dealing with that. You are simply going to provide a more tailored disclosure rule to address business opportunities, I think you indicated. Given the difficulties in regulating and controlling business opportunity scams, especially today with what we have on the Internet, Internet based, tell me how this new rule is going to apply to fix this problem. You know, moving from one disclosure requirement to another, is that going to solve the problem? I mean, can you be more specific?

Mr. BEALES. Well, we do not have at this point a specific proposal. It is something that I have begun talking with the staff about, about what could we do here. I think the fundamental problem in business opportunities is really an enforcement one because we find most of the business opportunities that we pursue, they are covered by the Franchise Rule. They are not in compliance. And the question is can we identify specific practices that would simply make our enforcement job easier. I think it is harder, the strategy in the Franchise Rule itself, for franchisees to provide information. Franchisees can then avoid difficulties in many instances and know what they are getting into. The difficulty in business opportunities is the information is frequently not provided in the first place, even though there is an existing requirement to do so.

So what we would like to do is to try to develop more tailored provisions, if we can, that would make the enforcement burden easier and make it cheaper for us to bring cases essentially. But there will remain an enforcement issue because that is the nature of the business opportunity beast in many cases.

Mr. STEARNS. Should Internet based business opportunity offerings be governed by a specific statute in the same manner that the franchisee-franchisor relationships of the auto and petroleum industries are?

Mr. BEALES. I don't think we have seen any need for that at this point.

Mr. STEARNS. Because you are saying its in the front end then. You don't think its in the post—

Mr. BEALES. Well, the problem in most of the business opportunity cases we bring is there is no post.

Mr. STEARNS. Right.

Mr. BEALES. It is "take the money and run" kind of scams.

Mr. STEARNS. Okay. Good. Yeah.

MR. BEALES. And hence we don't see a post-sale sort of problem in a lot of cases.

Mr. STEARNS. I see. So would you have to say yes or no to that question, that the Internet based—would you put a statute in the Internet business opportunities, a statute similar to the franchisee-franchisor or relationships to the auto and petroleum industry. Do you think yes or no to that?

Mr. BEALES. I would say no. I think the problems we have seen and we certainly have seen the problems of business opportunities promoted on the Internet, but we have been quite able to reach those problems under our existing authority.

Mr. STEARNS. Okay, thank you. My time has expired. Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman. Mr. Beales, under the rule are franchisors required to sign the disclosure documents that they provide to potential franchisees? In other words, do franchisors have to warrant or certify that the information in their disclosure documents is truthful, complete and not misleading?

Mr. BEALES. I think if the information is not truthful and complete or is misleading, that that would very clearly be a rule violation.

Mr. RUSH. So are they required to sign the disclosure documents that they provide?

Mr. BEALES. One of the things that is in the proposal would clarify that they can't try to waive liability for statements that are made in the disclosure document.

Mr. RUSH. So until—you haven't proposed the rule or the rule hasn't been finalized?

Mr. BEALES. That is right.

Mr. RUSH. Okay. So under the current status, are they required now today to sign?

Mr. BEALES. No, I don't believe they are. We think they are responsible and reinforce the rule that way.

Mr. RUSH. That is the way you enforce the rule?

Mr. BEALES. Yes. I mean, if there are statements made in the franchise disclosure documents that are not accurate, that is a rule violation.

Mr. RUSH. Okay, and what about being complete?

Mr. BEALES. Complete within the sense of the information that the rule requires to disclose, yes. If it doesn't include that information, that too is a rule violation and we enforce the rule that way.

Mr. RUSH. Does the FTC ever review or approve the disclosure documents it requires franchisors to give potential franchisees?

Mr. BEALES. We review them in particular investigations. We don't review them before the fact.

Mr. RUSH. Okay, so you don't approve them either?

Mr. BEALES. No. That is correct. We don't. A number of States do that under the Uniform Franchise Offering Circular, which in some States is filed and preapproved, but the FTC does not do that.

Mr. RUSH. Should it be permissible for a franchisor to state in a disclosure document that a franchise may be renewed even if the franchisee is required to sign a new agreement under different terms and conditions in order to do so?

Mr. BEALES. Well, I think what the franchisor states in the disclosure document must be an accurate reflection of what are the renewal terms of the contract. And if the renewal terms—and you can imagine a wide range of possibilities there. If the renewal terms specify that you can renew this contract on these terms, then that is what the disclosure document better say.

Mr. RUSH. And so the fact that the contract can be renewed should also be explicit in the contract? Is that what you are saying?

Mr. BEALES. Most franchise contracts do have a renewal clause or renewal terms under which they can be renewed.

Mr. RUSH. Given the current resources and obligations of the FTC, do you think that it would be helpful for franchisees to have a private right of action against violators of the Franchise Rule?

Mr. BEALES. Well, we have not seen very often instances of violations of the rule that were substantive violations. We have brought those cases. What we have seen more often is narrow technical violations where we have developed a referral program to bring people into compliance and to avoid future difficulties. In many circumstances that would violate the rule the franchisee probably has a private right of action under the contract that would—because something in the disclosure document doesn't accurately reflect what was in the contract. So there may well be a private right of action there as well.

Mr. RUSH. So you don't think that should be explicit?

Mr. BEALES. No, sir, I don't. I don't. There is in general—under all of the FTC's rules there is not a private right of action or under the FTC Act itself.

Mr. RUSH. Okay. Mr. Beales, can you explain why the FTC has taken so long to amend this rule?

Mr. BEALES. Well, I think it has primarily been a question of priorities. Most of the amendments are to conform the rule to the Uniform Franchise Offering Circular. But the FTC has always recognized compliance with the UFOC as compliance with the Franchise Rule. So as a practical matter, people who want to comply that way, and as a practical matter most franchisors do if they are national franchisors, they already can. We ought to clean up the rule. We ought to conform the rule, but the benefits from doing so are smaller than they might be in a different arrangement where we didn't recognize compliance with the States.

On the other hand, we persistently meet business opportunity frauds and that has been the place where more of our resources have been devoted.

Mr. RUSH. Now, I have in my possession this package, the chairman displayed it also, from the Pizza Hut. This is a disclosure packet, right?

Mr. BEALES. I don't know. I haven't seen it.

Mr. RUSH. Yes, my staff inform me that this is a disclosure package. It is pretty complicated. Very complicated.

Mr. BEALES. It is certainly thick.

Mr. RUSH. And encompassing. Is there any move by the FTC to simplify or to require a simplified process? I mean, this is—you know, you get some family who wants to open a franchise. They would have to hire a law firm to really look at this stuff and be able to decipher and understand it. And I know it is a very complicated financial arrangement that the consumers or potential business owners are engaging in, but this is outrageous. You know, this is a thick, a two-inch thick package of information here, you know, and don't you think that the FTC has some responsibilities or should assume some responsibility for trying to simplify this so it will become less burdensome on the potential business owner?

Mr. BEALES. There is always a tradeoff that we meet all the time in consumer protection regulation between short and sweet, but

necessarily incomplete and comprehensive. Given the amounts that are particularly at stake in franchise investments, both the amount of franchise fees and the amount of investment that is required, what the choice has been is to err if we do on the side of being complete so that franchisees have the information they need to make informed decisions.

That said, part of what is at issue in the proposed rule is at least in some places simplifications to try to make the information easier for its prospective franchisees to get at—for example, to try to make more use of graphics and charts, to present some of the information in a way that is more straightforward. I would not think it is likely to shorten that disclosure document very much, but hopefully it makes the information that is there more comprehensible.

Mr. RUSH. Let me ask you this. If you were a potential franchise owner with Pizza Hut, would you be able to sign this document without a lawyer?

Mr. BEALES. No, I would think I would want to hire a lawyer to help me in that kind of a relationship, and many franchisees, many prospective franchisees do.

Mr. RUSH. Mr. Chairman, I have just got one other question.

Mr. STEARNS. Sure.

Mr. RUSH. I am just—it just bothers me that, you know, we can—the FTC can say that they want to be thorough and they want to have complete disclosure information available and so therefore, you know, that this document is, this massive amount of documents here is appropriate. But on the other hand, the FTC takes 5 years, you know, to deal, to develop this rule. You know, it just seems to me that there is a level of disingenuousness there and I guess you said it wasn't a priority, but I would assume—I know that in my district, in my community that there are a lot of franchise owners, a lot of franchises, people who are employed by franchises. And I just think that the FTC, to make it—I would advise the FTC to make this a priority because it just seems like government is not caring about the problems of consumers and the problems of business owners, and I would also just suggest strongly that you all look at trying to simplify this because its just burdensome, intimidating, and I believe that it opens the door to all kinds of weird outcomes if in fact we don't get on top of this and get some control and corral this issue, this paperwork and this problem.

Thank you, Mr. Chairman. I yield back.

Mr. STEARNS. Thank my colleague. Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. I want to follow up. Obviously we are in agreement up here on the panel that if we are looking at amendments to the 1979 rule there has been no amendment for 5 years. For us that is very, very unacceptable, so we need to move expeditiously to do that.

Is it the case that the FTC spends only 6 percent of its staffs' time on Franchise Rule activities and enforcement when franchising, according to the GAO audit, represents over half of all retail sales in the United States?

Mr. BEALES. I believe it is either 6 percent or 8 percent of our staff resources that are devoted to franchise cases. So—

Mr. SHIMKUS. But you don't know the percent of the overall sales in the United States which comes from franchise operations?

Mr. BEALES. No. No.

Mr. SHIMKUS. But if it is more than 6 to 8 percent, wouldn't you say—if of course our staff is correct—if they are saying 50, the argument is there is probably not a direct proportional share of what efforts are going into this part of the overall economy versus other operations?

Mr. BEALES. Well, I think—I am not sure that looking at the fraction of sales, of retail sales, is the most useful way to make that comparison.

Mr. SHIMKUS. But if it is 50 versus 6, there is a definite—I would agree with you. I mean, you know, you can use statistics to prove or disprove anything. But I, again, if the proportion is so skewed, it would make the argument that there probably should be more of an effort in a certain area?

Mr. BEALES. Well, I guess I would look more at complaints.

Mr. SHIMKUS. Well, we are going to do that in the next panel. In fact, I want to follow up with a comment in the testimony and she will get a chance to testify in a panel, and I hope we have some members from the FTC that would hang around and listen, too. Sometimes I wish we would have complainants first and bureaucrats afterwards because then we could fully air it.

Ms. Kezios recommends that the U.S. Department of Commerce collect comprehensive and accurate statistical information about franchising and franchise practices by, one, requiring a national filing of disclosure documents and, two, data collection and analysis.

Do you agree with this recommendation and why or why not?

Mr. BEALES. I have not thought through that recommendation or explored it in any detail. I think—I mean, as a former academic and actually as a former academic who studies franchising, more information is always attractive. But there are burdens on the people who have to produce that information as well. We haven't seen a need for pre-filing or pre-approval of the disclosure documents in the franchise complaints or the franchise issues that we have seen.

Mr. SHIMKUS. And previous to this last response you talked about a better barometer is complaints. And you have already admitted that the Commission received 3,680 complaints regarding franchises in just the period between 1993 and 1999. And you state that since 1979 the Commission has pursued 200 franchise and business opportunity cases. This number, given the number of complaints, seems low. Why haven't we seen more enforcement action?

Mr. BEALES. Well, the complaints—it is a sizable number of complaints. It is about 2 percent of the total number of complaints that we get. So in terms of where our resources are allocated, franchising and business opportunities get a disproportionate share based on the number of complaints. The reason for that is the consumer injury in these kinds of cases tends to be quite high compared to what we see in a lot of other cases. We think there is—you know, we have tried very hard to leverage our resources in this area with both our Federal law enforcement through the Department of Justice and through State enforcement activities as well that gives us a lot more clout than that, than the 200 cases we have brought. In this sweep last week, for example, we brought 11



cases. The Justice Department brought 11 cases and there were more than 48 cases brought by—or 48 actions, enforcement actions, brought by the State. So those 70 cases would show up in that statistic as 11 FTC cases.

Mr. SHIMKUS. Mr. Chairman, if I could just finish up with this question.

Mr. STEARNS. Sure.

Mr. SHIMKUS. Does the fact that franchisors often prohibit franchisees from discussing their franchise experience with anyone after they leave the system undermine the Franchise Rule?

Mr. BEALES. Well, I think the thing that would be a problem for the—or a potential problem for the rule is if there is nobody you can talk to to find out about what their experience was like and you didn't know that.

Mr. SHIMKUS. The acronym "let the buyer beware," but the buyer ought to be able to do research prior to going into an agreement. I mean, when you buy a house you can go around and check fair market values of like homes. You can actually talk to contractors and people. There are things that you can do. But if there is a prohibition about discussions then that would seem to undermine some of the ability to go into an agreement.

Mr. BEALES. Well, one of the things that is in the proposed changes would be—

Mr. SHIMKUS. These are the amendments to the 1979 rule; is that the changes you are talking about?

Mr. BEALES. Yes.

Mr. SHIMKUS. And will we be looking at these any time soon or do we still have 5 years before we receive amendments? I mean, it is so ridiculous to keep saying that, to tell you the truth. The proposed amendments which are 5 years old and we are proposing these to occur, can you see our frustration?

Mr. BEALES. I can. I can.

Mr. SHIMKUS. So I think it probably would be incumbent upon the chairman and the committee to probably tie you down and say when will we see these. I will defer that to the chairman and, Mr. Chairman, I yield back my time.

Mr. STEARNS. That is a good question. You can ask it.

Mr. SHIMKUS. No, go ahead.

Mr. STEARNS. When will we see these?

Mr. BEALES. We are planning to forward the staff report in the fall. The staff report goes out for public comment and then after another comment period on the staff report a final recommendation would be forwarded to the Commission. I haven't tried to figure out the time line beyond the staff report, which is sort of the next step in the process. Typically the comment period would be like 60 days and then analysis of the comments.

Mr. STEARNS. Okay. So maybe October you will have the staff report and then 60 days thereafter?

Mr. BEALES. Well, the staff report—yeah, it may be somewhat longer than that for the Commission to consider the staff report, although I think in the rulemaking process that is limited. Most of that consideration is after the comment period, not before.

Mr. STEARNS. And after the 60 days what is going to happen?

Mr. BEALES. We will analyze the comments.

Mr. STEARNS. How long will that take?

Mr. BEALES. It depends in part on how many comments we get and how substantive the comments are.

Mr. STEARNS. What is the general time?

Mr. BEALES. Well, it varies from, I mean I have seen—well, in Magnus and Moss—

Mr. STEARNS. Less than 6 months?

Mr. BEALES. It certainly can be less than 6 months.

Mr. STEARNS. Okay. So in the next year and a half we should see the file?

Mr. BEALES. We would be hopeful that we could meet that timetable.

Mr. STEARNS. Okay. Mr. Walden.

Mr. WALDEN. Actually, Mr. Chairman, I have no questions at this time.

Mr. STEARNS. Okay, thank you. Thank you very much, Mr. Beales. I appreciate your coming again.

Mr. BEALES. Thank you for the opportunity.

Mr. STEARNS. And we will have the second panel now if they will come forward. Mr. Dale Cantone, Assistant Attorney General of the Maryland Securities Division; Mr. Les Wharton, Vice President, Legal Affairs, Franchise/License Division, Spherion; Ms. Susan Kezios, President of the American Franchise Association; Mr. Dennis Wiczorek, Partner, at Piper Rudick, and he is here on behalf of the International Franchise Association; and last, Mr. Jerry Rizer, who is President of Dairy Queen Operators' Association.

Let me thank all of you for attending this morning and we look forward to your testimony, and why don't we start from my right and go to my left. Mr. Cantone for your opening statement.

**STATEMENTS OF DALE E. CANTONE, ASSISTANT ATTORNEY GENERAL, MARYLAND SECURITIES DIVISION; PHILLIP LESLIE WHARTON, VICE PRESIDENT, LEGAL AFFAIRS, FRANCHISE/LICENSE DIVISION, SPHERION; SUSAN P. KEZIOS, PRESIDENT, AMERICAN FRANCHISE ASSOCIATION; DENNIS E. WIECZOREK, PARTNER, PIPER RUDNICK, ON BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION; AND JERRY RIZER, PRESIDENT, DAIRY QUEEN OPERATORS' ASSOCIATION**

Mr. CANTONE. Thank you, Chairman Stearns and member of the subcommittee. My name is Dale Cantone. I am the Deputy Securities Commissioner in the Office of the Maryland Attorney General. I also chair the Franchise and Business Opportunity Project Group of the North American Securities Administrators Association, known as NASAA, and on behalf of NASAA I appreciate the opportunity to appear before you today.

As franchising continues to be an important and evolving business strategy in today's economy, the laws dealing with franchising also must evolve to protect consumers who invest in a franchise. Current Federal and State franchise laws require, among other things pre-sale disclosure. This requirement is intended to provide each prospective franchisee with all of the information necessary to make an intelligent investment decision before the franchisee pays any money.

As has been recognized at the State level, 15 States have enacted laws regarding franchise offerings. These States require franchisors to prepare disclosure documents according to Uniform Franchise Offering Circular guidelines, called the UFOC. Since 1994, the FTC has accepted the UFOC as an alternative to the disclosure documents required under its own Franchise Rule. Although the UFOC is required in only 15 States, for practical reasons many franchisors prefer the UFOC format. This is because the UFOC is generally considered to be a better disclosure document than the one required under the FTC's Franchise Rule and because many franchisors intend to sell franchises in at least one of the registration States. But the UFOC is not required to be used in the States without a separate State franchise law.

Now, 23 years after the promulgation of the Franchise Rule, it is time for the FTC to update its disclosure document, the document that is required in all 50 States, and the logical model for the FTC to follow is the UFOC. The UFOC is more user friendly to prospective franchisees. It requires that disclosures be written in plain English. It also requires disclosure of items that are relevant in today's business climate; for example, issues related to computers, protected territory or the lack of one and use of advertising monies.

The Federal Trade Commission has recognized this fact and is currently considering a proposal to model its own Franchise Rule disclosure on the UFOC with some additional enhancements. NASAA supports this proposal. The adoption of a disclosure format based on the UFOC would be a significant improvement to the Franchise Rule.

What is still missing at the Federal level, however, is a private right of action under the Franchise Rule. Without a private remedy injured franchisees must rely on the already strained resources of governmental agencies for redress. When those agencies are unable to take action for whatever reason, franchisees are unable to sue to recover losses due to franchise law violations. As the FTC continues its work on the Franchise Rule review, NASAA remains ready to offer any assistance that will help to ensure the prospective franchisees receive the most readable and material disclosure possible.

The other issue I wish to address today relates to a type of investment opportunity called a business opportunity. Business opportunity ventures are regulated under the FTC's Franchise Rule, but they are clearly distinguishable from a franchise. Business opportunity sellers provide little, if any, assistance and training and exert little control over business opportunity buyers. The buyers generally do not operate under the sellers' trademark or trade name. Typical examples of business opportunities include vending machines, medical billing software programs, greeting card display racks.

As has been recognized in the last few years, the Federal Trade Commission has focused its enforcement activities on business opportunities. The FTC reports more complaints about business opportunities than franchises and complaints about business opportunities generally involved allegations of fraud or misrepresentation.

Just last week the Federal Trade Commission, the Department of Justice, and 17 States announced Project Busted Opportunity, a coordinated attack on business opportunity and work at home fraud. The sweep is just the latest in a series of Federal-State initiatives regarding business opportunities. There is no doubt that communication and coordination between Federal and State officials on business opportunity issues is critical. In many cases, business opportunity con artists maintain offices in one State, but avoid selling to consumers in that State in an effort to avoid prosecution and detection by State officials.

The FTC regularly does seek to communicate with State enforcement personnel in this area, through conference calls and e-mail, List Serve and an on-line complaint data base called Consumer Sentinel. For the last several years the FTC also has sponsored annual law enforcement summits on franchises and business opportunities. The summit wasn't held this year, but we do hope the FTC reconsiders reestablishing the summits in the future.

NASAA and State business opportunity enforcement officials look forward to continued opportunities to coordinate with the FTC on enforcement actions and consumer education on both franchises and business opportunities. By working together we can be more effective in these very important areas.

Mr. Chairman and members of the subcommittee, thank you for allowing NASAA to participate in this hearing.

[The prepared statement of Dale E. Cantone follows:]

PREPARED STATEMENT OF DALE E. CANTONE, DEPUTY SECURITIES COMMISSIONER, CHIEF, FRANCHISE AND BUSINESS OPPORTUNITIES UNIT, OFFICE OF THE MARYLAND ATTORNEY GENERAL, SECURITIES DIVISION, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman and Members of the Subcommittee: My name is Dale Cantone. I am the Deputy Securities Commissioner in the Office of the Maryland Attorney General. I also chair the Franchise and Business Opportunity Project Group of the North American Securities Administrators Association ("NASAA"). In the United States, NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. Many of the agencies that administer and enforce state franchise and business opportunity laws are members of NASAA.

On behalf of NASAA, I appreciate the opportunity to appear before you today. Franchising continues to be a vibrant and popular business strategy in our economy. Oversight of franchising is an important consumer protection for hundreds of thousands of existing and prospective franchisees. It requires careful attention by both federal and state authorities. NASAA welcomes the subcommittee's interest in this issue and looks forward to working with you and your staffs. My comments today will focus on two issues: state and federal franchise disclosure requirements; and state and federal cooperation on business opportunity enforcement initiatives.

#### FRANCHISE REGULATION: AN OVERVIEW

Oversight of franchising at the state level is grounded in the traditional commitment of grassroots officials to protect consumers whenever possible before they part with their money; and in those cases where money is lost in a fraudulent deal, to marshal the enforcement resources to shut down the violator and seek restitution if possible.

California adopted the first state franchise statute in 1971. Today, 15 states<sup>1</sup> have statutes that regulate the offering of franchises for sale. Eleven of these states<sup>2</sup> operate under similar or uniform statutes that require registration with a

<sup>1</sup> California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

<sup>2</sup> California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia and Washington. In addition, Oregon requires disclosure prior to the

state agency and delivery of disclosure documents to prospective franchisees prior to an offer and sale of a franchise.

Both state and federal franchise disclosure laws are intended to provide each prospective franchisee with the information necessary to make an intelligent decision regarding the franchise being offered. Further, state franchise laws bar the sale of franchises where such sales would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled.

At the federal level, the Federal Trade Commission ("FTC") adopted its Franchise Rule<sup>3</sup> in 1979. While the FTC's Franchise Rule requires presale disclosure, there is no federal requirement that a franchisor register its disclosure document with the Commission, and no one at the federal level reviews the disclosure documents that a franchisor must provide to prospective franchisees. The Franchise Rule expressly preserves the right of states to adopt laws that are not inconsistent with the Franchise Rule if those laws provide protections that are equal to or greater than that provided by the Rule.

The franchise registration laws that 15 states have adopted are designed to provide greater protections to prospective franchisees and prevent fraud in the sale of franchise offerings. Eleven states require that franchise disclosure documents be filed and reviewed by trained state personnel, called franchise examiners. Through their efforts, state examiners can better discover proposals that are fraudulent or unlawful, and thereby protect state consumers before they have parted with their money.

Although all states do not require registration of franchise offerings, few franchisors sell in non-registration states only. Thus, franchise reviews conducted by so-called "registration states" have improved the standard of disclosure generally in the franchise market.

In recent years, some have questioned the need for any state to perform reviews of offering circulars. Yet the registration and review function is an important part of the franchise regulatory scheme. Although large franchisors typically retain experienced lawyers to draft franchise disclosure documents, even large franchisors sometimes fail to disclose all of the information required by the disclosure guidelines. In addition, some large franchisors target unsophisticated franchisees. The franchise review process can better inform the unsophisticated franchisee about risks the franchisee may not fully appreciate. The states' ability to require financially undercapitalized franchisors to escrow franchise fees also benefits prospective franchisees. State examiners may identify specific "risk factors" that a franchisor must disclose on the cover of state disclosure documents. These risk factors highlight special concerns that a franchisee should consider before investing in a franchise.

In addition, not all franchisors are well established or experienced in preparing offering circulars. States routinely receive franchise registration applications from start-up and smaller franchise systems. Some of these applications are prepared without benefit of legal counsel. Some do not even begin to approach substantial compliance with the state guidelines. For these franchisors and, more important, for their prospective franchisees, the review function conveys a critical benefit.

State agencies that require filing of franchise disclosure documents also serve as an important repository of information for prospective franchisees to compare documents from various franchisors. In many instances, this information is crucial to the process undertaken by investors to evaluate franchise deals. Many franchisors do not deliver copies of their disclosure documents to the public upon request.

The states have a broad assortment of enforcement tools available under their franchise laws that allow them to move swiftly and decisively against violators. States may issue orders prohibiting violations of the law, as well as orders denying, suspending and revoking registration and exemption of franchises. In addition, states have injunctive and criminal referral authority.

Franchisees in registration states benefit tremendously from the private right of action granted under state law. In contrast, private parties cannot enforce violations of the FTC Rule; only the FTC has that authority. A private right of action allows consumers to sue for damages when they sustain losses due to franchise law violations. The experience of state regulators is that private remedies serve as a necessary supplement to governmental regulation and enforcement efforts in providing a deterrence to abuse. Without private remedies, injured franchisees can be protected only through governmental action. The absence of a private remedy places

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sale of franchises, but does not have a registration or filing process. Indiana, Michigan, and Wisconsin require disclosure and the filing of a "notice of franchise offering."

<sup>3</sup>Trade Rule 436, "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities Ventures" (16 CFR, Ch.1, Part 436).

a greater premium and demand on the already strained resources of the regulatory agencies and frequently means that fewer injured franchisees can be "made whole" than would be the case if a private right of action was explicitly authorized in the law.

#### THE ROLE OF NASAA

An important goal of NASAA is the promotion of efficient and uniform state laws. In the franchise regulation area, it is NASAA's intention to move forward and continue the serious efforts the Association has undertaken to promote uniformity of state law, provide enhanced training and educational opportunities for state franchise personnel, seek ever more cooperative relationships with the Federal Trade Commission, and solicit the advice and input of franchisors and franchisees.

To further the goal of state uniformity, NASAA authored and encouraged adoption of the UFOC Guidelines. NASAA sponsors regular franchise training programs and educational seminars for state franchise examiners. NASAA also regularly proposes uniform statements of policy on many franchise related issues. These statements of policy are model laws and regulations that are made available for states to adopt in accordance with their laws. NASAA recently implemented a new Internet "List Serve" by which state examiners and enforcement personnel can contact each other to discuss issues of common concern and seek effective solutions to matters involving franchise reviews and potential enforcement actions.

Two years ago, NASAA developed and launched a new program of coordinated franchise review, which has been adopted by all of the franchise registration states except California. Coordinated franchise is a voluntary program open to franchisors that allows them to file a franchise registration in multiple states at the same time. Coordinated review eliminates conflicting comments by state examiners and results in a single, uniform franchise offering circular that is made effective on the same date in multiple jurisdictions.

#### THE UNIFORM FRANCHISE OFFERING CIRCULAR GUIDELINES

NASAA authored the Uniform Franchise Offering Circular ("UFOC") Guidelines after holding public hearings and extensive discussion with members of the franchisor and franchisee communities, academics, and the FTC. On April 25, 1993, NASAA unanimously adopted the UFOC Guidelines as the recommended format for franchise disclosure documents at the state level. Within two years, the new Guidelines were adopted by each of the state franchise regulatory authorities that require registration of franchise offerings. On December 30, 1993, the FTC approved the use of the UFOC as an alternative to the FTC's disclosure requirements.

As part of its ongoing Rule Review, the FTC is currently considering a proposal to replace the franchise disclosure requirements<sup>4</sup> under the Franchise Rule with updated disclosure requirements based in large part on the UFOC Guidelines, with some additional disclosures. NASAA supports the FTC's efforts to modify the Franchise Rule in this way.

The UFOC is the only franchise disclosure document that franchisors may use in the 15 states that register franchise offerings. The UFOC Guidelines are, in fact, a revision of several earlier versions of the Guidelines, versions of which have been in effect since 1975. The UFOC Guidelines reflect an effort on the part of NASAA to produce a more readable and relevant disclosure document for franchisees, and one that does not unduly burden franchisors. It is a disclosure document that was based on the experiences of many individuals in the franchise community as to what constitutes "material" information about a franchise offering.

NASAA asserts that the UFOC is a superior disclosure document than the current disclosure document required under the Franchise Rule. The UFOC requires disclosure of information that franchisees need to know in order to make an informed investment decision in the present business environment. For example, the UFOC requires disclosure of required computer hardware and software (UFOC Guidelines, Item 8 A), including whether the franchisor will have independent access to the stored data (UFOC Guidelines, UFOC Guidelines, Item 11, Instruction 11 iii c). The UFOC Guidelines require extensive disclosure about a franchisor's use of advertising dollars and advertising programs (UFOC Item 11). There is extensive disclosure about protected territory, or the lack of one, and the franchisor's ability to establish alternative channels of distribution in a protected territory (UFOC Item 12). The UFOC is intended to be written in "plain English" (UFOC Instruction 150) and features a readable cover page that emphasizes the most important aspects of the disclosures in the document.

<sup>4</sup>Described at 16 CFR § 436 (a) (1) through (20).

There would be a significant advantage to franchisors if the FTC were to adopt a new Franchise Rule based on the UFOC model. Many franchisors, especially those that offer franchises in multiple jurisdictions, have experience with preparing an offering circular based on the UFOC Guidelines. The Guidelines are intended to produce a single disclosure document that may be used in multiple states. In addition, many of the questions of interpretation that inevitably accompany any new guideline or regulation have been answered. The UFOC Guidelines have been the subject of numerous programs and seminars open to franchisors and franchisees. In 1994 and 1998, NASAA published Commentaries to the UFOC designed to discuss and clarify issues of interpretation.

As part of the FTC's recent Franchise Rule Review, the FTC has sought input from NASAA and a variety of other sources representing both franchisors and franchisees. In addition, the FTC has sought to work with NASAA and the franchise review states to ensure that the new disclosure document to be required under the Franchise Rule provides enhanced and commonsense disclosures for franchisees. As a result, the FTC has identified several disclosure items not currently required under the UFOC Guidelines that the FTC may seek to require under the revised Franchise Rule, for example, new disclosures related to a franchisor's parent and franchisor initiated litigation.

The disclosure document that the FTC has proposed under its Rule Review is a significant improvement over the existing format. Adoption of a federal franchise disclosure document consistent with the current proposal would benefit prospective franchisees in every state, especially those who reside in the 35 states that do not currently require a disclosure document to be prepared under the UFOC Guidelines. NASAA and the franchise review states look forward to continuing to work with the FTC as it seeks to finalize the new Franchise Rule.

#### DISTINGUISHING BETWEEN DISCLOSURES FOR BUSINESS OPPORTUNITIES AND FOR FRANCHISES

One of the other proposals in the FTC's Franchise Rule Review is to include a specific definition of "business opportunity" that distinguishes it from a "franchise." NASAA applauds this effort. This distinction is necessary in order to avoid the current confusion caused by the FTC's attempts to regulate two distinct types of business enterprises under one rule. Typical "business opportunities" include distributorships involving vending machine, greeting card display racks, and medical billing software.

Currently, 24 states regulate the offer and sale of "business opportunities." Many states require registration of business opportunity sellers as well as presale disclosure to prospective buyers. In general, states require business opportunity sellers to provide a disclosure document that, in most cases, is simpler and more abbreviated than the type of disclosure document required for franchise offerings.

Most business opportunity ventures are clearly distinguishable from a franchise. Business opportunities generally require much smaller investments than the fees required to purchase a franchise and unlike franchisors, business opportunity sellers provide very little, if any, assistance and training and exert little control over business opportunity purchasers. The contracts are simpler and impose fewer restrictions on buyers. In addition, business opportunity buyers generally do not operate under the sellers' tradename, trademark, or service mark. The creation of a separate definition of a business opportunity under the Franchise Rule would recognize these differences.

A separate definition for business opportunities also would improve state and federal enforcement efforts. Prospective business opportunity buyers have expressed their concern and confusion over the type of investment being purchased. For example, a business opportunity under state law might be considered a franchise under the Franchise Rule. Adopting a clear and distinct definition of a business opportunity would enable prospective buyers to determine what rules apply—to their investments. This revision also would benefit state and federal enforcement efforts by clearly defining the type of investment opportunity being investigated.

#### FEDERAL AND STATE COOPERATION ON BUSINESS OPPORTUNITY ENFORCEMENT ACTIONS

On June 20, 2002, the FTC, Department of Justice ("DOJ") and 17 states announced "Project Busted Opportunity," a coordinated attack on business opportunity and workathome fraud. The initiative included a consumer education campaign and a law enforcement sting targeting hucksters who use deceptive earnings claims and paid "shills" to promote their scams or otherwise violate consumer protection laws. Seventyseven operations were caught in the sting.

The 17 state law enforcement agencies participating in Project Busted Opportunity announced a total of 48 actions against business opportunity sellers. Those actions include lawsuits, cease and desist orders, consent agreements, and fines. The FTC and DOJ each brought 11 cases in federal court.

Project Busted Opportunity is but the latest in a series of federal/state enforcement sweeps regarding business opportunity fraud. Since 1995, the FTC has organized at least six federal/state coordinated sweeps aimed primarily at business opportunities.<sup>5</sup>

From about 1995 until 2001, the FTC and NASAA have jointly sponsored annual law enforcement summits dealing with business opportunities, franchises and pyramid schemes. These summits presented an opportunity for state and federal law enforcement officials to communicate with each other and coordinate law enforcement issues. At the summits, state and federal law enforcement personnel had the opportunity to meet and discuss current and anticipated enforcement actions, upcoming sweeps, industry trends, investigative techniques, and consumer education. Last year, the FTC did not hold an annual law enforcement summit on franchises or business opportunities. NASAA hopes that, in the future, the FTC will join us again in co-sponsoring these important events.

FTC staff also regularly communicates with state enforcement personnel through regular conference calls, an FTC sponsored business opportunity List Serve, and Consumer Sentinel. Consumer Sentinel is an on-line complaint database repository available to approximately 250 law enforcement agencies around the U.S., Canada and beyond. The Consumer Sentinel database is a valuable resource, and has proven itself to be an especially effective tool in the fight against business opportunity fraud.

There is no doubt that communication between federal and state officials on business opportunity issues is critical. In many cases, business opportunity con artists maintain their offices in one state but avoid selling to consumers in that state, in an effort to avoid detection and prosecution by state law enforcement officials. In those instances, it is critical for states to work with each other and federal officials to make sure that the business opportunity con artists are identified, caught and brought to justice.

NASAA and state business opportunity enforcement officials look forward to continued opportunities to work with the FTC and each other to take effective action against con artists who commit business opportunity fraud. We hope to continue and expand interagency opportunities to work together on both enforcement matters and consumer education.

#### CONCLUSION

Mr. Chairman and members of the Subcommittee, NASAA appreciates your interest in franchising and the role of the states in safeguarding the interests of franchisees. It should be apparent that the current system of state franchise regulation is a vital component of the entire regulatory scheme in this area. Clearly, oversight of franchise and business opportunity offerings is an important consumer protection for the hundreds of thousands of people who invest in these operations. We look forward to a continuation of federal and state cooperation on franchising and business opportunity issues.

Thank you.

Mr. STEARNS. Thank you. Mr. Wharton.

#### STATEMENT OF PHILLIP LESLIE WHARTON

Mr. WHARTON. Good morning, Mr. Chairman, members of the subcommittee. Thank you for inviting me today to discuss the FTC Franchise Rule. My name is Les Wharton. I am the Vice President of Legal Affairs for the Franchise/License Division of Spherion Corporation.

Spherion is a staffing company founded in 1946. We are headquartered in Fort Lauderdale, Florida, and operate a network of approximately 940 locations primarily in North America. Our stock is publicly traded on the New York Stock Exchange. We were

<sup>5</sup> See United States General Accounting Office, *Federal Trade Commission Enforcement of the Franchise Rule: Report to Congressional Requesters*; Table 7, p. 66 (July 2001).



created in the merger of two large staffing companies in 1999, Norrel and Interim Services. Spherion has been franchising since 1956. I chair the International Franchise Association's Corporate Counsel Committee, and I am also the vice chair of the Legal Legislative Committee of that organization. I have been involved in franchising since 1981.

I believe that the Federal and State pre-sale disclosure process is critically important in providing a framework within which small business franchise investors can evaluate franchise investment opportunities. At Spherion we want our franchisees to be fully aware of how our business operates before they become franchisees. We also want our franchisees to understand how a franchise relationship is structured and what our respective obligations are during the course of the relationship.

Preparation of a disclosure document takes substantial time and effort and is expensive. But pre-sale disclosure, the pre-sale disclosure process is good for franchise investors and for franchise systems. It provides the basis for both parties to consider whether they want to do business with each other.

We want our franchisees to make a commitment to our brand and our way of doing business, and the only way that they can do that is if they are fully informed about what we do and the way that we do it. We don't want any surprises about what is expected of us after the relationship begins, and neither do our franchisees.

It is not in our short-term or long-term interest to expand our business with franchisees unless they are fully aware of our operating standards and business philosophy, and it is not in their short-term or long-term interest to make an investment with us unless they understand and embrace our business concept. The pre-sale disclosure process protects both franchisees and franchisors and creates a business climate in which franchising has flourished.

I am very encouraged about the FTC current effort to revise and modernize its Franchise Rule. There are a number of proposed revisions that will be particularly important, but I would like to take a moment to discuss four of the proposed revisions.

First, we believe that the proposal to replace the current FTC rule format with the Uniform Franchise Offering Circular format, developed by State franchise regulators, is a very positive step. This will eliminate inconsistency between disclosure documents provided to franchise investors.

Second, I believe it is important that the FTC develop separate disclosure rules for franchises and business opportunities. Franchise investments are so distinct from business opportunities that each should have and must have its own rule.

Third, I agree with the FTC's recommendation not to require a mandatory earnings claim. A uniform, "one size fits all" approach to disclosing earnings information will not work. Our business operations are significantly different from the operations of other franchised businesses in other industries. It makes no sense to require all franchised businesses, regardless of the industry in which they operate, to provide earnings information on a uniform basis. I believe that the best way for the franchise investor to evaluate the potential from a franchise business is, one, to thoroughly re-

view the franchise disclosure document; two, to get professional legal and financial assistance in that review; and, most importantly, to talk with as many current and former franchisees as possible before making that development. It is important to note here that a list of the names and addresses and phone numbers of the current franchisees as well as those who have left the system within the last year is required by the rule to be part of the disclosure document.

Fourth, I support the FTC's efforts to modernize the rule in order to permit an electronic disclosure. At the time it was promulgated we didn't even have fax machines. Now we have e-mail Web sites. It has significantly altered the way that we do business.

I believe that the FTC has created a thorough and comprehensive record on which to move forward in its rulemaking, and I believe that as a result the forthcoming revisions to the rule will receive wide support from interested parties.

In closing, let me reiterate my support for the pre-sale disclosure process and emphasize the great benefits of pre-sale disclosure for both the franchisees and the franchisors. Franchising is founded on open and honest relationships, and on realistic expectations about the franchise business. There is no better way to ensure a mutually successful franchise business enterprise than for both parties to enter into the business fully aware of what their mutual rights and obligations are.

Thank you.

[The prepared statement of Phillip Leslie Wharton follows:]

PREPARED STATEMENT OF PHILLIP LESLIE WHARTON, VICE PRESIDENT, LEGAL AFFAIRS, FRANCHISE/LICENSE DIVISION, SPHERION CORPORATION

Good morning.

Mr. Chairman and members of the Subcommittee thank you for inviting me to appear today to discuss "The FTC Franchise Rule: Twenty-Three Years After Its Promulgation."

My name is Les Wharton. I am the Vice President, Legal Affairs, for the Franchise/License Division of—Spherion Corporation ("Spherion").

Spherion is a staffing company that delivers performance-enhancing solutions to businesses in recruitment, technology and outsourcing services. Founded in 1946, Spherion is headquartered in Ft. Lauderdale, Florida and operates a network of approximately 940 locations primarily in North America, and includes operations in Europe and Australia/Asia. Its stock is publicly traded on the New York Stock Exchange. Spherion's revenues last year were \$2.7 billion.

Spherion operates its clerical and light industrial staffing business through 372 company owned and 246 franchised locations. It has been franchising that business since 1956.

I am also Chairman of the International Franchise Association's Corporate Counsel Committee, a committee of approximately 60 in-house franchise counsel, and Vice-Chair of the Legal/Legislative committee of the International Franchise Association. I have been involved in franchising since 1981. I am a member of the American Bar Association (the "ABA") Forum on Franchising and I have served for some time as a member of the Steering Committee of the Forum's Corporate Counsel Division. I am also a member of the Franchise Committee of the International Bar Association. I have been a speaker on franchise topics at IFA meetings and Legal Symposia, and at the ABA Annual Meeting as well as at the Forum on Franchising Annual Meeting.

It is a pleasure to be here to discuss this important topic. I believe that the federal and state pre-sale disclosure process is critically important in providing a framework within which small business franchise investors can evaluate franchise investment opportunities. At Spherion, we want our franchisees to be fully aware of how our business operates before they become franchisees. We also want our franchisees to understand how our franchise relationship is structured and what our respective obligations are during the course of the relationship.

The presale disclosure process is good for franchise investors and for franchise systems, because it provides the basis for both parties to consider whether they want to do business with the other. We want our franchisees to make a commitment to our brand and our way of doing business, and the only way they can do that is if they are fully informed about what we do and why we do it. We don't want any surprises about what is expected of us after the relationship begins, and neither do our franchisees.

It is not in our short or long term interest to expand our business with franchisees unless they are fully aware of our operating standards and business philosophy. And it's not in their short or long term interest to make an investment with us unless they understand, and embrace, our business concept. The presale disclosure process protects both franchisees and franchisors, and creates a business climate in which franchising has flourished.

I am very encouraged about the FTC's current effort to revise and modernize its Franchise Rule. There are a number of proposed revisions to the Rule that will be particularly beneficial to Spherion. I would like to take a moment to mention several of those proposed revisions.

First, we believe that the proposal to replace the current FTC Rule format with the Uniform Franchise Offering Circular format developed by state franchise regulators is a very positive step. The UFOC was updated several years ago, and unlike the FTC Rule is accepted in all states that have adopted state franchise laws. For a company like Spherion, with operations all across the U.S., the harmonization of the federal and state disclosure formats will be a significant improvement. This will eliminate any inconsistency between disclosure documents provided to franchise investors and create greater consistency for anyone considering a franchise investment.

Second, I believe that it is important that the FTC develop separate disclosure rules for franchises and business opportunities. Franchise investments are sufficiently distinct from business opportunities that each should have its own rule. In addition, because the vast majority of complaints alleging violations of the FTC Rule involve business opportunities and not franchises, separate rules would result in greater accuracy in categorizing complaints and obtaining relief for investors.

Third, I agree with the FTC's recommendation not to require mandatory earnings claims. A uniform, one-size-fits-all approach to disclosing earnings information will not work. Spherion's business operations are significantly different from the operations of other franchised businesses in other industries. It makes no sense to require all franchised businesses, regardless of the industry in which they operate, to provide earnings information on a uniform basis.

Further, since we do not maintain the books of our franchisees, it would be virtually impossible for us to ascertain the validity of any cost information that they provided us to use in making such earnings claims. As a result, franchise investors would receive information that we could not verify and which could be less than accurate.

I believe that the best way for a franchise investor to evaluate the potential earnings from a franchised business is to obtain and thoroughly review the franchise disclosure document, retain professional legal and financial assistance in that review and most importantly, to talk to as many current and former franchisees as possible before making the investment. A list of our franchisees, including addresses and telephone numbers, is included in the disclosure document.

Finally, I would like to indicate support for the FTC's efforts to modernize the Rule in order to permit electronic disclosure. At the time the FTC Rule was promulgated, we didn't even have fax machines. Now we have email and websites that have significantly altered the way in which we do business. I believe that the FTC's efforts in this area are critical, as electronic communication has the potential to provide greater, more readily available information to franchise investors while simultaneously reducing costs both to franchisors and franchisees.

There are other proposed changes to the FTC Rule in which I have an interest, but I wanted to highlight these four because of their importance to Spherion as well as the rest of the franchise community. I believe that the FTC has created a thorough and comprehensive record on which to move forward with its rulemaking, and believe that as a result the forthcoming revisions to the Rule will receive wide support from all interested parties.

In closing, let me reiterate my support for the presale disclosure process and emphasize the great benefits of presale disclosure for both franchisees and franchisors. Franchising is founded on open and honest relationships, and on realistic expectations about the franchised business. There is no better way to ensure a mutually successful franchise enterprise than for both parties to enter into the business fully aware of their mutual rights and obligations to make the business a success.

Thank you again for taking the time to discuss this important subject, and for inviting me here to appear today.

Good morning.

Mr. STEARNS. I thank the gentleman.

Ms. Kezios.

#### STATEMENT OF SUSAN P. KEZIOS

Ms. KEZIOS. Mr. Chairman, my name is Susan Kezios, president of the American Franchise Association. The Franchise Association is made up of the small businesspeople who buy the franchises from the corporate franchisors like Mr. Wharton's company.

We are here because 23 years after the promulgation of the FTC rule, my franchisees, my members have big problems. They have got big problems postsale because of what happens and what doesn't happen in the presale process. We estimate that our members, 15,000 of our AFA members in the aggregate, we have about \$7.5 billion in sunk costs in their businesses.

So these are the men and women, the families who buy the franchises, who invest their money, and who work the businesses. Like everybody else here, we are all for full and complete disclosure; however, under the current scheme, I am here to tell you that that is an impossibility.

There is some important background that you should know. The FTC's Franchise Rule was promulgated in 1979 based on 1960's market conditions. So it was designed to address the dysfunctions of what was going on in franchising in the 1960's, and in the 1960's the scam in franchising was in the presale process. The scam in franchising today is not in the presale, it is in the contract.

During those days, the 1960's into the 1970's, when the FTC's rule was being debated, certain corporate franchisor lawyers worked to hobble the promulgation of the rule. When the rule's promulgation was inevitable, they worked then to weaken its effectiveness. That is where we are today. We have a weak rule with even weaker enforcement.

Our members have little faith in the FTC. They have little faith in the FTC's enforcement of the rule for three reasons. One, as has already been mentioned by a member of this subcommittee, the disclosure documents are written to circumvent the existing rule. Any franchisor—corporate franchisor lawyer worth his or her salt can write a disclosure document that will meet the minimum requirements of the FTC's rule.

Second, the franchise contracts that the franchisees sign actually deprive small business owners of many basic legal rights, common law rights. Someone surmised earlier that I am sure we can go and bring a private right of action. No. In fact, in many contracts you waive your right to a jury trial in order to become a franchise owner of XYZ Company.

And No. 3, corporate franchisor lawyers write the contracts in such a way that the contracts can change after you sign. They become a moving target, and for somebody whose investment is sunk into the business, they can't move anywhere, they have to deal with that contract afterwards.

When our members enter into franchise contracts and into the franchise business relationship, they do so with the intent of deal-

ing with their franchisor in good faith. Franchisors today are even teaching each other—the corporate franchisor lawyers are teaching each other how to draft contracts to negate the duty of good faith. That is something that I will submit to the committee that came to our attention recently.

So you need a fleet of attorneys to begin with to understand that 2-inch-thick disclosure document. And as Mr. Rush pointed out, how many families are going to invest in the time and invest in the lawyers to do that?

Now, in my written statement, we talk about two areas that the subcommittee can take a look at. Mr. Shimkus pointed out one of them is—one of our recommendations is that some Federal agency has to collect data on franchising. No Federal agency has collected data on franchising since 1988. That is when the U.S. Department of Commerce ceased its collection of franchise data. And no branch of the Federal Government has ever been a Federal repository for those documents.

Our second recommendation, as in my written statement, is that we would recommend the FTC to require corporate franchisors to disclose historical financial performance information, what Mr. Wharton is calling income claims here, to prospective franchisees. Let me emphasize historical financial performance information. We are not talking about what you might do, projected earnings. Franchisors routinely receive this information from their small business franchisees in monthly, weekly, sometimes daily accounting requirements. And there is no Federal rule, there is no State law that prohibits disclosure of historical financial performance information. This is a totally voluntary disclosure in the FTC rule, and most franchisors simply volunteer not to disclose it. And what is most ironic about this historical performance information, 99.9 percent of the cases that the FTC took up against franchisors involved misleading or misrepresented earnings information to the prospective buyer.

Now, our members also feel that the FTC staff incorrectly believes their authority does not extend to postsale franchise relationships, and as has already been pointed out, the GAO's audit brought some interesting data of its own. Franchise complaints have increased tenfold. Over 90 percent of those complaints have to deal with postsale problems or a combination of pre- and postsale problems.

I mean, what more evidence do you need that the Federal Trade Commission is asleep at the wheel when it comes to what are the real problems out there for franchisees?

We believe that franchising has grown significantly from the 1960's, from its infancy. It then may have been a method of distribution. It has evolved into a powerful industry, a largely self-regulated interstate commerce industry. We would urge members of this panel to consider our point of view. The relationship between the franchisors, the corporate franchisors, and the small business franchisees has suffered from benign neglect for too long, and hopefully this subcommittee will begin a new debate on the appropriate guidelines for or future. Thank you.

[The prepared statement of Susan P. Kezios follows:]

PREPARED STATEMENT OF SUSAN P. KEZIOS, PRESIDENT, AMERICAN FRANCHISEE ASSOCIATION

Chairman Stearns and Members of the Subcommittee: My name is Susan P. Kezios. I am the President of the American Franchisee Association (AFA). The American Franchisee Association was founded in February 1993 and is the largest trade association of small business franchisees in the United States. We strive in every way possible to promote a business-to-business relationship predicated upon good faith and fair dealing because we represent the people who invest in franchised businesses and who actually work in them. The entrepreneurial men, women and families who make up our fifteen thousand AFA members own over 30,000 franchised outlets in 60 different franchise systems. In the aggregate, we estimate our members have invested, excluding real estate, more than \$7.5 billion in sunk costs to build the brand names of their franchise systems.

We are grateful for this opportunity to present our views on the activities of the Federal Trade Commission (FTC) in its enforcement of its Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (16 CFR part 436) (aka, "Franchise Rule," "the Rule," or the "FTC's Franchise Rule") because it is our membership, and other would-be small business franchisees that the Rule was intended to inform in the first place. Like our counter-parts, the AFA welcomes and supports full pre-sale disclosure as a means to improve and grow franchising.

The AFA and its members have been active in responding to both the Commission's Advanced Notice of Proposed Rulemaking (ANPR) and Notice of Proposed Rulemaking (NPR). In addition, we actively participated in each of the FTC's series of public workshop conferences held in 1995, 1996 and 1997. All of the AFA's extensive suggestions for improvements to the Rule and of the FTC's role in enforcing the Rule have already been put in writing to the Commission. Copies of those suggestions are attached to my testimony.

The FTC's Franchise Rule was promulgated in 1979 based on 1960's market conditions. It was crafted to address the dysfunctions of franchising during the 1960's when franchising was in its infancy. Certain franchisors and their lawyers worked in those days to hobble promulgation of the Rule. Change often comes slowly, and at that time, they fought the Rule like tobacco companies fought the health warning labeling of cigarettes and automakers fought seat belts. When they couldn't stop the Rule's promulgation they worked to weaken its effectiveness. The end result is that twenty-three years later we have a weak rule with even weaker enforcement. That being said, I would like the Subcommittee to consider directing the FTC to take action in three areas that would give the franchise investor more useful, accurate and complete information in order to make an informed decision. First, we ask that the Subcommittee direct the FTC to change the language on the front cover page now required by the FTC to be affixed to each disclosure document. This cover page reads in part, **"To protect you, we've required your franchisor to give you this information. We haven't checked it and don't know if it's correct."** The cover page then deputizes the prospective franchisee by concluding with, **"If you find anything you think may be wrong or anything important that's been left out you should let us know about it. It may be against the law."**

The FTC's cover page gives two distinct but misleading impressions to the purchaser of a franchise; first that the "government" is somehow involved in the sale of franchises and is watching out for the investor's interests and second, that if the purchaser finds anything wrong, that the government would actually do something about it. That's the hollow invitation presented by the FTC cover page. It's an empty invitation because the available data shows they are simply not going to do anything about the majority of franchise complaints presented to them. Franchisors know that the FTC cover page warning carries very little weight; they attach it to their disclosure documents with a wink and a nod, knowing that it helps them overcome a prospective franchisee's hesitancy.

The second area on which we would like the Subcommittee to focus its efforts has to do with the collection of data. No branch of the federal government has collected data on franchising since the U.S. Department of Commerce ceased its collection of franchise data in 1988. And no branch of the federal government has *ever* been a central repository for the offering circulars prepared by franchisors.

We recommend that the Subcommittee require the FTC to direct franchisors to file their offering circulars a minimum of annually with the Commission. The means are readily available for these documents to be filed electronically and made available to the public at a modest cost. This would facilitate the kind of comparison shopping for franchise opportunities the Rule was originally designed to foster.

The Subcommittee has been provided with copies of at least two different offering circulars (Domino's and Pizza Hut) to serve as examples and I would invite Members to thumb through those yellow-page sized documents. Despite the magnitude of even just the initial investment required by the small business man or woman interested in becoming a franchisee, there is no signature of any franchisor officer anywhere to be found on the circulars. Given the current Enron-inspired plummet in investor confidence, perhaps another reform would be an FTC requirement for corporate validation of franchise offerings.

We also recommend that the Subcommittee require the FTC to compile, analyze and publish statistical information on franchise business ownership and performance and on national franchise practices. These reports could finally begin to create a body of comprehensive, objective and accurate information about the operation of franchise systems and franchised businesses.

Third, we recommend that the Subcommittee direct the FTC to require that franchisors provide historical financial performance data in the disclosure documents they are required to provide to prospective franchisees. Let me emphasize *historical* financial data, not *prospective* or future anticipated financial estimates. If providing pre-sale information is important, then it is a fatal flaw of the FTC's Franchise Rule that disclosure of some measure of financial performance is not required. The fiction that franchisees can and should buy a franchise without receiving this most elementary data is well outside the norm in commercial practices. It is inherently misleading (by omission) not to disclose historical financial performance information.

A major problem in the go-go 1960's, when franchising was beginning to roar out of its infancy, was those folks selling franchises and promising investors they would make specific large amounts of money if only they bought a particular franchise. You see, corporate franchisors collect royalties from their outlet owners on *sales*, not *profits*, so it is in the franchisor's best interest to have risk-taking franchisees open as many outlets as possible. The FTC's requirements regarding "earnings claims" (Item 19 in the offering circular) were born out of that era.

Twenty-three years after its promulgation, franchisors hide behind and misuse the Item 19 disclosure requirement of the Franchise Rule. Prospective buyers are told by franchise salespeople that they are "prohibited by law" from making any earnings representations. There is no federal rule or state law that prohibits franchisors from providing accurate earnings information in the disclosure document. Providing earnings claims is a *voluntary* disclosure that the majority of franchisors, by at least tacit agreement among them, volunteer *not* to make.

What is most ironic about the voluntary disclosure of earnings claims is that of the franchise enforcement cases undertaken by the FTC during the time period studied in both the GAO's July 1993 and 2001 Reports, 99.9% of the cases cited had to do with fraudulent or misleading earnings information. Yet, surprisingly, the FTC does not think the American consumer is entitled to that information.

The worst part about franchisors' not providing historical financial performance information is that those of us in the industry know that the information is being given out all the time. Moreover, this information is readily available to franchisors as they require franchisees to provide this data to them as part of routine financial reporting under the franchise agreement. We need to make it mandatory and we need to make it reliable.

Finally, it is clear to our members, based on the General Accounting Office's (GAO) July 2001 audit of the FTC's enforcement of the Franchise Rule that FTC staff believe, *incorrectly*, that their authority does not extend to post-sale franchise relationship matters. Regardless, the GAO audit itself provided some interesting data including the fact that franchise complaints to the FTC in general increased ten-fold during the time period studied. Also that 92% of the franchise complaints that come to the FTC have to do with post-sale franchise relationship problems (or a combination of pre- and post-sale problems).

The GAO's 2001 audit did *not* conclude that there are not franchise relationship problems, but rather only that there is no data on the *extent* of franchise relationship problems. Relationship problems often occur because of the zealotry of franchisor lawyers who draft the contracts on behalf of their clients. A variety of clauses are added to franchise contracts to provide a wide array of weapons that deprive franchisees of common law rights. These include waiver of jury trial rights, dispute resolution in distant locations, indemnification for the franchisor even for its own negligence, one-sided arbitration clauses and waiver of required bonds to obtain injunctions. The heavily one-sided, take-it or leave-it franchise agreement we see today would not be tolerated in any other industry where true competition is a reality.

While prospective franchisees can always decide not to buy franchises, many of the provisions our members find objectionable have become “standard operating procedure.” It doesn’t matter if you’re looking at franchise A or franchise B—the agreements for both will require, for example, that the franchisee waive his/her right to a jury trial. In other words, as the 1999 AFA study of the top eight pizza franchisors demonstrated, there is no meaningful choice among franchise agreements with respect to the legal rights of a franchisee. There may have been true choice between franchise agreements in the 1960’s and 70’s when the promulgation of the FTC’s franchise rule was being debated, but not today.

Franchisees joke that they’re the only small business people who go to sleep one night thinking they’re in one kind of business only to wake up the next morning in a totally different business. That’s because franchise contracts can and do change during the term. Most franchise agreements provide that the franchisor can change its operations manual or other company policies from time-to-time without notice to or with the consent of the franchisee. In effect, the franchise agreement becomes a moving target for the franchisee because the franchisor has the unilateral right to change the terms of the deal. This is perhaps the biggest threat to a franchisee’s sunken investment because the franchisee typically bears the cost of implementing whatever change the franchisor decides to make to the system.

Twenty-three years after its promulgation the consumer approach taken by the FTC is totally inadequate in protecting the amount of money and time invested by franchisees in their businesses. Even when franchisees are given the required disclosures the information provided is often inadequate, misleading, internally inconsistent, erroneous or just missing altogether.

Mr. Chairman, we believe that franchising has grown from its roots as a method of distribution and has evolved into a powerful industry—a largely self-regulated, interstate commerce industry. We would like to urge Members of this panel to ponder our point-of-view. The relationship between franchisor and small business franchisee has suffered from benign neglect for too long. Hopefully, this Subcommittee will begin a new debate on appropriate guidelines for the future. Franchisees have sought more openly disclosed, honest information long before the Arthur Anderson accounting revelations. We need to have more accountability from the corporations that offer investment opportunities and an energized Federal Trade Commission can fulfill its consumer protection mandate by insisting upon such from corporate franchisors.

Mr. STEARNS. Thank you.

Ms. WIECZOREK. Welcome.

#### **STATEMENT OF DENNIS E. WIECZOREK**

Mr. WIECZOREK. Thank you. Good morning. And thanks for the opportunity to appear before you, Mr. Chairman, and the rest of the committee. My name is Dennis Wieczorek. I am a partner in the Chicago office of the law firm Piper Rudnick. I have been practicing franchise law for 25 years. I am appealing today on behalf of the International Franchise Association, which is the largest association representing the entire franchise community, franchisors and franchisees.

IFA has been and continues to be one of the most vocal supporters of the disclosure of a wide range of information to prospective franchisees. IFA believes that disclosure is critical when an individual is making such an important investment decision. If a franchisee and franchisor have a mutual understanding of the rights and obligations right at the start, there is a much higher likelihood that they will work together to make the relationship continue and prosper.

IFA has been an active participant in formulating the rules of franchise offer disclosure. It participated in the creation of the Uniform Franchising Offering Circular guideline in the 1970’s, and similarly was involved in the overhaul of those UFOC guidelines in 1993.



A few years thereafter the FTC began the review of its franchise rules. IFA has had an extensive role in public workshops and hearings and in preparing written comments on the rule. While IFA does not agree with all aspects of the rule revisions that have proposed by FTC, it is clear to IFA that FTC has bent over backwards to make the rule revision process as open and inclusive as possible. We have not yet seen the final version of the Franchise Rule, but a few comments are appropriate regarding some of the overall trends already evident from the FTC's public statements on the rule.

First, it is important to divorce business opportunities from franchises in any new trade regulation rule. The FTC uses considerably more resources in enforcement activities against business opportunities dollars, and there is no basis for tarring franchising with the same brush.

In addition, the FTC should move toward a single disclosure format and take all necessary steps to achieve uniformity in the disclosure process.

While it appears that the FTC is addressing those issues, IFA will continue to pursue a number of other changes to improve the Franchise Rule. It is essential that the FTC recognize the extraordinary costs and burdens that franchisors must bear in complying with disclosure rules. The FTC must stop short of creating excessive new requirements that add unnecessary burdens and unnecessary pages, that erect high entry barriers to new entrants into the franchise business, and that unduly complicate the disclosures to be read by prospective franchisees.

As you know, the General Accounting Office recently completed a study on enforcement of the Franchise Rule. In summary, the GAO confirmed that the TFC used most of its enforcement resources over the last 7 to 8 years on business opportunities, because the overwhelming majority of complaints came from buyers of business opportunities, not from buyers of franchises.

The report also states, and I quote, according to FTC staff, data the FTC has collected, while limited, suggest that franchise relationship problems are isolated occurrences rather than prevalent practices.

The GAO also states in the report that the FTC believes that it does not have the statutory authority to intervene in private contractual matters, particularly when there is no evidence of systemic abuse. IFA believes that this is the right approach, and that other methods to resolve relationship problems, the National Franchise Mediation Program, IFA's ombudsman program, and other internal dispute resolution programs, are the appropriate way to deal with those issues. That is where nearly all relationship problems should be resolved, not in court, and not by a government agency.

In summary, let us allow FTC the opportunity to do its job. It needs more resources. Let us take care of that. IFA may not agree with everything that the FTC does, nor with all of the changes proposed in the new rule, but IFA endorses the FTC's philosophy of franchise regulation. IFA, like the FTC, believes strongly in the concept of full and fair disclosure and will continue to provide its support for the FTC's efforts to improve franchise disclosure.

Thank you, Mr. Chairman.

[The prepared statement of Dennis E. Wieczorek follows:]

PREPARED STATEMENT OF DENNIS WIECZOREK, PARTNER, PIPER RUDNICK, ON  
BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION

INTRODUCTION

Good morning, Mr. Chairman and members of the Subcommittee. My name is Dennis Wieczorek and I am here today on behalf of the International Franchise Association. I am a partner in the Franchise and Distribution Practice group of Piper Rudnick, which has served as General Counsel to the International Franchise Association since the association was founded in 1960.

Piper Rudnick is a national law firm with offices throughout the U.S. I have practiced as a franchise lawyer for 25 years and have worked with clients ranging in size from 1 or 2 unit development stage entities to some of the world's largest franchise companies.

*The International Franchise Association*

Founded in 1960, the International Franchise Association is the oldest, largest and only association that represents the entire franchise community, with more than 4,000 individual franchisee members, 30,000 franchisee members represented through their franchisee associations, 800 franchisor members and 300 franchise supplier members. Once a franchisor-only association, the IFA leadership recognized a decade ago that to truly serve as the "voice of franchising," franchisees should be included as members of the association. Since 1993, franchisees have been integrated into all aspects of the IFA, including the Executive Committee, Board of Directors and committee structure. Currently, a franchisee serves as Chairman of the International Franchise Association. Another franchisee is Treasurer of the IFA and five other franchisees serve as elected members of the IFA Board of Directors.

The IFA's franchisor members include some of the most recognizable names in the U.S. economy, and many of those companies operate thousands of franchised units. But the vast majority of IFA's membership, more than 70%, operate fewer than 200 franchised units and are themselves small businesses. Regulatory compliance burdens for those companies can make the difference between success and failure in the marketplace, which in turn impacts job creation, economic development and entrepreneurial opportunities for franchise investors, their families and employees.

One of IFA's goals in expanding membership to embrace franchisees was to ensure that the IFA speaks on behalf of the entire franchise community on legislative, regulatory and other public policy initiatives that affect franchising. The IFA also actively supports vigorous enforcement of, and thorough compliance with, the FTC Franchise Rule and state franchise disclosure laws. It is important to remember that franchising is a business concept in which franchisors and franchisees must work together to ensure the mutual success of the enterprise. This requires a careful balancing of both parties' interests in order to ensure that the regulatory climate promotes continued growth of franchised businesses.

The IFA's mission is to protect, enhance and promote franchising. IFA conducts many programs, seminars and conferences to educate current and prospective members of the franchise community, as well as the public, about what franchising is and how franchising works. Over the years, the IFA has adopted and embraced a number of other initiatives to promote healthy and mutually beneficial relationships within the franchise community. Primary among these is the IFA's Self-Regulation program, which includes the IFA Code of Ethics, the IFA Ombudsman program and on-line compliance and education programs for the franchise community. The on-line educational programs, Franchise Compliance and Franchising Basics, were created to ensure that franchisors fully comply with existing federal and state franchise disclosure laws and that franchise investors are fully aware of what franchising is and how franchising works. All of these programs will help minimize long-term disruption to franchise systems and promote expedited resolution of business disputes in franchise systems.

The International Franchise Association has also endorsed, and promoted since its inception, the National Franchise Mediation Program ("NFMP"), the only program designed specifically for franchising to assist franchise systems in mediating resolution to business disputes. In addition, a number of franchise systems, working in conjunction with the FTC, have created a program known as the National Franchise Council ("NFC"). The NFC administers an alternative Rule enforcement program to assist the FTC and franchise companies in addressing minor and technical violations of the FTC Franchise Rule. These programs, developed over a number of years by the IFA and the franchise community, demonstrate a commitment to self-regula-

tion and to the creation of a business climate in which franchisees and franchisors can work together to avoid, identify or resolve potential disputes within individual franchise systems.

*What is Franchising and What is the Role of Franchising in the Economy?*

Franchising is a strategy for the growth and expansion of a business in which the franchisor licenses to the franchisee, for a period of time, the trademark, intellectual property, operating and business plan and other proprietary information necessary for the operation of the business. The franchisor also provides training, support and advertising and marketing assistance necessary to promote the brand and achieve continued brand recognition and market penetration. In return for the right to operate this carefully tested and proven system, the franchisee makes regular royalty payments to the franchisor, usually on a monthly schedule and calculated using the gross monthly revenue of the franchised unit as a basis.

Franchise relationships are unique business arrangements based upon a contract between the franchisee and the franchisor in which the obligations, rights and remedies of the parties are spelled out in great detail. Federal and state disclosure laws, such as the FTC Franchise Rule, identify specific criteria that distinguish a franchise from other forms of distribution relationships. These criteria include a registered trademark; the on-going payment of royalties or other fees; and a continuing and significant involvement of the franchisor in the operation of the franchised business.

Franchising is not an industry, instead it is a strategy for business growth and expansion that has been successfully employed by more than 75 different industries, ranging from hotels to printing to real estate to restaurants and scores of others. The services and products offered by these businesses to their customers vary widely, as do the manner in which companies in these industries operate their businesses.

Today, franchising accounts for approximately \$1 trillion in sales, or nearly 50% of all retail sales in the U.S. According to the Profiles in Franchising study conducted by the IFA Educational Foundation, there are 320,000 franchised units in the U.S. which employ 8 million people. Franchising is an incredibly successful method of expanding a brand that has created hundreds of thousands of entrepreneurial opportunities, giving franchisees the opportunity to be in business for themselves but not by themselves. In the process, franchising has created literally millions of jobs and become an engine of small business growth and development in our economy, and today is responsible for sharing America's free enterprise values with more than 100 other nations.

*The Benefits of Presale Disclosure*

The International Franchise Association appreciates the opportunity to participate in today's discussion of the FTC Franchise Rule and the effectiveness of the Rule in promoting a healthy and balanced regulatory climate for the franchise community and American consumers. The IFA has worked with the FTC since the early 1970's to help craft a federal disclosure rule that will provide prospective franchise investors with the information necessary to make an informed business decision about a franchise investment, while simultaneously maintaining a reasonable compliance burden for franchise systems.

The IFA has always vigorously supported the enforcement of disclosure laws because prospective small business franchisees, franchising and its customers are best served when those investing in a franchise have all relevant information about the franchise prior to making the franchise investment. In particular, the International Franchise Association has been actively involved in working with the FTC since 1995 on the FTC's proposed revisions to the Rule, and has appeared at numerous public workshops to discuss those revisions and submitted a number of written comments (attached to my remarks) expressing the International Franchise Association's perspective on the proposed revisions to the Rule.

The International Franchise Association is firmly committed to the disclosure process because we believe it is critically important for franchise investors to have realistic expectations about how franchised businesses operate, and about the interdependent relationship between franchisors and franchisees. Investing in a franchised business is not a guarantee of success. Franchised businesses, like any other free market enterprises, require commitment, hard work and dedication (among other things) in order to be successful.

One of the IFA's primary functions is to serve as a resource for the public and potential investors to educate them about what franchising is, and how franchising works. Franchising is *not* for everyone. Franchised businesses are based on the standard and uniform appearance, operation and delivery of products and services

to customers. This requires franchisees to adhere to, and comply with, minimum quality standards established by the franchisor for the operation of the business. The requirement to adhere to operating standards may be something that is not universally appealing to all independently-minded entrepreneurs.

The beauty of the franchise disclosure process is that while there are literally hundreds of franchised businesses from which an entrepreneur can choose, the disclosure process provides the future small business franchisee with the framework within which to conduct a thorough and comprehensive evaluation of those investments. As a result of this evaluation, the franchise investor can make a decision about which, if any, is the right investment. That is one of the reasons that the IFA promotes and distributes the FTC's *Consumer Guide to Buying a Franchise*. For years, the *FTC Guide* has been republished in IFA's Franchise Opportunities Guide, posted on our website and disseminated to thousands of news media outlets to increase public awareness. The *FTC Guide* provides franchise investors with guidance about what information is important in evaluating a franchise and how to obtain and evaluate this information. The Guide also recommends that franchise investors retain professional services of legal and financial experts to assist in a thorough evaluation of all presale information obtained as part of the disclosure process.

This evaluation also requires a considerable amount of self-evaluation and introspective thinking about the business or industry in which a franchise investor wants to be involved. If the prospective investor determines that none of those investments are attractive, the future entrepreneur is free to establish his or her own independent business. The disclosure process provides the information necessary to reach a fundamental decision about whether to make the investment, and to compare between and among franchise systems in order to find the franchised business that matches an individual's interests, skills and needs.

#### *The FTC Disclosure Rule and Proposed Revisions*

As noted earlier, the International Franchise Association's longstanding support for the disclosure process is rooted in our belief that disclosure regulations strike the appropriate balance between the investor's need for information and the legitimate concerns of franchise systems about overregulation in the marketplace. The IFA commends the FTC staff for the manner in which they have conducted the process leading to the review of the franchise rule. We have actively participated in this process, beginning in early 1995 with the informal request for comment, the first public workshop in September 1995, the subsequent workshop in March, 1996, the Advanced Notice of Proposed Rulemaking in early 1997, the subsequent regional workshops held around the country in 1997 and the Notice of Proposed Rulemaking in 1999. We believe that the inclusive and thorough approach adopted by the FTC in this rulemaking effort resulted in a process that provided ample opportunity for all interested parties to participate, and has produced a record that clearly identifies the areas addressed by the Rule that are most in need of revision.

#### *GAO Audit*

The IFA also participated in numerous discussions with the General Accounting Office ("GAO") during the 2000-2001 audit conducted by the GAO on the Enforcement of the FTC Franchise Rule. We believe that the results of the GAO audit affirm our long-held beliefs that: (1) the vast majority of complaints alleging violations of the franchise rule (more than 92% according to the GAO) involve business opportunities, not franchises; (2) the FTC effectively enforces the Rule; and (3) there is no empirical data to support the notion that there are pervasive problems in franchise relationships.

According to the July 31, 2001 GAO Report on Franchise Rule Enforcement:

- From January 1993 to June 1999, a seven year period, the FTC received 3,680 business opportunity and franchise complaints, with 92% involving business opportunities and 8% involving franchises. (GAO-01-776, pages 3,10)
- During the same period, and after analyzing complaints, the FTC launched 332 investigations. 162 cases went to court for violations of the Franchise Rule and/or section 5 of the FTC Act (which declares unlawful unfair or deceptive acts or practices in or affecting commerce.) (GAO-01-776, pages 13,16)
- Of the 162 cases, 88% or 142 involved business opportunities, only 12% or 20 involved franchises. In each of the 162 cases brought to court, the FTC obtained some form of relief, including injunctions, civil penalties or monetary redress for investors. (GAO-01-776, pages 3,10)
- Since the Franchise Rule review process began in 1995, the FTC has received comments or statements for the record from a total of 96 individual franchisees or trademark-specific franchisee associations. FTC staff noted that nearly half of the comments submitted were identical form letters that discussed their gen-

eral support for broader franchise relationship controls but shed little, if any light, on their specific experiences. FTC staff also reported more than half of the comments raised issues involving only three franchisors. The FTC said there was little consistency among the remaining individual comments, which covered a wide range of issues. (GAO-01-776, page 22)

- FTC staff stated that the isolated instances of franchise relationship problems do not justify FTC conducting a more widespread investigation of relationship issues or developing a new rule that addresses the terms and conditions of franchise contracts. (GAO-01-776, page 23)
- According to FTC staff, data the FTC has collected, while limited, suggest that franchise relationship problems are isolated occurrences rather than prevalent practices.” (GAO-01-776, page 4)

#### *IFA Comments on Proposed Revisions to Franchise Rule*

The attached written comments submitted by the International Franchise Association to the FTC as part of the rulemaking process spell out in great detail the specific areas in which we believe the Rule should be revised. I will not repeat in detail each and every one of those comments in these remarks. However, I would like to highlight several issues of great interest to the International Franchise Association and its members which we believe are among the most important aspects of the proposed revisions to the Rule.

#### *The FTC and UFOC*

The FTC disclosure format coexists with a franchise disclosure format developed by a number of states called the Uniform Franchise Offering Circular (“UFOC”). The UFOC disclosure format and the FTC format are similar, but not identical, and the UFOC disclosure format is required in nearly all of the states that have enacted their own franchise disclosure laws. The FTC disclosure format is not accepted in those states.

Both the FTC and UFOC disclosure formats require, among other things, the disclosure of such items as the business experience of the franchisor; its litigation and bankruptcy history; franchise fees, royalties and other payments required under the franchise agreement; requirements for purchase of inventory, equipment or supplies; territorial restrictions; transfer or termination of the franchise; and financial statements; and contact information for current and former franchisees of the system. However, there are differences between the format and detail required under the FTC and UFOC documents, which can generally be described as deficiencies in the FTC format.

#### *Adoption of UFOC Format for Disclosure*

One of the proposed changes to the FTC Rule is to adopt the UFOC format for disclosure, which would enhance uniformity of the disclosure document that franchise investors receive and would simultaneously streamline and simplify the disclosure process for franchisors. And because state regulators updated their disclosure format several years ago, by adopting the UFOC format the FTC will not only harmonize its rule with the state format, but will also significantly modernize its rule. The IFA strongly supports this proposed change to the FTC Rule.

#### *Separate Rule for Franchises and Business Opportunities*

The IFA also supports the recommendation that business opportunity ventures be removed from coverage of the Franchise Rule. We believe that the structure, operations and experiences of business format franchises—IFA’s members—are sufficiently different from business opportunities to warrant creation of a separate rule for each. We applaud the recommendation that the Rule distinguish between business format franchises and business opportunities.

#### *Electronic Disclosure*

We also strongly support a revision to the Rule to permit electronic disclosure. The FTC staff clearly recognizes the benefits recent technological advances offer in providing a mechanism for swift, cost-effective disclosure. We do have some concern that continuing to require a franchisor to furnish hard copies of select portions of the disclosure document undermines the effectiveness of this provision. However, we believe that if the FTC adopts a mechanism that will permit minor revisions to this requirement as electronic filing becomes more prevalent, the Rule may preserve the beneficial effects of electronic disclosure for both franchisees and franchisors.

#### *Application of Rule to Exclusively Domestic Franchise Sales*

The IFA also supports the FTC recommendation that the rule be clarified to reflect its application to exclusively domestic—as opposed to international—franchise

sales. We agree that there is no benefit to prospective foreign investors from attempting to apply the Rule extraterritorially, and we believe that in fact such attempts may result in confusion about or conflict with regulatory and statutory obligations in foreign jurisdictions.

*Earnings Claims*

Finally, the IFA strongly supports the FTC's recommendation that the Rule not contain a mandatory earnings disclosure. The IFA believes that a mandatory, one-size fits-all approach to financial performance information is impractical and could actually impair the advance of free enterprise franchising, as it fails to take into consideration the many variations that exist among the scores of industries and thousands of companies that employ franchising as a method of expanding their businesses.

The IFA agrees with the FTC that such information is currently available, either directly from franchise companies that make earnings disclosures or through direct communication with current and former franchisees. IFA believes that the competitive force of the marketplace should drive the decision-making process regarding whether or not individual franchise systems make earnings disclosures. We are very encouraged that the FTC has adopted a similar philosophy in its decision not to mandate uniform disclosure of earnings information.

*Conclusion*

Let me conclude by thanking you, Mr. Chairman and the members of the subcommittee for giving the International Franchise Association the opportunity to appear here today to discuss these important issues. The IFA strongly believes that the FTC disclosure rule has had a positive impact on the evolution of franchising, and that the Rule has helped create a climate in which thousands of businesses and tens of thousands of entrepreneurs have had an opportunity to achieve the American dream of being in business "for themselves, but not by themselves."

The IFA believes that the proposed revisions to the FTC Franchise Rule will be beneficial in modernizing the Rule, and ensuring that prospective franchise investors have ready access to meaningful and reliable information about franchise investments. Armed with this information, entrepreneurs can conduct due diligence in researching these franchise investments, make informed decisions about their investments and enter the small business franchise community with realistic expectations about what franchising is and how franchising works.

As "The Voice of Franchising" for more than 40 years, the IFA will continue to work with the FTC to complete revisions to and implementation of the revised Franchise Rule.

Thank you again for inviting me to appear here today. Good morning.

Mr. STEARNS. I thank you.

And Mr. Rizer. Welcome.

**STATEMENT OF JERRY RIZER**

Mr. RIZER. Thank you. My name is Jerry Rizer. My home is in Elizabethtown, Kentucky. I own and operate three Dairy Queen stores. I have been a Dairy Queen franchisee operator for 20 years. I am also the president of the Dairy Queen Operators Association, and the Dairy Queen Operators Cooperative, which represent over 1,400 DQ franchisees and 3,900 DQ franchisees respectively.

The Dairy Queen system in the United States employs approximately 160,000 people including many teens holding their first jobs. In the aggregate we purchase as much as \$400 million annually in equipment and supplies.

The FTC rule and its enforcement of the rule has been woefully deficit in three major ways. No. 1, the rule affords us no protection against the most dangerous threats to our existence: abuse of competition by our franchisor in our supply chains, and encroachment on our developed stores by new stores franchised by our own franchisor.

No. 2, astonishingly the rule allows big franchisors like IDQ to sell franchises without disclosing track records of financial perform-

ance of existing franchised stores, and without disclosing the financial impact on new or existing franchisees of IDQ's manipulation of supply chains or encroaching new store development.

No. 3, Federal law does not allow franchisees who are injured by franchisors' blatant violation of the rule through deceptive misdisclosure, or omission of material information, or even outright fraud to bring a legal action to recover their losses cause by the violation.

Mr. Chairman, we know that you are aware of the findings of the GAO audit last year of the FTC's enforcement of franchising rule, that the vast majority of franchise complaints of the FTC involve postsale relationship problems, like those described above, that the FTC doesn't even investigate the vast majority of even the legitimate franchise complaints it receives, and that in the last 5 years the FTC has brought only legal enforcement action against a franchisor during a period when literally thousands of private lawsuits have been filed under State franchise laws where those exist.

It is absolutely incomprehensible to our association that franchisors can violate the FTC rule with apparent impunity because the FTC lacks the resources or the will to enforce its own rules, and Federal law does not provide private parties the right to sue for harm caused by violations of the rule. The rule is a paper tiger.

Mr. Chairman, it would be a simple matter indeed for Congress to redress this travesty with legislation as simple as amending the Federal Trade Commission Act or the Clayton Act to add this: Section blank. A person who is injured by a violation of the trade regulation rule on franchising, CFR Part 436, as it now exists or as it may subsequently be amended or recodified may bring an action against the person who committed the violation in a State or Federal court of appropriate jurisdiction for damages, rescission, cancellation, or such other relief as the court deems appropriate, and is entitled also to recover the person's costs and attorney fees to obtain relief.

If, as the franchisors and their trade association assert, all is well in franchising, and presale disclosure cures whatever problems exist, the private right of action will not produce any measurable burden on the court system or the franchisors. Courts have ample power already to sanction frivolous or unfounded complaints, so that is not an issue. But where real harm has been caused, it will for the first time afford at least the opportunity for justice to be done.

Thank you for consideration of these views.

[The prepared statement of Jerry Rizer follows:]

PREPARED STATEMENT OF JERRY RIZER, PRESIDENT, DAIRY QUEEN OPERATORS ASSOCIATION, INC.

The Dairy Queen Operators Association ("DQOA") and the Dairy Queen Operators Cooperative ("DQOC") presents these views to the Committee for its oversight of the United States Federal Trade Commission's enforcement of its Trade Regulation Rule on Franchising (16 C.F.R. Part 436) (the Rule).

DQOA/DQOC is an independent trade association and cooperative representing the interest of more than 3,900 Dairy Queen stores in the U.S. owned by American entrepreneurs. The typical Dairy Queen owner owns just one or two store(s), and for most, this investment represents substantially all of the owner's (and his fam-

ily's) net worth. Dairy Queen franchisees are owner-operators—they get their hands dirty working these stores themselves.

Dairy Queen franchisees in the U.S. employ approximately 160,000 people, including many teens holding their first jobs, learning the virtues of hard work, punctuality, and serving customers. In the aggregate, we purchase as much as \$400 million annually in equipment and supplies. A new Dairy Queen store can cost as much as a million dollars to build.

The business is highly risky. Under the *best* circumstances, the pre-tax operating margin on a Dairy Queen/Brazier store, *before* allocating profit to the owner, is just 10%, leaving very little to compensate the owner for his or her hard work and investment. We pay a “tax” to our franchisor of 4% of our top line sales, and a mandatory “tax” to a national marketing fund 100% controlled by our franchisor of as much as 6%. We therefore have only 90% of our sales to cover our payrolls, our vendors’ bills, our bank loans, and our real taxes, and that all comes after our franchisor, who always gets “first dollar.” With what amounts to a razor-thin margin, our franchisees struggle, to earn a minimal return on investment and a living income with the *last* dollars left after everyone else is paid.

We have had severe challenges running our businesses and making our payrolls, and some of the worst of these come from our own franchisor, International Dairy Queen, Inc. (“IDQ”), which is owned by multi-billionaire Warren Buffett’s company, Berkshire-Hathaway.

The FTC’s Rule and its enforcement of the Rule has been woefully deficient in three major areas:

1. The Rule affords us no protection against the most dangerous threats to our existence: abuse of competition by our own franchisor in our supply chains, and encroachment on our developed stores by new stores franchised by our franchisor.
2. Astonishingly, the Rule allows big franchisors like IDQ to sell franchises *without disclosing* the track record of financial performance of existing franchised stores, without disclosing the financial impact on new of existing franchisees of IDQ’s manipulation of supply chains or encroaching new store development.
3. Federal law does not allow franchisees who are injured by a franchisor’s blatant violation of the Rule—through deceptive misdisclosure, or omission of material information, or even outright Fraud—to bring a legal action to recover their losses caused by the violation.

#### RULE OMISSIONS

*Sourcing.* The Rule mandates selected disclosures prior to the sale: of a franchise. But, it does not even address the many pernicious practices of many large franchisors such as IDQ which cause widespread and significant harm to franchisees.

IDQ was not content to receive just its 4% off-the-top royalty and 5 to 6% marketing fee (part of which covers IDQ’s corporate costs relating to advertising and marketing). IDQ also took enormous fees, which many of our members regard as naked kickbacks, from suppliers based on franchisees’ purchasing volume. IDQ also took huge markups on goods it resold to franchisees. And to protect this huge income stream, IDQ abused its market power over the Dairy Queen system to try to keep franchisees—through their independent purchasing cooperative—from using independent competitive sources for equipment and supplies. IDQ’s abuses of sourcing cost our system tens of millions of dollars of unnecessary and avoidable costs every year. The Rule doesn’t even address these abusive and anticompetitive practices.

In 1994 we were forced to sue IDQ to stop the practices. Because of the deficiencies in federal law, it was an uphill fight. In 2000, we finally settled the case, but IDQ has still not cooperated with its own franchisees, preferring to try to hold onto its huge sourcing revenues. It took us six years of hard-fought litigation to reach a compromise settlement because the FTC Rule does not prohibit franchisors from abusing their authority over sourcing, to allow the free interplay of normal competitive forces in the marketplace to work for franchisees. And federal courts have declined to apply normal principles of antitrust law to franchise systems, allowing franchisors to monopolize and abuse supply chains in their systems to the detriment of franchisees who are locked in by the iron chains of grotesque franchise contracts drafted by huge: franchisor law firms without the chance for franchisees to negotiate or influence the terms of those contracts.

*Encroachment.* Those same one-sided, oppressive contracts allow, and the FTC Rule does not even address, big franchisors like IDQ to compete against their own franchisees by encroaching on established franchisees with new stores. The franchisor profits, the franchisees lose, and the Rule ignores the whole problem.



Here is an example to illustrate our plight. Suppose a town has an established Dairy Queen (or any other franchised small business). Suppose the existing store has annual gross sales of \$700,000. IDQ gets the first 4% of that, or \$28,000. Suppose IDQ franchises a second store in that same market, with the result that their *combined* sales are \$1.1 million. IDQ's take goes *up* to \$44,000, but each store only takes in (on average) \$550,000. The existing franchisee's sales have *dropped* by \$150,000, which is probably more than that owner was making before the encroachment occurred. In other words, Warren Buffett's franchisor's income went up by more than half, but the franchisee lost his entire profit, or a very large part of it.

The FTC Rule allows this to occur. The FTC Rule doesn't even require disclosure of this impact much less prohibit this kind or plainly unfair trade practice. And this happens every day throughout this country.

I would venture to guess that no franchisee anywhere bought his or her franchise expecting his own franchisor to become his biggest competitive nightmare. Yet federal law allows this to happen.

*Financial Disclosure.* I was shocked when I first learned that the FTC Rule allows franchisors to sell franchises without telling their prospective buyers how existing units are doing financially, or what the buyer might expect to do with his franchise. What could be more basic or more important to a buyer than financial performance data? Our franchisor already has the data, and I'm sure most others do, too. But they are allowed conceal that vital information because the Rule makes that disclosure optional.

What if the franchisor *knows* that a large portion of its franchisees are struggling financially? Why in the world should the FTC allow the franchisor to hide that from a prospective new franchise?

The same is true of disclose of the financial impact of franchisor interference with free competition in sourcing, or of franchisor encroachment. Why shouldn't the FTC require a large franchisor like IDQ or McDonald's or Holiday Inn to have to disclose such simple data as:

"Our involvement in the supply chain in this system adds about x% to your costs of doing business," or

"If we use our right to encroach on your franchise, it may take away as much as 50 to 100% or more of your operating profit.?"

#### PRIVATE REMEDIES

Mr. Chairman, we know that you are well aware of the findings of the GAO audit last year of the FTC's enforcement of the Franchising Rule that the vast majority of franchise complaints to the FTC involve post-sale relationship problems like those described above, that the FTC doesn't even investigate the vast majority of even the legitimate franchise complaints it receives, and that in the last five years the FTC has brought only *one* legal enforcement action against a franchisor (during a period when literally *thousands* of private lawsuits have been filed under state franchise laws where those exist).

It is absolutely incomprehensible to our association that franchisors can violate the FTC Rule with apparent impunity, because the FTC lacks the resources or the will to enforce its own Rule *AND* federal law does not provide private parties the right to sue for harm caused by violation of the Rule. The Rule is a paper tiger.

Mr. Chairman, it would be a simple matter indeed for Congress to redress this travesty with legislation as simple as amending the Federal Trade Commission Act, or the Clayton Act, to add this:

Section. — A person who is injured by a violation of the Trade Regulation Rule on Franchising, C.F.R. Part 436, as it now exists or as it may subsequently be amended or recodified, may bring an action against the persons who committed the violation in a State or federal court of appropriate jurisdiction for damages, rescission, cancellation or such other relief as the court deems appropriate, and is entitled also to recover the person's costs and attorneys fees to obtain relief.

If as the franchisors and their trade association assert all is well in franchising and presale disclosures cure whatever problems exist, this private right of action will *not* produce any measurable burden on the court system or the franchisors. Courts have ample power already to sanction frivolous or unfounded complaints, so that it is not an issue. But, where real harm has been caused, it will—for the first time—afford at least the opportunity for justice to be done.

Thank you for your consideration of these views.

Mr. STEARNS. Thank you.

Let me just say, Mr. Rizer, if we allowed a franchisee to sue in his State, then you would have 50 States in which you would have suits, and in all deference to the company, you know, you can have a lot of nuisance suits. It can drive a company out of business. So the idea of allowing private right of action in each State—now, Mr. Rush and I might not agree on this, but I have some concern of allowing a franchisee to sue in separate States.

I notice here in Pizza Hut, they say if you are going to sue, it will have to be in Kentucky. I think it says—anyway, they specify where you have got to sue. You can see that perspective, can't you, that it would just be very difficult for a company to sustain litigation from 50 States, going into 50 different courts? That is just a comment.

I think what you suggested and what others have suggested, including mandatory earnings disclosure in its revised Franchise Rule, I think is good. Can I just ask down the panel, do you think the idea that the FTC should—although right now I understand they are not including mandatory earnings disclosure in its revised Franchise Rule, do you think that they should?

Mr. CANTONE. Speaking for NASA, NASA has been on record for years as supporting in concept mandatory earnings disclosure, and, in fact, NASA had worked for the last several years to try to propose mandatory earnings claims at the State level. But for practical reasons, and one of the main reasons is because the Federal Trade Commission has signaled it is not going to mandate earnings claims, it kind of made us stop on that process for the time being because of issues of uniformity.

So we think if there is mandatory earnings disclosures which support in theory, it is best to be adopted on a uniform national basis because of issues of uniformity so that everybody has the same rules and not just rules in certain States.

Mr. STEARNS. My question, though, then the parent company has to come up with historical data. That might be for a good operator. But you have a weak operator, and the person who gets it will say, I didn't get those figures. That is because you didn't do what the company told you to do. That historical information has some problems with it, depending on the operator, whether he does what the franchisor tells him what to do, and whether he has good business sense, whether he is putting capital in the property. If he just drains the property dry, and you show up and there is no flowers, there is dirtiness in the restaurant or motel room, it doesn't matter what the historical data shows. You cannot sue based upon your lack of performance. So those are one of the problems.

Go ahead.

Mr. WHARTON. I addressed it a little bit in my remarks, Mr. Chairman, but basically I think that there is a practical problem in trying to get—because it is so diverse. Franchising is not—

Mr. STEARNS. So you don't think that you could come up with a standardized historical information that would be applicable which the franchisee could take to the bank?

Mr. WHARTON. I think it would be very difficult, and I think that the alternate is to get it from—what we suggest when someone is coming in is talk to as many of those existing owners. They are all listed in our UFOC. Talk to them.

Mr. STEARNS. Make them do the due diligence before they buy.

Mr. WHARTON. Exactly. Find people that are not doing well. Make sure you find someone that is not doing well. Understand why.

Mr. STEARNS. I have a friend who opened up a Burger King, and he did it in university town, and he did real well until the university had a Burger King within the student union. It took all of his business, so he is thinking about suing. You know, you could have given him historical data. It wouldn't have been meaningful for his site. It might have showed that you are going to make a million dollars in gross a year, but if someone opens up and the student union has it right there, then no one is going to go off campus to get it. So, you know, go ahead.

Ms. KEZIOS. Not having historical financial performance information when you buy any business is not done in any other commercial activity except franchising. Why should franchisees have to buy a business and guess perhaps at what franchisees have done in the past? I used to be a franchise broker 20 years ago. The joke was, as we were selling franchises, if the franchisors had to report historical financial performance data, half of the franchisors wouldn't be franchising today because people can't make any money.

Now, I have got a document here from Growbiz International, their uniform franchise offering circular. They are providing an Item 19. So for some reason they found it easy. They have got the data. Franchisors get this data, Mr. Chairman. Some days at the end of the day they know exactly what the franchisees have done. This is like buying a car without an engine. It doesn't make any sense not to have historical financial performance data.

Mr. STEARNS. Okay.

Mr. WIECZOREK. This is a remedy. This is a remedy in search of a problem. If franchisees are interested in a business, they should talk to every conceivable person that is listed in the document. If someone is a prospective Dairy Queen operator, they can call up Mr. Rizer and say, how are your stores doing? That is what they should do. That is incumbent on them to do it. Information is available now.

Mr. STEARNS. It is like when a person goes in to buy a business, you know, you have to do the due diligence to find out—if the owner says, we are grossing XYZ, you better look at the sales tax to be sure that is true. You probably should sit there and look at the business, to see what goes in, because lots of times, unless you do your due diligence, those historical figures don't mean much.

Mr. Rizer.

Mr. RIZER. There is an inaccuracy here in what people are saying. The document that you are showing up here doesn't list a list or is not required to list a list of current and former franchisees, or at least it is not being complied with at the present time. So as the fellow next to me is suggesting they call me, they would only call me if my name and number was listed. The uniform offering agreements that I have received list only those locations in the State that I reside.

Mr. STEARNS. But Pizza Hut, it looks like it has all of the open franchise stores. I mean, there is just gobs of names here that I could call.

Mr. RIZER. I received the document. I received one a few weeks ago. It only had Kentucky in it. That is all I have ever been told was required.

Mr. WIECZOREK. Most franchisors will list all of their franchisees, but the guidelines do permit you to list at least 100 in the State that you are in or States contiguous to you. So every UFOC will have at least 100 franchisees listed in it, but they must include all former franchisees who left the system in the last year. So there is another group that they can talk to also.

Mr. STEARNS. My time has expired.

Mr. Rush.

Mr. RUSH. Mr. Wharton, you testified against requiring earnings disclosures because each business is different. However, the SEC, the Securities and Exchange Commission, has been successfully requiring uniform earnings disclosures of publicly traded companies for decades. Now, how is this any different? And I would like for all of the panelists to take a stab at this. Be brief if you can.

Mr. WHARTON. Basically, Congressman, I think that one of the issues is that the information that is gathered in the franchise context has to come from the owner themselves or the franchisee that is out there in the market, and they may or may not provide accurate information for various reasons. With the SEC rules, you are reporting on information that your company has control over.

Ms. KEZIOS. Well, the argument that you have no control over what the franchisee reports is moving the question. I mean, the franchisee is reporting the information. That is what you put in the document. I mean, that is avoiding the question totally.

Mr. ZWIECZOREK. Congressman, the only information that a franchisor usually gets is sales information. It does not get on a consistent, reliable basis cost and expense data from franchisees, so that, in effect, what a lot of people are saying is that you should give earnings. It is almost impossible to give earnings because you can't get that data from franchisees, you can only get top line sales data.

Ms. KEZIOS. In certain franchise chains, they do have all of that information. They know exactly. They prepare the financial statements for the franchisees. So it is not standard what Mr. Wiczorek is just mentioning.

Mr. RIZER. I have got three letters at home from International Dairy Queen's attorney requesting that I provide a P&L listing the sales, the cost of goods, the expenses in each and every category. This comes once a year to me, and I provide that information.

Mr. RUSH. Mr. Cantone.

Mr. CANTONE. Most franchisors don't provide any information, including gross sales information. The numbers that we are saying are approximately 80 percent of franchisors provide absolutely no earnings information at all, and I think that is something that a prospective franchisee should take a look at as to what is the answer to that question: Why are you not giving this information? And I think it can be very telling. It is very difficult for franchisors, however, to put together really meaningful earnings information. It is a very complex area, but I do think it is something that franchisors should really strive to do, and they haven't done it vol-

untarily, so I think the time certainly is right for somebody to take a hard look at whether or not they should be forced to do it.

Ms. KEZIOS. In the 1960's when the rule was promulgated, the reason that this disclosure is a voluntarily disclosure is because there were folks in those days selling franchises saying, give me \$10,000; you will make \$1 million next year. That is why that was put—this is 23 years later. That doesn't happen anymore. Those guys don't sell franchises like that. They know how to sell them without making that kind of a blatant earnings disclosure.

What is worse is we know that the information is being given out there, perhaps not in that blatant a manner, but it is being given out there, and we need the information in a document. We need it reliable, and we need it accurate.

Mr. RUSH. Ms. Kezios, the FTC states, based on the data they have, that franchise relationship problems are isolated occurrences. Why aren't there more franchise complaints against those kinds of postsale franchise relationship problems to the FTC?

Ms. KEZIOS. The 1993 GAO audit of the FTC was like putting a neon sign on the door of the Commission saying, don't bother, franchisees, because the 1993 audit pointed out that the FTC acted on less than 6 percent of all franchise complaints brought to it. So franchisees are, why do we even bother? Susan, why are you telling us to complain with the FTC for? Which we have continued to do, which is why we surmise there has been an increase in the complaints.

Now, the FTC data doesn't reveal the full extent and nature of franchise relationship problems. They don't have enough data to begin with. So for them to make that conclusion is erroneous to begin with. They don't have enough data on the franchise relationship problems.

I would say that over 90 percent of the complaints that come to me have to do with postsale or a combination of pre- and postsale. What bigger number do you need to show that a preponderance of the complaints have to do with postsale?

Mr. RUSH. Mr. Wieczorek, what types of litigation, if any, do franchises have to list in their disclosure documents?

Mr. WIECZOREK. Right now a franchisor is required to list all claims made against them by franchisees and also any counter-claims that may be made by a franchisee if a franchisor sued the franchisee. There is a requirement that it be material. If someone sues you for 10 cents, you don't have to put that in, but any material litigation does have to be disclosed. And that goes for current actions, plus you must report all litigation that has been resolved unfavorably against the franchisor for the last 10 years.

Mr. RUSH. Mr. Chairman, I got one additional question. Let me just ask this question.

As I traveled through America, you know, a lot of times by car, and I go to different communities, I am always astonished by in the—in some communities there is a lot of franchise options for consumers, a lot of different stores. But when I return home to central city America, to my own Chicago, then I can count maybe on one hand the number of franchises that is really being in business in communities like mine.

I wonder if someone can give me some idea about what is the difference there? I know that there are—all of the expert testimony and all of the research says that in central city, low-income areas, sales are explosive in terms of consumer sales. Every time there is a Kentucky Fried Chicken franchise opened up, or Burger King franchise opened up something, they always break records. I remember when McDonald's first came to the west side, on the west side of Chicago, on Madison, broke all kinds of records for the first few months of operation.

But it seems as though there is a barrier, some kind of wall. We can't get more franchised business located in central city communities. Can anybody take a stab at that, or is that something that you have looked at or thought about? If not, I would like to invite you to tour some of those communities and see the differences, because, I mean, it makes excellent business sense. And I am not sure if there is just not—you don't see the opportunities. Sometimes we can only see the opportunities in our background because that is where we focus at, but I am telling you there is a real serious issue in terms of diversity in terms of franchise opportunities, certainly in my community.

Mr. WIECZOREK. One of the main issues is capital, and these days with the banking and financial industry the way it is, it is difficult to find capital for anybody to expand. But franchisors in a number of concepts, particularly in the food business, are trying to open more doors to minorities and women and others to open franchises, but a lot of it is a lack of capital in trying to find financial resources to get those businesses open.

So I think that there are efforts to do that, but it is difficult in these economic times.

Mr. RUSH. I want to work with you on that, because I don't think that is really the case. I really don't think—I mean, I think it is a question of having a determined approach to it.

Thank you, Mr. Chairman.

Mr. STEARNS. Thank you.

Mr. SHIMKUS.

Mr. SHIMKUS. Thank you, Mr. Chairman. And I will wax philosophically for a few minutes before I ask a question or two.

First of all, we appreciate the jobs and economic development, growth of both the franchisors and the franchisees. This is a debate of being torn between two lovers and trying to pick out—trying to slice the baby and figure out what we need to do. A lot of our experience up here is—mine would be based upon a Flintstones episode where Barney and Fred wanted to buy a—I think it was a tyrannosaurus rib shack. And so the local used car dealer next to them put a whole bunch of cars around the little restaurant, and they bought it, obviously. They weren't well informed. And they couldn't turn a profit. And I actually remember the jingle from the waitresses who were trying to sing the song as they were trying to get people to work there.

So what you would like the—you really need to get together and solve this problem before you encourage us, either through pressure to the FTC to change things where our lack of expertise might actually end up doing more harm than good on both sides.

But I tell you one thing that I think many of us feel, especially those who support small business across the board, small or large businesses, is the whole basic principle of legal certainty. Businesses will not get capital investment in areas if there is no legal certainty, in the inner city, maybe brownfields redevelopment; in a small franchisee it might be lack of legal certainty, the cause of lack of a moving target on a contractual signing with the franchisor, which I find just really ridiculous that a franchisor would offer a contract to a franchisee that could change. I mean, how in the heck does someone have any legal certainty for a period of time to try to project capital investments, costs and a return on their investment?

So I would encourage, as we move to push the FTC to move forward in promulgating a rule or amendments to the rule, that if we don't fall into the same problem as identified in the 1979 rule based upon 1960 experience, that we don't promulgate 2002 amendments to the 1979 rule that are based upon 1980 experiences, because we don't want to be back here in 15 years.

So let me ask, are the abuses that are identified in some of the reports, we have got—the Attorney General's office, you probably get abuses.

Mr. CANTONE. We hear about abuses all of the time, but I don't think we hear about abuses to the extent they exist in the marketplace for some of the same reasons that we have talked about. I go out and speak to franchisees and hear stories about renewal problems or encroachment issues, but for many reasons franchisees don't complain to my office because they don't complain to the FTC because they realize we don't have jurisdiction to handle these issues.

We haven't had a complaint about encroachment in our office for more than 5 years, but we hear time and again that it is a real issue.

Mr. SHIMKUS. Which would be the example of the chairman's—with the university. That would be an encroachment issue.

Mr. CANTONE. Absolutely. I hear from Ms. Kezios, from her and her members. So we realize it is an issue, it is a concern. And a lot of franchisors do not provide protected territory, which leaves franchisees open to the possibility that they could have a competing franchise across the street from their same franchisor.

Mr. SHIMKUS. Mr. Rizer, so you are operating as a franchisee for a Dairy Queen, but the International Dairy Queen could, in essence, locate within a geographical area that you are now serving?

Mr. RIZER. If they wanted. There are ways. Yes. Now, regardless of—

Mr. SHIMKUS. Regardless of what contractual arrangements you have made in the past.

Mr. RIZER. Right. There are ways. You asked a question about FTC complaints. I am surprised that you have any. I am a small businessman. I am independent. I go in, and I work my store. I normally get up at 4:30 in the morning to go to work, and my day doesn't end until 3, 4 in the afternoon, and I am in bed at 7. Great. I don't have time to call and complain to someone else, let alone the government, which I really don't see as being something to solve my problems.

Most Dairy Queen franchisees that I know are independent. They take care of their own problems, and until yesterday, I didn't know I could complain to the FTC. As a matter of fact, we went through a lawsuit with International Dairy Queen in the 1990's, early 1990's, and we did have our executive director and counsel go to the FTC and the Justice Department with complaints, and we were told, well, you have an action here for a lawsuit, sue them.

Well, we weren't looking to sue. We wanted a good relationship with our franchisor, but we were told we had to sue to get any redress to our grievances. We did that, and we won, in our opinion, won the lawsuit and money to go along with it.

It was ultimately a settlement. We are happy with that. But we didn't want to sue them, we want to get along.

Mr. SHIMKUS. This UFOC—and I can't—I don't remember the acronym. I would like it up. Do you have great hopes that that will be helpful if the FTC offers that as part of the amendments to the 1979 rule? Does everyone agree with that?

Mr. CANTONE. Absolutely. The UFOC is far superior. As a matter of fact, we have been talking about these required disclosures, like the list of franchisees and other issues. We are talking about the UFOC. If you look back at the FTC rule, for example, that is why in Kentucky you only have a list of Kentucky. The UFOC requires 100 franchisees in the State and surrounding States. That is just one example.

The UFOC is far superior to the FTC disclosure document, which really is kind of an anachronism in 2002.

Mr. SHIMKUS. When do you think—since the FTC, which you all heard me talk about has been 5 years in promulgating the amendments to the rule, and, as we also observed, they really weren't very assertive in actually giving a parameter when we might see some timeframe in these amendments, when do we need amendments to the rule? Does everyone agree—yesterday. I mean, everybody is shaking their head, yes.

Mr. Wharton, you are not?

Mr. WHARTON. Well, I think we need it as soon as possible.

Mr. SHIMKUS. Not yesterday?

Mr. WHARTON. Well, I think, Congressman, the most—they need to do it as quickly as possible. Most franchisors are complying with the UFOC now. That is exactly what they do because it is permitted by the FTC.

Mr. SHIMKUS. Most of our experience is based on—like Mr. Rizer's Dairy Queen or McDonald's or that. Yours is different in that extent. Give us your basic business.

Mr. WHARTON. It a stamping business. Basically what happens, instead of—one major distinction would be instead of having multiple franchise owners in a particular market area, we will normally have one franchise owner in a market area. And that franchise owner has one or two offices at most, because what we are doing is providing people either temporary staffing or permanent staffing in a market area.

Mr. SHIMKUS. It is a little different business model.

Mr. WHARTON. It is. That is one of the things you have to think about. There are all kind of different business models out there, because if you line it all up with the fast food or the hospitality in-



dustry, it doesn't quite work. But we need it as quickly as possible. But currently, as a practical matter, most of the franchisors—I say most; it is probably about 99 percent of the franchisors are using the UFOC, which went through substantial revision in the mid-1990's to bring it up to date.

Mr. SHIMKUS. Chairman, if I can finish the panel then—I know I am overtime.

Ms. KEZIOS.

Ms. KEZIOS. Yesterday would be nice. You should be aware, though, that there are regional franchisors who choose to sell just in the States where there are no State regulators reading documents. Everybody in the franchise industry knows that if you are starting up and you are young, go to a State where you don't need to file a document, where nobody is going to read it. So there is no one looking over anybody's shoulder in those States.

Mr. SHIMKUS. That is why the FTC rule is important, to cover those States where there is no compliance or no reporting.

Ms. KEZIOS. That is why the FTC rule is still ineffective in those States.

The amendments are needed quickly.

Mr. WIECZOREK. Yes. The FTC should take action as soon as possible. Franchisors have been waiting for themselves to get the new documents prepared and done. But, as Mr. Wharton said, the UFOC has been in place, the new UFOC has been in place, for the last 7 or 8 years. That is largely what the new FTC rule will require. So most franchisors are already doing it. But there are some additional improvements that the FTC is trying to do.

Mr. RIZER. It needs to be done as soon as possible. It would be nice if it was yesterday, but until we have a private right of action, what good is it to continue to make rules that aren't enforced or used? It make no sense.

Mr. SHIMKUS. I will end by saying there is a perfect example of how business and associations or States, through the UFOC, respond, how much more rapidly than the Federal Government if they have had this now for 7 years, and we have been waiting 5 years for amendments to a rule that we still don't have a timeline from that is going to probably marry closely the UFOC. That is just my frustration. And with that I yield back.

Mr. STEARNS. Thank you.

I am going to ask one question, then I think each Member would like to ask additional questions. If you could have your way, which two amendments to the FTC rule would you suggest? And I will just go from right to left with Mr. Cantone. And would these amendments help with the postsale relationship problems?

Mr. CANTONE. Mr. Chairman, are you talking about amendments that are not being considered right now?

Mr. STEARNS. Yes.

Mr. CANTONE. In my personal opinion, Mr. Chairman, there are two issues that spring to mind, and they may or may not be able to be addressed in the rule. But one of the issues that we see time and time again is that franchisors frequently are able to require that any meaningful dispute resolution be held in the State of the franchisor, and for small franchisees who might live States away

from the franchisor, it basically stops that franchisee from going forward and doing any dispute resolution.

The way that they do that is by requiring arbitration, and under the Federal Arbitration Act as we view it, the location for the arbitration can be at the option of the franchisor. Maryland, for example, has a requirement in our franchise law that litigation be—about the franchise offering must take place in Maryland. That is a protection to franchisees to allow them dispute resolution in Maryland. That only applies to litigation. Most franchisors require disputes be held through arbitration, and under the current state of the law, they can require that that arbitration take place where the franchisor is located. That, I think, is a really, really big problem. The franchisees cannot even start to resolve disputes through litigation or arbitration or whatever. That basically prevents them from going around and resolving any of the problems they have.

The other issue that I have is with the fact that the current—and this might be just a theoretical problem that might have not have an answer to, is franchising covers such a huge number of industries, from hotel franchises at one point to the other end of the spectrum, janitorial franchises, which really in most cases are the type of franchise directed to people who have less resources for getting a lawyer or resources even to review the document. You held up that document. The most complex franchise disclosure documents and disclosures are in this industry, and most frequently they require a very small investment.

That, I think, is an issue that really is a problem in franchising today as we know it, and I think it is a problem that needs some resolution. I don't know that the FTC rule as currently drafted or State laws really address the fact that there are some real problems out there in one segment of the industry.

Mr. STEARNS. Mr. Wharton.

Mr. WHARTON. I guess I would say that the—the proposal to confirm it to the UFOC is probably the most important piece. I think that the UFOC is a simplified—somewhat simplified document. It has all of the information. I think it was during the mid-1990's when it was revised one—it was done with both the regulators and the franchisors and the franchisees participating in the process to ensure that information that was really important was in that document; and that it was done further in plain English, that was another change that was made to it.

While it seems complex, I think that the documents at least uniformly touch all of the areas that they need to touch, and that, in itself, if the prospective owner will go through the document with an advisor, doesn't have to be an attorney, but some independent advisor that is a professional, to help them analyze the opportunity, I think that will actually go to help solving a lot of the postsale problems, because the—if both sides understand, if both parties to the transaction understand what is in there and what the issues are going to be and what the problems are going into the arrangement, then I think that you solve a lot of the postsale problems. Not all. It is a long-term relationship. It is like a marriage. I think there are always going to be disputes. The question is, how do you work through those. And most franchisors try and

work with their franchise communities to work through those issues.

Ms. KEZIOS. Other than the two issues that I brought up already, the problem with the documents is that they are legal works of art, so it is going to be very difficult to ever figure out the rules of the game how the documents are written out, based on how the corporate franchisor lawyers are writing them. For example, talk about a postsale issue encroachment, you need to have language as clear as this in the document. You have no protected area. Your franchisor, without compensation to you, may place another store in a location that may completely erode your profitability. That needs to be put in there. Plain English.

Litigation. The franchisor lawyers, they are hiding the ball on the litigation. You asked the question, Mr. Rush, what kind of litigation is required in the document? The litigation where franchisors are suing the franchisees is not required in the document now. It should be required. Pending litigation is not required in the document. So if I am looking at a Dunkin' Donuts contract offering circular, there may be five pieces of litigation. They have got 200 lawsuits pending. Wouldn't you like to know what is going on with those other 200 lawsuits that the franchisor has filed against franchisees? This is what I mean by hiding the ball.

These guys know how to write these contracts. There is no way that you are going to be able to figure out—Mr. and Mrs. Smith, who are taking their life savings to invest in these businesses, are not going to be able to figure that out at the outset. These are not contracts of equal bargaining power. There is no equal bargaining power in a franchise relationship.

Mr. WIECZOREK. I am one of those lawyers that Susan is referring to. I really don't know how to hide the ball, and our clients don't try to hide the ball, I can assure you. The most important thing is—something that Congressman Rush pointed out—is that these documents are big and intimidating documents, and we are not—as lawyers drafting them, we are not trying to draft them so that they are intelligible, we are drafting them because that is what the rules require us to say. These are all disclosures and documents that are attached to it that are required by the law, and we have no way around that.

So I agree that there should be some effort on the part of government to figure out ways to make the information more accessible, more readable. And certainly someone should have a lawyer represent them or a financial advisor represent them when they are buying a franchise. But even then it would still be helpful to have the document available on a more accessible basis.

Mr. RIZER. Well, I am not a lawyer, and so I don't know what to suggest, other than what I have suggested in my statement. The private right of action would be very helpful, and it doesn't matter whether there is State court or Federal court. If there is no cause for an action, I am not going to bring one. So that wouldn't be a burden, as you mentioned.

Mr. STEARNS. All right. Mr. Rush, any additional?

Mr. RUSH. Yes.

Mr. Rizer, I want to continue where you just stopped off. If you had a private right of action, what would that do for franchisees

that can't—what power or what influence, bargaining power, would that give to franchisees that they don't have right now? And let me just also ask, you indicated that you were advised to sue your franchisor, and you didn't really want to do that. If you had the right of private action, just having that there, would that help—you think would help influence the franchisor to come in and make some kind of settlement with you earlier rather than having to go through the process?

Mr. RIZER. Yes. Always having a big stick to wave around is a wonderful thing. You don't have to use it. It is just that they know that it is possible. They will be able to come and talk to you. At the present time there is no reason. As far as I am understanding, all of this is about the companies, franchisors, complying with the rules of the FTC. And a private right of action, if I am harmed because they didn't follow the rules, if they lied or were deceptive, if they said I could buy—back in the 1990's it was that they said that I could buy from anybody, but that wasn't the case, well, to me that is lying to me.

Mr. RUSH. So having a private right of action could kind of balance the—the territory, give you some kind of common area of discussion, common influence.

Mr. RIZER. It would give them a reason to come talk.

Ms. KEZIOS. Private right of action is the only market force that franchisors will pay attention to. When the corporate franchisor lawyers worked in the 1970's to hobble the promulgation of the rule, when the rule's promulgation was inevitable, they took out the private right of action.

FTC staff are on the record back then—this is from the FTC staff comments in 1979: The Commission believes that the courts should and will hold that any person injured by a violation of the rule has a private right of action against the violators under the Federal Trade Commission Act as amended in the rule.

Now, that didn't happen, but FTC staff has been on the record since then saying they fully expected that it would happen, and it never happened.

Mr. RUSH. Mr. Wiczorek.

Mr. WIECZOREK. I would like to respond to that. In Mr. Rizer's case, obviously they brought an action because they had the right to bring an action. They had a big stick to use. And right now franchisees do have big sticks to use. They have lawsuit rights for breach of contract, for common law fraud, for violation of State law, FTC acts, for violation of State franchise disclosure laws. I don't think any franchisee believes that they are hobbled now in terms of having rights to bring suit.

So no other trade regulation rule that is administered by the FTC has a private right of action. The courts created—Congress created the FTC as an expert in the area of the issues covered by the various rules. So when the FTC decides that a company violated the FTC rule, they are exercising their expert objective decisionmaking power that it was a violation. If you threw it out to the courts, who knows what is going to happen? The rule would be interpreted 1,000 different ways, and that is a problem.

Mr. RUSH. Let me ask you, Mr. Wiczorek, the IFA, how many members do you have?

Mr. WIECZOREK. IFA has about 1,000 franchisor members, about 30,000 franchisee members, and about 200 supplier members.

Mr. RUSH. So you represent—

Mr. WIECZOREK. Both sides, yes.

Mr. RUSH. And, Ms. Kezios, how many members does the AFA have?

Ms. KEZIOS. Fifteen thousand.

Mr. RUSH. Do you represent any franchisors?

Ms. KEZIOS. No, we don't I might add that for 40 something years the IFA didn't represent franchisors either. It was upon our growth in 1993 that the IFA opened its arms all of a sudden to franchisees as members, strictly to co-op our efforts.

Mr. RUSH. What about suppliers?

Ms. KEZIOS. No, we don't.

Mr. STEARNS. Thank you.

I am going to thank all of you for participating, sincerely. And we have had a lively discussion. In a democracy that is what is important. You get your views out. You don't always agree. But I think this hearing has been very helpful. I think it is one of the few hearings on franchisors and franchisees we have had in Congress, so I am pleased to chair it. I want to thank Mr. Rush for his attendance, and so, again, thank you all, and the subcommittee is adjourned.

[Whereupon, at 11:55 a.m., the subcommittee was adjourned.]