

**REPORT OF THE AMERICAN BAR ASSOCIATION  
SECTION OF ANTITRUST LAW  
ON PROPOSED SMALL BUSINESS FRANCHISE ACT<sup>1</sup>**

**I. INTRODUCTION**

**A. Background**

On November 10, 1999, Congressman Howard Coble (R-NC) introduced H.R. 3308, the "Small Business Franchise Act of 1999" ("the Act").<sup>2</sup> This legislation, if adopted, would substantially expand federal regulation of franchise relationships and other distribution arrangements.

**B. Structure of the Act**

The Small Business Franchise Act ("Act" or "SBFA") contains 14 major substantive sections, covering subjects ranging from discriminatory practices to the appropriate forum for the resolution of franchise disputes. Appendix I provides a copy of the Act. From the perspective of the Section of Antitrust Law, the provisions of the Act raising the greatest potential concern would:

- Prohibit the termination of any franchise agreement without "good cause" as defined in the Act;
- Render unenforceable covenants not to compete by a franchisee following expiration of the franchise relationship;
- Limit the ability of franchisors to enforce otherwise available intellectual property arrangements following the expiration or termination of a franchise relationship;
- Impose a broad duty of "good faith" on both parties to a franchise agreement that is considerably broader than the common-law covenant of good faith implied in all contracts;
- Impose a duty of competence on franchisors (referred to in the Act as a duty of "due care");

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<sup>1</sup> The views expressed herein are presented on behalf of the Section of Antitrust Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association or of any other ABA section.

<sup>2</sup> H.R. 3308 is virtually identical to the Small Business Franchise Act of 1998, H.R. 4841. Hearings on the subject of franchise relationships were held on June 24, 1999, before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee.

- Limit requirements that franchisees purchase goods and services from franchisor-designated sources of supply; and
- Prohibit “encroachment” by the placement of new outlets for the franchised business “in unreasonable proximity to” a previously established outlet.

The Act applies to “franchises,” which are defined by reference to the Franchise Rule promulgated by the Federal Trade Commission.<sup>3</sup> However, it is not clear under the Act whether the various exemptions and exclusions from the FTC Rule would limit the Act’s coverage. For example, neither automobile dealerships nor ordinary distributor or dealer arrangements are typically considered “franchises” within the meaning of the FTC Rule<sup>4</sup>, but they are not expressly excluded from the SBFA's coverage. Thus, the SBFA could apply to a wide variety of distribution relationships not currently within the FTC Rule.

### C. Recommendations

For the reasons set forth in this Report, the Section of Antitrust Law (the “Section”) opposes the adoption of the Small Business Franchise Act. The Section believes that, on balance, the Act is inconsistent with antitrust policies, may unduly restrict competition, may raise consumer prices and limit the array of competitive goods and services, and should not be adopted. To summarize, the Section opposes the SBFA for the following reasons:

- There is no convincing empirical evidence of widespread, systematic and regular abuses by franchisors of franchisees which justify this sweeping legislation.
- Many of the potential abuses that the SBFA seeks to address are already subject to existing, well-developed bodies of law, such as the antitrust laws, trademark laws, and common-law contract doctrines (including the duty of good faith).
- There may be situations where franchisors engage in opportunistic behavior that deprives franchisees of their reasonable expectations upon entering into franchise relationships, and where existing legal remedies or market forces for some reason fail to punish or deter such behavior. However, many key provisions of the proposed Act are not reasonably tailored to deal only with such harmful and inefficient opportunistic conduct.

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<sup>3</sup> Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436 (1979) (hereinafter “FTC Rule”). On October 15, 1999, the FTC gave notice of proposed rulemaking to amend the FTC Rule. The notice, and related information, is available on-line at <http://www.ftc.gov/os/1999/9910/index.htm#15>.

<sup>4</sup> See, e.g. *Informal Staff Advisory Opinion Issued to Automobile Importers of America, Inc.*, reprinted in 1 Bus. Franchise Guide (CCH) ¶ 6382 (Aug. 9, 1979).

- The SBFA takes a single approach to address potential franchisor abuses, involving extensive legislative redrafting of franchise agreements. Doing so conflicts with the competitive principles underlying the antitrust laws and unnecessarily restricts the efficient functioning of franchise relationships, representing a legislative cure that the Section believes, based on the current record, is more problematic than the harms at which the Act is aimed.
- Because of its over-breadth, the SBFA is likely to have unintended adverse consequences, including:
  - Sweeping in ordinary distribution arrangements as to which no showing of abuse exists;
  - Limiting the flexibility of businesses to structure and conduct business to meet changing market conditions;
  - Limiting the ability of businesses to innovate and change the way they operate;
  - Limiting the ability of businesses to expand;
  - Impairing the ability of franchisors and manufacturers to end relationships with inefficient or nonperforming franchisees and distributors; and
  - Undermining the value of a brand, trademark, or method of doing business, which impairs the value of that business to both the franchisor and all franchisees.
- The Section believes that most of the objectives of the SBFA can better be achieved through more comprehensive, plain language, disclosures prior to execution of a franchise agreement regarding such matters as:
  - Restrictions imposed on the franchisee's ability to operate a similar business in the same area after the agreement ends;
  - Grounds on which the franchisor can terminate the agreement;
  - The goods and services the franchisee must buy from the franchisor and/or its affiliates, and the likely economic consequences of those requirements; and
  - Any limitations on the ability of the franchisor to compete directly with its franchisees or set up other outlets to compete with them.

With information about these matters, prospective franchisees should be able to evaluate a range of then-available alternative opportunities prior to entering the relationship, which should stimulate comparison-shopping and competition in the terms of franchise relationships. Encouraging that free competition is preferable to legislatively imposing the terms of all relationships.<sup>5</sup>

## II. OVERVIEW OF FRANCHISING AND COMPETITION LAW

### A. The Section's Approach to the Proposed Legislation

The Antitrust Section is dedicated to the pursuit of several objectives, including:

. . . Advancing an understanding of domestic and foreign antitrust laws and the free market competitive process and their importance in maximizing consumer welfare in our society and in the global community, and advocating respect for, and compliance with the law and legal system[; and]

. . . Advocating sensible competition principles as a fundamental underpinning of public policy and legislation . . . .<sup>6</sup>

The efficient distribution of our economy's goods and services to consumers and end users has contributed significantly to the country's economic growth and has been a focus of antitrust policy. The Section's analysis is governed by this framework.

### B. Franchising

Suppliers may use a variety of approaches to distribution: some suppliers may be vertically integrated, owning their distribution channels; others use independent agents, wholesalers, distributors, or dealers – sometimes in tandem with supplier-owned outlets. Franchising is a form of distribution characterized by a dealer's operation of a business that is strongly identified with the supplier's trademarks or tradenames; by the dealer's operation pursuant to the supplier's marketing plan or system, or with the significant control or assistance of the franchisor; and by the payment of some franchise fee representing the right to do business using the franchisor's name and system.

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<sup>5</sup> See, discussion on disclosure in Section III.A.1, *infra*. The information cited is already largely covered by the FTC Rule and the Uniform Franchise Offering Circular ("UFOC") required by many states. The FTC's October 15, 1999 rulemaking proposal, *supra*, note 1, would generally enhance available disclosures. To the extent that existing or proposed disclosure requirements do not cover all relationships affected by the proposed SBFA, the remedy, if needed, may be to expand existing disclosure requirements to apply to those additional relationships. (The costs and burdens of requiring additional disclosures or expanding transactions subject to disclosure would have to be evaluated; however, the Section is already on record in support of FTC Rule pre-emption of state requirements in order to minimize costs and avoid inconsistencies.) To the extent that the disclosure requirements are not adequately enforced, the remedy is not new legislation, but better enforcement, or, if needed, specific legislation that creates a private right of action based on violation of such disclosure requirements.

<sup>6</sup> See Long-Term Plan of the Section, available at <http://www.abanet.org/antitrust/longplan.html>.

Franchising constitutes an important method of distribution, in a multitude of different economic markets. By some estimates it currently represents about 35% of the United States total retail sales.<sup>7</sup> It is a method of attracting both financial capital to finance expansion and human capital (i.e., motivated franchisees who provide the actual distribution of the goods or services at issue) and is used by many kinds of suppliers, including small businesses looking to expand, as well as large, well-known public companies. Franchisees are drawn from both small, first time entrepreneurs, looking for a way into business, and large established businesses that seek the benefits of valuable licenses. Thus, franchising covers an extraordinary range of industries and participants, with significant variations in their particular circumstances.

Franchises are commercial relationships and are creatures of contract. The parties' legal rights are typically reflected in written agreements which allocate with various degrees of specificity the parties' rights and obligations, as well as risks and rewards. Franchise agreements frequently contain clauses providing for protection of the franchisor's trademarks and intellectual property, as well as provisions that vest system control in the franchisor including provisions for termination of franchisees. There is, however, no "standard" form or forms of franchise agreement. The specific terms of any particular franchise contract will depend on a number of factors, including the desirability of the franchisor's products or services, the know-how of the parties, the amount of the parties' respective investments, the time frame in which it is likely that the franchisee can recoup its investment, and the market conditions in which both the franchisor and the franchisee conduct business and distribute products or services.

### C. Antitrust law

The antitrust laws provide:

... a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. [They] rest[] on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions. But even were that premise open to question, the policy unequivocally laid down by the Act is competition.<sup>8</sup>

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<sup>7</sup> See J. Trutko, et al., *Franchising's Growing Role in the U. S. Economy, 1975-2000* (May 1993), a summary of which is available at <http://www.sba.gov/ADVO/research/rs136html>. This Small Business Administration study found that franchises represented 34% of total U. S. retail sales in 1990 and projected they would represent 38% of total U. S. retail sales by the year 2000. Industry sources assert that franchising's percentage of U.S. retail sales is now more than 40%.

<sup>8</sup> *Northern Pacific Railway v. United States*, 356 U.S. 1, 4 (1958).

Integral to unfettered competition as the best means to allocate economic resources is the right of parties to contract to allocate risks and benefits to advance their best interests. In an ideal setting, that would secure the optimal allocation of resources, risks and rewards, promoting economic efficiency, consumer welfare, and societal well being – values at the core of antitrust law.

Early antitrust decisions recognize this principle. The Supreme Court has recognized that “the legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains.”<sup>9</sup> Consequently, the Court has construed Section 1 of the Sherman Act to render unlawful *only* those restraints of trade that *unreasonably* restrict competition.<sup>10</sup> In addition, antitrust law has “long recognized [the] right of [a] trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal.”<sup>11</sup>

At the same time, competition and the freedom to contract do not mean a free for all or the law of the jungle. Various methods of competition, and competition itself, must often yield to other public policy goals, some of which may put significant restraints on competition. In this regard, two federal statutes, the Petroleum Manufacturers Practices Act<sup>12</sup> and the federal Automobile Franchise Act<sup>13</sup> contain restraints enacted to address documented abuses in franchising in specific industries.

Because of disparities between franchisors and franchisees in terms of sophistication and knowledge about franchise offerings,<sup>14</sup> and in light of the franchise-specific investments typically required of new franchisees, the Federal Trade Commission and a number of states have enacted rules or statutes that require extensive presale disclosure about significant aspects of the franchise relationship. In a minority of states, “relationship” laws impose restrictions on the termination or non-renewal of franchises or some other distribution arrangements, and others restrict a franchisor's establishment of new franchises in areas served by existing franchisees.

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<sup>9</sup> *Chicago. Bd. Of Trade v. United States*, 246 U.S. 231, 238 (1918).

<sup>10</sup> *Standard Oil Co. v. United States*, 221 U.S. 1, 58 (1911). After reviewing the legislative history of the Sherman Act and common law rules relating to restraints of trade, the Court concluded that it was not Congress’ intention to prohibit all contracts or even all contracts that caused insignificant or attenuated restraints of trade, but rather only those agreements “which were unreasonably restrictive of competitive conditions.” *Id.* The principle that Section 1 of the Sherman Act prohibits only unreasonable restraints of trade has been repeatedly reaffirmed by the Supreme Court.

<sup>11</sup> *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919).

<sup>12</sup> 15 U.S.C. § 2801-2806.

<sup>13</sup> It is commonly referred to as the *Automobile Dealers’ Day in Court Act*, 15 U.S.C. §§1221-1225.

<sup>14</sup> More recently, some believe these disparities have lessened as the result of increased wealth and sophistication of some franchisees, franchisee consolidations, the advent of franchisee associations and improved representation of franchisees.

#### D. Application to the Act

In evaluating franchise legislation, including the SBFA, the Section has focused on the extent to which federal regulation of all franchises is warranted and whether the various provisions in the Act would promote (or undermine) the purposes of the antitrust laws, while considering other public policy goals. In assessing proposed legislation of this type, it is appropriate to undertake a cost-benefit analysis and ask whether the alleged benefits of greater governmental intervention outweigh the likely cost to economic efficiency resulting from that intervention. Thus, from the standpoint of the Section, whether a particular legislative proposal favors one or the other party to a franchise contract is irrelevant. The proper analysis focuses on what impact, if enacted, the Act would likely have on the firms using or contemplating franchising as a method of distribution. What would be the likely impact of the legislation on interbrand competition? Does it threaten to chill innovation and to impede flexible and effective responses to market conditions in the marketplace? What is its likely impact on prices and quality for consumers? Will it reduce the supply or variety of goods or services (including locations) available to consumers from what would otherwise be available absent the restraint?

The SBFA contains some provisions that would govern disclosures in franchise relationships and others that regulate substantive terms of the franchise relationship. The Section has generally supported and continues to support disclosure regulations because disclosure provides a means for prospective franchisees to make informed decisions before entering a franchise relationship, and thereby promotes the efficient allocation of capital and franchisee efforts. In contrast, the Section has largely opposed and continues to oppose substantive regulation of the terms of franchise contracts, because, barring widespread, systematic abuses across an entire industry, it is best to leave the development of such terms to market forces.

The proposed legislation apparently is based on a belief that abuses now exist in some significant fashion in franchise relationships that cannot be addressed or deterred by some combination of market forces, disclosure or existing legal remedies (including, but not limited to, contract law, the law of fraud and deceit, other tort remedies, state franchise and unfair competition statutes, and antitrust law). The Act reflects an underlying concern about unfair or opportunistic behavior by franchisors that may result in franchisees' forfeiture of a business (e.g., through termination or "encroachment" or enforcement of post-term non-compete clauses), in which the franchisee has invested financially and personally.<sup>15</sup>

To thwart or remedy such unfair, opportunistic behavior, the Act proposes what amounts to a legislative list of mandatory and prohibited contract terms. They are to govern every franchise agreement or arrangement (no matter what the structure of the market, or the size or sophistication of franchisor and franchisee, the disparity in bargaining power, or the actual or probable abuses that have existed in a particular market

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<sup>15</sup> The Section has published a monograph concerning policy issues associated with state laws that regulate termination of franchisees and the establishment of new outlets. See ABA Antitrust Section, Monograph No. 17, FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND THE ESTABLISHMENT OF ADDITIONAL FRANCHISES (1990) (hereinafter, the "1990 Monograph") at 28-70.

or industry).<sup>16</sup> In effect the SBFA would federalize concepts found in substantive franchise regulation in a minority of states (such as precluding terminations without "good cause") and add other concepts (such as a so-called duty of competence) rarely, if at all, found at common law or in existing state legislation. The Act represents an attempt, on a national basis, to define the terms that will govern franchise and distribution relationships used in hundreds of markets, and affecting the very terms of hundreds of thousands of franchise agreements without regard to the special needs of the parties or a particular industry.<sup>17</sup> The SBFA might thus be characterized as a "one size fits all" regulation.

The Section believes that legislation that regulates all franchise contracting is inappropriate absent a strong showing of market failure, or a clear showing of widespread abuses and more paramount social values. Otherwise, legislation regulating the content of commercial distribution relationships may defeat or distort the ability of the free market to allocate risks, rewards and resources. Such regulation could unduly burden competition and chill innovation, producing a less efficient economy and reducing consumer welfare. It could do so, for example, by leading franchisors not to make marketing decisions they would otherwise make, because of the costs of complying with or litigating over the Act's provisions or by creating disincentives for franchisees to compete vigorously to deliver the highest quality of goods and services at the lowest prices.

Opinions differ about the significance of any abuses presently occurring in franchising (such as unfair and unjustifiable forfeitures by franchisees in the face of opportunistic franchisor behavior) and whether abuses are widespread.<sup>18</sup> Hearings on this issue held before the House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, on June 24, 1999, included testimony concerning alleged abuses, but these were largely anecdotal reports that do not, in the Section's view, provide sufficient justification to enact the wide sweep of the proposed Act.<sup>19</sup> If specific

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<sup>16</sup> The Section previously has reviewed and commented on significant proposed federal and multi-state legislation that may affect competition in both franchising and more traditional distribution channels such as dealerships. A summary of the Section's prior positions of most relevance to the SBFA appears in Appendix II.

<sup>17</sup> The Section expresses no opinion on potential constitutional issues raised by legislation modifying existing contracts.

<sup>18</sup> Compare Warren S. Grimes, *Market Definition in Franchise Antitrust Claims: Relational Market Power and the Franchisor's Conflict of Interest*, 67 *Antitrust L.J.* 243-281 (1999), with Benjamin Klein, *Market Power and Franchise Cases in the wake of Kodak: Applying Post-Contract, Hold-Up Analysis to Vertical Relationships*, 67 *Antitrust L.J.* 283-326 (1999).

<sup>19</sup> For example, of witnesses at the June 24, 1999 hearings, three were legislators, six were franchisees or their representatives, and three were franchisors or their representatives; most provided only personal or anecdotal information. One, Dr. Timothy Bates, presented data as to failure rates of franchised businesses which he claimed contradicted data from franchisor-industry sources asserting lower-than-normal failure rates for franchised locations. However, it does not appear that Dr. Bates sought to examine causes of failures. Whether failures resulted from any particular franchisor conduct to which the SBFA might be directed or from failures by franchisees does not appear to have been a focus of the study. Even in perfectly competitive environments without abuses, the nature of competition dictates that many ventures will fail. Thus, failure rates alone are not particularly useful empirical evidence for the proposed legislation. The individual written statements of witnesses and the witness list are available on-line at <http://www.house.gov/judiciary>.

abuses are ultimately identified, in specific industries, it may be appropriate to create clearly focused, carefully targeted, narrow legislation to address these issues in particular industries. But the Section does not believe there has been adequate empirical evidence of widespread abuses to warrant the far-ranging provisions of the Act, or that it has been shown that existing legal remedies cannot adequately address such abuses as may exist.<sup>20</sup>

Based on the above analysis, the Section cannot support the proposed Act. The Act operates in an overly broad manner, without reference to practices, abuses or need in any particular industry or in franchising as a whole. The SBFA adopts a highly regulatory approach to key elements of a franchise agreement, impairs the ability of franchisees and franchisors to allocate risks and benefits applicable to their individual situation by contract, undermines protection of intellectual property in ways that are likely to reduce franchisor incentives to develop new ideas, elevates intrabrand over interbrand competition in ways contrary to most current antitrust analysis, and threatens to chill franchisor or system innovation and hinder adaptation to competitive forces and distributor performance. Over time, this rigidity may limit the ability of franchise systems to compete and may result in higher prices and reduced choice and convenience to consumers.

The Section's concerns with respect to individual provisions of the SBFA are summarized below.

### III. ANALYSIS OF KEY PROVISIONS OF SBFA

#### A. Restrictions on Termination and Post-Termination Rights

Section 4 of the SBFA would prohibit the termination of any franchise agreement prior to its expiration without "good cause". The Act defines "good cause" to include the (a) franchisee's failure to comply with a "material provision" of the franchise agreement within 30 days after receipt of a notice specifying each material term of the franchise agreement with which the franchise is not in compliance; (b) failure to diligently pursue substantial continuing action to cure any such default if it cannot be cured within 30 days; (c) voluntary abandonment of the franchised business; (d) the franchisee's conviction of a felony which substantially impairs the goodwill associated with the franchisor's trademark; (e) repeated default by the franchisee of the same material provision of the franchise agreement, but provided that the franchisor enforces that provision in a manner substantially similar to enforcement of that provision against other franchisees; (f) the franchisee's operation of the business in a manner creating imminent danger to public health or safety; or (g) the franchisor's withdrawal from the marketing area, where the franchisor pays the franchisee reasonable compensation for damages arising out of the shortened term of the agreement and commits not to enforce any contractual prohibition on the franchisee's continuation of the business at the franchise location following termination of the franchise agreement.

Section 4 also prohibits a franchisor from enforcing any post-term covenant not to compete. Section 4 permits the enforcement of intellectual property protections typically

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<sup>20</sup> See *Nynex Corp., v. Discon, Inc.*, 525 U.S. 128, 119 S. Ct. 493, 499 (1998).

found in a franchise agreement, subject to several limitations: first, the franchisee may be required to alter the appearance of the business premises only to the extent that, following modification, it would not be “substantially similar” to the franchisor’s trade dress used by other franchisees “within the proximate trade or market area” of the terminated franchise; and, second, the franchisee can be required to modify its manner or mode of business operations, but only to the extent that such are “unique to the franchisor” and then in common practice by other franchisees operating under the same trademark “within the proximate trade or market area” of the terminated franchise.<sup>21</sup>

#### 1. **Prohibiting Termination Without “Good Cause”**

Termination is the affirmative act of ending an agreement prior to expiration of the term of the relationship. Some distribution relationships that are covered by the SBFA,<sup>22</sup> may not be reduced to writing, and others may have a written agreement, but fail to address termination. Most franchise agreements, however, spell out the circumstances under which the parties may terminate their agreement. In some instances the agreement authorizes termination without cause (with or without a specified period of notice); in other arrangements, the franchisor may only terminate the franchisee for “cause” as defined in the agreement. Variations as to all of these terms are as multitudinous as the parties and industries involved; there is no “standard” approach to termination. The discretion allocated to the franchisor to terminate an agreement will vary from industry to industry and from system to system within any particular market. Differences in termination rights may reflect differences in bargaining power, the marketing philosophy or strategy of the franchisor, and the competitive conditions in the market (including the amount of financial investment by the franchisee in the franchise and the estimated time for recoupment of that investment).

Franchisors have an interest in controlling the use of their trademarks in order to enhance the value of the marks and the goodwill associated with them. The power to terminate is viewed by franchisors as essential to maintain uniform standards of quality throughout the franchise system and to protect their reputation and brand equity. A substandard franchisee not only harms its own reputation, but also that of the franchisor and all other franchisees within the system. Termination can be an essential means of replacing inefficient or nonperforming dealers whose deficiencies can undermine the value of the system. It may be crucial to the development, growth and continued success of franchise systems to be able to replace those franchisees who, for example, fail to invest in advertising, promotion, new equipment or facilities, or who fail to market aggressively to maximize the franchise’s potential.

Although economic theory teaches that exercise of a power to terminate without cause may be tempered by enlightened self-interest (i.e., the franchisor has no economic incentive to terminate arbitrarily agreements with franchisees that contribute value to a franchise system), the SBFA proceeds from a belief that a limited “good cause” standard, embodying criteria that may or may not be reflected in actual franchise agreements, strikes

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<sup>21</sup> See generally ABA Antitrust Section, Monograph No. 17, *supra*, note 14.

<sup>22</sup> See text accompanying note 2, *supra*.

an appropriate balance between bad faith or arbitrary terminations and efficient or appropriate ones.

“Good cause” termination legislation stems from the view that termination clauses have been contractually imposed by franchisors having much greater bargaining power than franchisees, and can then be exercised by franchisors in an arbitrary or improperly acquisitive manner, depriving franchisees of the accrued benefit of their investments and efforts over the years of their relationship with the franchisor. This could occur, for example, if the franchisor seeks to terminate a franchisee in order to open its own outlets in a good market. And it is assumed in such statutes that franchisees need statutory protection because they lack bargaining power and sophistication.

In evaluating the need for such legislation it is important to focus on the extent to which bad-faith, unjustified opportunistic terminations have occurred. The Section has not seen data to indicate that it is, in fact, widespread or commonplace, or that it has gone without redress by those victimized by such tactics.

It should also be kept in mind that effective disclosure laws applicable to franchise relationships (although not to other distribution arrangements that are not franchises under the FTC and state law regimes) can help redress informational imbalances between franchisors and franchisees. Together with the growth in franchising opportunities, disclosure laws provide a significant balance against the chances that a prospective franchisee will be “forced” to accept the terms of a particular franchisor or forego becoming a franchisee. And, as franchising has matured, in many industries large, powerful franchisees have emerged owning multiple franchises. The presence of these franchisees may tend to “level the playing field,” not only for those franchisees, but also for the systems in which they function.

Even if disclosures and existing remedies fail to provide a complete solution to problems with opportunistic terminations, the Section believes that existing law or enhanced disclosure requirements would still be preferable to the proposed SBFA, absent documentation of widespread documented instances of misappropriations of franchisee-developed opportunities. Simply put, the Section believes that the statutorily-defined “good cause” limitations on franchise terminations imposed by the SBFA may well have undesirable adverse effects on competition. The statute would substitute a broad legislative judgment of “good cause” for the business judgments made by business people who must react to changes in their industry, the performance of their distribution system, and the strategies of their competitors (both franchisors and others), and who put their own substantial investment at risk by licensing their intellectual property to franchisees. Additionally, disputes over application of the statute could increase the incidence of litigation even in situations where the termination is efficient and an appropriate response to changed conditions or new information. The “one size fits all” approach to termination in the SBFA could undercut franchising as a method of distribution in many industries and lead to increased vertical integration by firms that would otherwise sell through franchisees. Finally, to the extent that the statutory standard increases the costs of termination or reduces the credible prospect of termination as a method to insure quality franchisee operations, that standard may hurt other franchisees who have as much to lose as their franchisor from substandard operations that adversely affect the brands under

which they operate. Ultimately, consumer welfare may be adversely affected by unduly protecting the vested interests of underperforming franchisees.

## 2. Invalidating Post-Term Covenants Not to Compete

Many franchise agreements prohibit the franchisee, following expiration or termination of the franchise agreement, from operating a competitive facility at or near the location where the franchised business previously operated for some specified time period. Such covenants not to compete, while an obstacle to the franchisee's continuation of a business format with which it may have been associated for many years, may serve legitimate purposes. The principle underlying post-term non-competition covenants is that the franchisor has provided the franchisee with the methodology and know-how to operate a successful business and that if the franchisee could compete at the same or a nearby location following expiration of the term, the franchisee would unfairly appropriate the franchisor's know-how and intellectual property rights.<sup>23</sup> Thus, non-competition covenants can serve as a backstop for the intellectual property protections typically found in franchise agreements. Another principle is more functional: the covenant provides the franchisor with the opportunity to appoint a new franchisee and provide that franchisee with breathing room from one source of possible competition while re-establishing the franchised business.

Not all franchise agreements contain post-term covenants not to compete. In some franchise systems, such as those in the lodging industry, such covenants would effectively preclude the franchisee from making any effective use of a facility which could not be used for other purposes. (In other industries, such as the auto industry, such covenants are not commonly used.) These variations suggest that flexibility is important: in some businesses post-term covenants are both appropriate and necessary, but not in other businesses. As with the across-the-board application of "good cause" requirements for termination, the SBFA would prohibit such covenants in all industries and under all circumstances, thereby depriving franchise systems of essential flexibility.

To be sure, other contract terms and rules governing the protection of intellectual property can protect against unfair competition by the franchisee.<sup>24</sup> Franchisors might argue, however, that covenants not to compete provide a contractual protection not subject to the uncertainty of intellectual property enforcement (*i.e.*, is the former franchisee misusing the trade secrets? Does the franchisor's trade dress have secondary meaning?).

Opponents of non-competition covenants also argue that they create or extend exclusivity protection to a degree the law would otherwise not recognize. Thus, through such a restraint, the franchisor (and the new franchisee) are sheltered from competition that does not involve actual misuse of protected intellectual property. (Additionally, these covenants can have *in terrorem* effects that discourage otherwise beneficial economic activities that are not truly ancillary to the former business.) But whether this is a widespread problem is unclear. Indeed, most states restrict the enforceability of covenants

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<sup>23</sup> See text in Section III. B.3, *infra*.

<sup>24</sup> These include intellectual property protections such as those discussed in Section III.B.3, *infra*

not to compete that are unreasonable in duration or scope, and a minority of jurisdictions prohibit post-term non-competition covenants altogether.<sup>25</sup>

On balance, the Section believes that advocates of the ban against post-term covenants do not advance reasons sufficient to justify an expansion of franchisee protection beyond that already provided by state statutes and common law doctrines which already protect franchisees against unreasonable covenants.

### **3. Limiting Intellectual Property Protections**

The SBFA restricts two intellectual property protections used in franchising.

Under the SBFA a franchisor may enforce trade dress rights only to the extent the trade dress is “substantially similar to the standard design, decor criteria, or motif and used by other franchisees . . . within the proximate trade or market area.” This “substantial similarity” standard differs from the well-defined “likelihood of confusion” standard otherwise employed when trade dress is infringed.<sup>26</sup> Further, the franchisor would be entitled to protect only “the standard design,” rather than any variations that may have been permitted or required to tailor the franchise system to a local market. Finally, such trade dress could not be enforced unless it is actually used “within the proximate trade or market area.” The statute does not define this market area. Nor does it explain whether trade dress would become unprotectable if franchisees are widely dispersed, and therefore not operating within each other’s market area, even where the franchisor’s trade dress has national or international recognition.

The SBFA also would permit the franchisor to protect its business operation trade secrets only to the extent necessary “to avoid any substantial confusion with the manner or mode of operations which are unique to the franchisor and commonly in practice by other franchisees . . . within the proximate trade or market area.” These standards for enforcement are different from those found in the Uniform Trade Secrets Act, adopted in some form in virtually every state, which protects trade secrets if they have some economic value because they are not generally known and are the subject of reasonable efforts to maintain their secrecy.<sup>27</sup>

While SBFA proponents believe franchisees as a group need to be protected against overreaching by franchisors, in the absence of better data showing abuse, it is not apparent that standards generally applicable to intellectual property protection need to be rewritten in the franchise context. The Section is unaware of any studies or literature to indicate that franchisor abuses of intellectual property are widespread or unable to be addressed through

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<sup>25</sup> See generally ABA Forum on Franchising, COVENANTS AGAINST COMPETITION AND FRANCHISE AGREEMENTS (1992).

<sup>26</sup> See, e.g., *Taco Cabana Int’l, Inc. v. Two Pesos, Inc.*, 932 F.2d 1113 (5th Cir. 1991), *aff’d*, 505 U.S. 763 (1992).

<sup>27</sup> See, e.g., Cal. Civ. Code § 3426.1(d).

existing bodies of law. If franchisors abuse their intellectual property rights to preclude or otherwise discourage innovation in a manner not inherent in the intellectual property grant, it presents a matter of concern to competition. But that should be addressed on a case-by-case basis. On the other hand, denying franchisors bargained-for standard intellectual property protections (and in the trade dress and trade secret area arguably limiting otherwise applicable rights) would be expected to discourage intellectual property licensing -- a result that is contrary to public policy -- and may, to some extent, discourage franchising as a method of product or service distribution, resulting in a net loss to consumer welfare.

## **B. Duty of Good Faith**

The SBFA would impose on each party to a franchise contract a statutory duty to act in good faith in both the performance and enforcement of the contract. Section 5 of the SBFA defines “good faith” in two parts: an obligation to do nothing that would destroy or injure the right of the other party to receive the expected fruits of the contract, and a requirement of honesty in fact and observance of reasonable standards of fair dealing in the trade. Section 5 of the SBFA also provides that no provision in a franchise agreement can override the duty to act in good faith “or otherwise allow a disparate result in the franchise relationship.”

The nature and scope of the duty of good faith in contract law has been the subject of extensive judicial and critical commentary. Thus, for example, issues such as the precise formulation of the concept, the extent to which proof of subjective bad faith should be required or permitted to sustain a claim, and the extent to which the duty of good faith should be limited to specified contractual duties (rather than creating its own substantive cause of action), are addressed in a multitude of franchising decisions. Whatever their differences, those precedents have generally been sensitive to the specifics of the relationship being adjudicated, so as to respect essential features of the parties’ bargain.

The Section endorsed a limited covenant of good faith set forth in a 1987 NCCUSL Uniform Franchise Act (which concept had replaced a “good cause” termination/nonrenewal proposal found in earlier drafts of the Uniform Act) that defined “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” (NCCUSL Uniform Franchise Act § 201). Official comments to this provision made clear, however, it did not impose a fiduciary duty or a good cause standard, and that it did not “add to or override substantive provisions of a contract....”<sup>28</sup>

The definition of “good faith” in the SBFA although borrowing some of the phraseology used in certain cases, the Uniform Commercial Code and NCCUSL’s proposed Uniform Franchise Act, appears to create a scope and content for the duty of good faith that is very different. That is, the good faith standard found in the Act would override explicit contractual provisions in franchise agreements, which is contrary to the law of most jurisdictions. (It also contains a “reciprocal provisions” with no “disparate result” clause that is not well-defined and is essentially unknown in current law.)

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<sup>28</sup> The Uniform Act is not currently in force in any state, and is now considered moribund by NCCUSL.

As indicated in the discussion of “good cause” termination requirements above, the Section recognizes that both in terminations and in the course of performance of the relationship, some actions by some franchisors may defeat reasonable expectations of their franchisees, and this could cause considerable injury to such franchisees. However, the task of determining when that behavior has occurred – what constitutes “reasonable expectations” – is already addressed by common law, and necessarily involves case-by-case consideration. Finally, the Section is concerned that if the statute were used to override bargained-for contractual provisions, it would engender unwarranted and undesirable uncertainty in commercial franchise contracts. Permitting the enforcement only of reciprocal provisions (those which do not have a “disparate result”) also constitutes an imprecise and novel re-writing of franchising agreements, that could also spawn unwarranted and undesirable uncertainty. Such uncertainty may in turn chill innovation by franchisors and increase the cost of resolving disputes, because of the assertion of claims for breaches of this far-ranging “duty.”

In sum, as constructed, the Act’s duty of good faith goes well beyond judicial interpretations of the duty of good faith and may detract from, rather than enhance, efficient and non-opportunistic contract performance. However, the Section does not object to a more narrow, focused good faith requirement, such as that found in the NCCUSL Uniform Franchise Act.

### **C. Duty of Competence**

Section 5 of the Act also would impose a duty of “due care,” or competence, on the franchisor. Unless the franchisor either represents it has greater skill or knowledge, or conspicuously disclaims that it has skill or knowledge, the franchisor would be required to exercise “the skill and knowledge normally possessed by franchisors in good standing in the same or similar types of business,” which involves a “special level of expertise” resulting from “acquired learning and aptitude developed by special training and experience in the business to be licensed under the franchise agreement” or from “extensive use and experience with the goods and services or the operating systems of such businesses” and “which is the result of experience in organizing a franchise system and in providing training, assistance and services to franchisees.”

Proponents of the Act believe there are good reasons to protect franchisees from transferring capital to franchisors that are incompetent. In an ideal or perfect market, capital (both money and effort) would pursue productive activities. Any other allocation of capital is by definition inefficient. A franchisor’s lack of competence can raise efficiency concerns, because it results in franchisee money and effort pursuing unproductive, even counterproductive, activities. By extension, widespread investment of money and effort by franchisees on behalf of incompetent franchisors would have adverse effects on markets for the distribution of goods and services and injure not only franchisees but consumer welfare. On the other hand, it cannot simply be assumed that franchisor incompetence is widespread or that franchisees, as a group, cannot differentiate between “competent” and “incompetent” franchisors. FTC and state disclosure regimes, press reports as to the track records of franchisors and franchise systems, access to the services of attorneys and other business advisors, all can provide some insight into whose systems work and whose do not. Do any of these assure perfect information? No. Still, it is an assumption, and probably a valid one, that, over time, the marketplace will weed out

incompetent franchisors. Additionally, some levels of incompetence may be so gross as to give rise to claims for fraud or breach of contract, even without the superimposition of a statutory duty of competence.

In contrast, instituting a statutory duty of competence, one that is untethered to the franchise contract struck by the parties, may dampen change and innovation in the operation of franchise systems (lest an unsuccessful change in the franchise system be open to attack in litigation as being planned and implemented by the franchisor without “due care”).<sup>29</sup> Here, the SBFA enters uncharted and (so far as the record shows, not warranted) territory: this proposed duty of competence is an untested concept as applied to franchising and has not been adopted by the courts or other legislative bodies. It would essentially engraft professional malpractice concepts onto a host of business relationships that fall within its definition of a “franchise.” Because of the potentially chilling effect on market entry and innovation, the Section believes that imposing a statutory duty of competence would be anticompetitive and unwise.

#### **D. Independent Sourcing of Goods and Services.**

Under many franchise systems, franchisees are not free to obtain all of the items they use in their businesses from sources entirely of their own choosing. Instead, under the terms of franchise agreements, they must comply with sourcing standards prescribed by the franchisor. These standards vary from system to system and, within any given system, from item to item. For some items, particularly those that are not essential to the franchise operations, sourcing is virtually unrestricted. For other items, the controls may range from required compliance with the franchisor’s specifications, to pre-approval of suppliers by the franchisor, to mandatory purchases from the franchisor or its affiliates.

Section 10 of the SBFA would override required purchase terms and permit franchisees to purchase goods and services from sources of the franchisee’s choosing so long as they meet “reasonable established uniform system-wide quality standards” established by the franchisor. “In order to promote competition,” franchisors must approve at least two sources. This rule would not apply to “reasonable quantities” of inventory and other items that are “central to the franchised business” and incorporate some intellectual property right of the franchisor or when “agreed to by both the franchisor and a majority of franchisees.”

Franchisors can use sourcing controls as an efficient and practical way to ensure the quality and uniformity of goods and services sold under the franchisor’s mark, as indeed required by the federal Lanham Act.<sup>30</sup> Such controls can also protect trade secrets,<sup>31</sup> avoid

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<sup>29</sup> See Robert Joseph, *Do Franchisors Owe A Duty Of Competence?*, 46 Bus. Law. 471, 478-81 (1991), asserting reasons why a negligence cause of action should not be recognized in the usual franchise situation.

<sup>30</sup> 15 U.S.C. §§ 1051, *et seq.*

<sup>31</sup> See, e.g., *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348, 1353 n.12 (9th Cir. 1982).

the impracticability of specifications in certain circumstances,<sup>32</sup> and promote the distribution of the franchisor's product in product-based systems.<sup>33</sup> They can also help the franchisor to establish a reputation for being a provider of the highest quality goods and products.

While sourcing controls can thus promote system quality and uniformity, franchisees point to countervailing considerations. For example, certain forms of sourcing control may restrict franchisee freedom more than is necessary to reasonably assure system quality and uniformity. Controls may increase franchisee costs (and consumer prices) by limiting competitive sourcing options. In addition, some sourcing controls are intended to enhance franchisor profits by requiring purchases from the franchisor, an affiliate or an authorized supplier which provides rebates to the franchisor.

Federal antitrust laws have long condemned as *per se* unlawful certain "tying arrangements."<sup>34</sup> Federal and state antitrust laws on tying arrangements are designed to prohibit unreasonable restraints of trade in all industries, including franchising. Although tying claims have been used to challenge franchisors sourcing controls, most recent cases have held that franchisors do not hold "market power" merely by reason of contracted sourcing restrictions with their franchisees and so have not invalidated the sourcing restriction.<sup>35</sup>

Undoubtedly the SBFA is intended to reverse that outcome in future cases, but it is unclear whether such legislative intervention would serve competition or consumer welfare. In franchising, antitrust protections against tying are augmented by existing disclosure requirements, which provide franchisees -- before they enter into a franchise relationship -- with detailed information concerning required purchases in the franchise system. Contract law may also be used to attack supplier decisions that are not made in good faith consistent with the franchisor's contract obligations and the reasonable expectations of the particular parties to the particular contract. More importantly, sourcing controls vary widely in their purpose, nature and effect. Their competitive implications are not uniform and are the subject of considerable debate among academics and other experts.<sup>36</sup> For these reasons, such controls are better addressed through the evolving application of existing antitrust law to particular cases, disclosure to franchisees, and the parties' own negotiations than by attempts at complex and uniform legislative codification.

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<sup>32</sup> See, e.g., *Susser v. Carvel Corp.*, 332 F.2d 505 (2nd Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

<sup>33</sup> See, e.g., *Krehl v. Baskin-Robbins Ice Cream Co.*, *supra*.

<sup>34</sup> See, e.g., *Northern Pacific Railway v. United States*, *supra*, note 6, 356 U.S. at 5-6; *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 12-18 (1984); *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 461-64 (1992).

<sup>35</sup> See, e.g., *Queen City Pizza v. Domino's Pizza, Inc.*, 124 F.3d 430 (3d Cir. 1997), *cert. denied*, 118 S. Ct. 1385 (1998); Janet McDavid & Richard Steuer, *The Revival of Franchise Antitrust Claims*, 67 *Antitrust L.J.* 209, 226-36 (1999).

<sup>36</sup> See generally for contrasting points of view Grimes, *supra*, note 17, and Klein, *supra*, note 17.

## E. “Encroachment”

Section 11 of the SBFA would prohibit a franchisor from “encroaching” on a franchise business by placing one or more new outlets “in unreasonable proximity” to an existing franchised outlet if it is probable that the existing outlet will suffer a five percent (5%) or more decline in sales within the first twelve months. A franchisor may avoid the prohibition by offering to pay to each existing outlet that suffers a sales decline of more than 5% during a twelve month period as a result of the new outlet an amount equal to 50% of the sales of the new outlet for 24 months. The SBFA imposes upon the franchisor the burden of proving that a decline in sales occurred for reasons other than opening of the new outlet.

Franchise systems employ a variety of techniques to deal with market expansion. These techniques range from no contractual protection at all, to protection against establishing additional franchises within a specific radius of the existing outlet, to commitments not to expand within a certain radius until the franchisor has conducted an impact study verifying no or only minimal effect on existing franchisees. These provisions are tailored to the particular industry and vary greatly depending upon the marketplace for the franchised product or services. Special industry legislation (notably motor vehicle acts) has limited appointment of additional dealers in “relevant market areas,” which are defined in various ways.

The subject of “encroachment” or “cannibalization” has attracted extensive controversy in many franchise systems (particularly mature ones) where a franchisee is given a franchise at specific address with no territorial exclusivity. Existing franchisees may feel that they have been the early “risk-takers” who have taken a chance on an unproven concept or developing area or location, and should not be penalized for their success by “cannibalization” of their market through the insertion of additional franchisees. They have also argued that franchise agreements, which are drafted by franchisors and rarely negotiable, do not adequately protect the franchisee’s investment. Proponents of legislative solutions to “encroachment” argue that a franchisor’s power to add franchisees in locations near an existing franchisee is tantamount to the power to terminate the existing franchisee and should be regulated in the same manner as an actual termination.

Franchisors, on the other hand, note that newly established franchise locations are typically contemplated by both parties from the outset, increase consumer exposure, enhance brand-name identity, provide superior consumer service and generate additional advertising revenues for all franchisees. Franchisors say they exercise care in establishing new franchised outlets, because the weakening of existing franchisees may have a deleterious effect on the entire system. Opponents of legislation argue that encroachment laws artificially transfer market power to existing dealers, decrease intrabrand competition by increasing the costs of establishing additional outlets, increase consumer prices and decrease consumer service.

After considering these issues and the others summarized in the Section’s 1990 Monograph,<sup>37</sup> the Section has concluded that the SBFA’s encroachment provisions carry a

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<sup>37</sup> ABA Antitrust Section, Monograph No.17, *supra*, note 14, at 71-72, 78-82 & 101-116.

risk of anticompetitive effects for which there appear to be insufficient countervailing justification. Franchisees should know at the outset of the relationship from the UFOC or other required disclosures whether the franchisor retains the ability to establish any additional franchises in the vicinity of the franchisee's unit, and of any franchisor policies or practices restricting that ability. Armed with these disclosures, franchisees can make informed choices among the range of franchise alternatives then available to them. To be sure, the pre-sale disclosures do not necessarily permit a franchisee to predict exactly the risk of post-sale opportunistic "encroachment" by a franchisor. However, other legal remedies may be available, and it would be inefficient to legislate the circumstances in which a franchisor will be barred from, or required to pay a charge for, establishing new outlets, as illustrated by the SBFA itself:

The low threshold for impact on existing franchisees -- a potential sales diminution of five percent (5%) in twelve months -- could deter a franchisor from establishing new franchises in all but the most robust market areas. While such deterrence would undoubtedly protect the existing operator for at least the short term, this protection could come at the cost of the long-term system-wide benefits and reduce consumer welfare (convenience, choice and additional price competition) that may result from additional points of consumer exposure. Further, the profit sharing provision may increase consumer prices. Finally, the SBFA standard applies uniformly, without permitting distinctions between growing business segments and segments that have already matured, and without considering the potential impact of the standard on multi-unit franchise operators with contractual expansion rights. (For example, it is not clear how the SBFA would treat competition to an existing franchisee by a new franchisee doing business using the Internet and thereby reaching into an existing territory.) On balance, therefore, the Section opposes the SBFA encroachment provision.

#### **IV. CONCLUSION**

For the reasons set forth above, the Section believes that the SBFA should not be adopted. Although certain provisions in the SBFA may merit further attention, on balance, the Section believes that adoption of the SBFA has not been shown to be necessary and is likely to have unintended consequences that may sweep in ordinary distribution relationships, damage existing business relationships, and harm competition by impairing the ability of franchise systems to innovate and expand.

**APPENDIX I TO REPORT ON  
SMALL BUSINESS FRANCHISE ACT**

**Submitted by the  
American Bar Association  
Section of Antitrust Law**

HR 3308 IH

106th CONGRESS  
1st Session  
**H. R. 3308**

To establish minimum standards of fair conduct in franchise sales and franchise business relationships, and for other purposes.

**IN THE HOUSE OF REPRESENTATIVES**

**November 10, 1999**

Mr. COBLE (for himself, Mr. CONYERS, Mr. JONES of North Carolina, Mr. ANDREWS, Mr. JENKINS, Mr. PICKERING, Mr. JOHN, Mr. TOWNS, Mr. WAMP, Mr. DICKEY, Mr. COBURN, Mr. LATOURETTE, Mr. NORWOOD, Mr. HILLEARY, Mr. ROTHMAN, Mr. GRAHAM, Mr. CANNON, Ms. ESHOO, Mr. CRAMER, Mr. GALLEGLY, Mr. PHELPS, Mr. SPENCE, and Mr. HERGER) introduced the following bill; which was referred to the Committee on the Judiciary

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**A BILL**

To establish minimum standards of fair conduct in franchise sales and franchise business relationships, and for other purposes.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**SECTION 1. SHORT TITLE; TABLE OF CONTENTS.**

(a) SHORT TITLE- This Act may be cited as the 'Small Business Franchise Act of 1999'.

(b) TABLE OF CONTENTS- The table of contents of this Act is the following:

- Sec. 1. Short title; table of contents.
- Sec. 2. Findings and purpose.
- Sec. 3. Franchise sales practices.
- Sec. 4. Unfair franchise practices.
- Sec. 5. Standards of conduct.
- Sec. 6. Procedural fairness.
- Sec. 7. Actions by State attorneys general.
- Sec. 8. Transfer of a franchise.
- Sec. 9. Transfer of franchise by franchisor.
- Sec. 10. Independent sourcing of goods and services.
- Sec. 11. Encroachment.
- Sec. 12. Private right of action.
- Sec. 13. Scope and applicability.
- Sec. 14. Definitions.

## **SEC. 2. FINDINGS AND PURPOSE.**

(a) FINDINGS- The Congress makes the following findings:

(1) Franchise businesses represent a large and growing segment of the nation's retail and service businesses and are rapidly replacing more traditional forms of small business ownership in the American economy.

(2) Franchise businesses involve a joint enterprise between the franchisor and franchisees in which each party has a vested interest in the franchised business.

(3) Most prospective franchisees lack bargaining power and generally invest substantial amounts to obtain a franchise business when they are unfamiliar with operating a business, with the business being franchised and with industry practices in franchising.

(4) Many franchises reflect a profound imbalance of contractual power in favor of the franchisor, and fail to give due regard to the legitimate business interests of the franchisee, as a result of the franchisor reserving pervasive contractual rights over the franchise relationship.

(5) Franchisees may suffer substantial financial losses when the franchisor does not provide truthful or complete information regarding the franchise opportunity, or where the franchisor does not act in good faith in the performance of the franchise agreement.

(6) Traditional common law doctrines have not evolved sufficiently to protect franchisees adequately from fraudulent or unfair practices in the sale and operation of franchise businesses, and significant contractual and procedural restrictions have denied franchisees adequate legal recourse to protect their interests in such businesses.

(7) A franchisee's freedom to contract is greatly limited by the disparity of bargaining power, lack of consistent legal standards, and other factors described above. This Act is necessary to restore freedom to contract, and to remove restrictive barriers impeding entry into industries and markets dominated by franchise systems.

(b) PURPOSE- It is the purpose of this Act to promote fair and equitable franchise agreements, to establish uniform standards of conduct in franchise relationships and to create uniform private Federal remedies for violations of Federal law.

## **SEC. 3. FRANCHISE SALES PRACTICES.**

(a) IN GENERAL- In connection with the advertising, offering, sale or promotion of any franchise, it shall be unlawful for any person--

(1) to employ a device, scheme, or artifice to defraud;

- (2) to engage in an act, practice, course of business or pattern of conduct which operates or is intended to operate as a fraud upon any prospective franchisee; or
- (3) to obtain property, or assist others to obtain property, by making an untrue statement of a material fact or any failure to state a material fact.

**(b) MISREPRESENTATIONS IN REQUIRED DISCLOSURE-**

(1) In connection with any disclosure document, notice, or report required by any law, it shall be unlawful for any franchisor, subfranchisor, or franchise broker, either directly or indirectly through another person--

(A) to--

- (i) make an untrue statement of material fact;
- (ii) fail to state a material fact; or
- (iii) fail to state any fact which would render any required statement or disclosure either untrue or misleading;

(B) to fail to furnish any prospective franchisee with--

- (i) all information required to be disclosed by law and at the time and in the manner required; and
- (ii) a written statement specifying, prominently and in not less than 14-point type, whether the franchise agreement involved contains a right to renew such agreement; or

(C) to make any claim or representation to a prospective franchisee whether orally or in writing, which is inconsistent with or contradicts such disclosure document.

(2) For purposes of this subsection, the term 'disclosure document' means either the disclosure statement required by the Federal Trade Commission in Trade Regulation Rule 436 (16 C.F.R.

Sec. 436) as amended from time to time, or any offering format allowed or required by State law.

**SEC. 4. UNFAIR FRANCHISE PRACTICES.**

(a) **DECEPTIVE AND DISCRIMINATORY PRACTICES-** In connection with the performance, enforcement, renewal, or termination of any franchise agreement, it shall be unlawful for a franchisor or subfranchisor, either directly or indirectly through another person--

(1) to engage in an act, practice, course of business, or pattern of conduct which operates as a fraud upon any person;

(2) to hinder, prohibit, or penalize (or threaten to hinder, prohibit, or penalize), directly or indirectly, the free association of franchisees for any lawful purpose,

including the formation of or participation in any trade association made up of franchisees or of associations of franchises; or

(3) to discriminate against a franchisee by imposing requirements not imposed on other similarly situated franchisees or otherwise retaliate, directly or indirectly, against any franchisee for membership or participation in a franchisee association.

(b) TERMINATION WITHOUT GOOD CAUSE-

(1) It shall be unlawful for a franchisor, either directly or indirectly through an affiliate or another person, to terminate a franchise agreement prior to its expiration without good cause for such termination.

(2) For purposes of this subsection, good cause shall exist only where--

(A)(i) the franchisee fails to comply with a material provision of the franchise agreement after receiving notice that specifies the precise basis for the default, each material term of the franchise agreement with which the franchise is not in compliance, and a 30-day period to cure the default; and

(ii) if the nature of the default is such that it cannot be cured through reasonably diligent conduct, the franchisee fails to initiate within 30 days, and diligently pursue substantial continuing action to cure the default;

(B) the franchisee, without the requirement of notice and opportunity to cure--

(i) voluntarily abandons the business licensed by the franchise agreement, except that loss or termination of a leasehold for the business prior to the term of a franchise agreement by reason of eminent domain, foreclosure sale, natural disaster or other termination not the fault of the franchisee shall not be considered abandonment by the franchisee;

(ii) is convicted of a felony, for which imprisonment of 1 year or more can be imposed, which substantially impairs the good will associated with the franchisor's trade mark, service mark, trade name, logotype, advertising, or other commercial symbol;

(iii) is repeatedly in default of the same material provision of the franchise agreement, where the enforcement of such provision is substantially similar to enforcement of that provision with other franchisees; or

(iv) operates the business licensed by the franchise agreement in a manner that creates an imminent danger to public health or safety; or

(C) the franchisor withdraws from the marketing area of the business licensed by the franchise agreement and pays the franchisee reasonable compensation for damages incurred from the shortened term of the agreement and agrees in writing not to enforce any contractual prohibition against the franchisee continuing to engage in the business at the franchised location.

(c) Post-Term Restrictions on Competition-

(1) A franchisor shall not prohibit, or enforce a prohibition against, any franchisee from engaging in any business at any location after expiration of a franchise agreement.

(2) Nothing in this subsection shall be interpreted to prohibit enforcement of any provision of a franchise contract obligating a franchisee after expiration or termination of a franchise--

(A) to cease or refrain from using a trademark, trade secret, or other intellectual property owned by the franchisor or its affiliate;

(B) to alter the appearance of the business premises so that it is not substantially similar to the standard design, decor criteria, or motif in use by other franchisees using the same name or trademarks within the proximate trade or market area of the business; or

(C) to modify the manner or mode of business operations so as to avoid any substantial confusion with the manner or mode of operations which are unique to the franchisor and commonly in practice by other franchisees using the same name or trademarks within the proximate trade or market area of the business.

## **SEC. 5. STANDARDS OF CONDUCT.**

(a) DUTY OF GOOD FAITH-

(1) A franchise contract imposes on each party thereto a duty to act in good faith in its performance and enforcement.

(2) As used in this subsection, a duty of good faith shall--

(A) obligate a party to a franchise to do nothing that will have the effect of destroying or injuring the right of the other party to obtain and receive the expected fruits of the contract and to do everything required under the contract to accomplish such purpose; and

(B) require honesty of fact and observance of reasonable standards of fair dealing in the trade.

(3) No provision of any franchise agreement, express or implied, shall be

interpreted or enforced in such a way as to obfuscate a party's duty to act reasonably and in good faith with the other, or otherwise allow a disparate result in the franchise relationship.

(b) DUTY OF DUE CARE-

(1) A franchise agreement imposes on the franchisor a duty of due care. Unless a franchisor represents that it has greater skill or knowledge in its undertaking with its franchisees, or conspicuously disclaims that it has skill or knowledge, the franchisor is required to exercise the skill and knowledge normally possessed by franchisors in good standing in the same or similar types of business.

(2) For purposes of this subsection--

(A) the term `skill or knowledge' means something more than the mere minimum level of skill or knowledge required of any person engaging in a service or business and involves a special level of expertise--

(i) which is the result of acquired learning and aptitude developed by special training and experience in the business to be licensed under the franchise agreement, or the result of extensive use and experience with the goods or services or the operating system of such business;

(ii) which is the result of experience in organizing a franchise system and in providing training, assistance and services to franchisees; and

(iii) which a prospective franchisee would expect in reasonable reliance on the written and oral commitments and representations of the franchisor; and

(B) a franchisor shall be permitted to show that it contracted for, hired or purchased the expertise necessary to comply with the requirements of this subsection and that such expertise was incorporated in the franchise or communicated or provided to the franchisee.

(3) The requirement of this subsection may not be waived by agreement or by conduct, but the franchisor may limit in writing the nature and scope of its skill and knowledge, and of its undertaking with a prospective franchisee, provided that no inconsistent representation, whether written or oral, is made to the prospective franchisee irrespective of any merger or integration clause in the franchise agreement.

(c) LIMITED FIDUCIARY DUTY-

(1) Without regard to whether a fiduciary duty is imposed generally on the franchisor by virtue of a franchise agreement, the franchisor owes a fiduciary duty to its franchisees and is obligated to exercise the highest standard of care

for franchisee interests where the franchisor--

(A) undertakes to perform bookkeeping, collection, payroll, or accounting services on behalf of the franchisee; or

(B) administers, controls or supervises (either directly or through any subsidiary or affiliate) any advertising, marketing, or promotional fund or program to which franchisees are required to, or routinely, contribute.

(2) A franchisor that administers or supervises the administration of any fund or program described in paragraph (1)(B) shall--

(A) keep all moneys contributed to such fund or program in a separate account;

(B) provide an independent certified audit of such fund within 60 days following the close of the franchisor's fiscal year, which shall include full disclosure of all fees, expenses, or other payments from the account to the franchisor or to any subsidiary, affiliate, or other entity controlled in whole or in part by the franchisor; and

(C) disclose the source and amount of, and deliver to such fund or program, any discount, rebate, compensation, or payment of any kind from any person or entity with whom such fund or program transacts.

(3) While not limiting the ability of any court to identify other circumstances for which a fiduciary duty may also exist, this subsection does not create or extend a fiduciary duty by implication to other aspects of a franchise.

## **SEC. 6. PROCEDURAL FAIRNESS.**

(a) It shall be unlawful for any franchisor, either directly or indirectly through another person, to--

(1) require any term or condition in a franchise agreement, or in any agreement ancillary or collateral to a franchise, which directly or indirectly violates any provision of this Act; or

(2) require a franchisee to assent to any disclaimer, waiver, release, stipulation or other provision which would purport--

(A) to relieve any person from a duty imposed by this Act, except as part of a settlement of a bona fide dispute; or

(B) to protect any person against any liability to which he would otherwise be subject under this Act by reason of willful misfeasance, bad faith, or gross negligence in the performance of duties, or by reason of reckless disregard of obligations and duties under the franchise agreement; or

(3) require a franchisee to assent to any waiver, release, stipulation, or other provision, either as part of any agreement or document relating to the operation of a franchise business, in any agreement or document relating to the termination, cancellation, forfeiture, repurchase, or resale of a franchise business or as a condition for permitting a franchisee to leave the franchise system, which would purport to prevent the franchisee from making any oral or written statement relating to the franchise business, to the operation of the franchise system or to the franchisee's experience with the franchise business.

(b) Any condition, stipulation, provision, or term of any franchise agreement, or any agreement ancillary or collateral to a franchise, which would purport to waive or restrict any right granted under this Act shall be void and unenforceable.

(c) No stipulation or provision of a franchise agreement, or of an agreement ancillary or collateral to a franchise, shall--

(1) deprive a franchisee of the application and benefits of this Act, of any other Federal law, or of

the law of the State in which the franchisee's principal place of business is located;

(2) deprive a franchisee of the right to commence an action (or, if the franchise provides for arbitration, initiate an arbitration) against the franchisor for violation of this Act, or for breach of the franchise agreement, or of any agreement or stipulation ancillary or collateral to the franchise, in a court (or arbitration forum) in the State of the franchisee's principal place of business; or

(3) prevent a franchisee from participating as a member of a class permitted by Rule 23 of the Federal Rules of Civil Procedure or applicable State law.

(d) Compliance with this Act or with an applicable State franchise law is not waived, excused, or avoided, and evidence of violation of this Act or of such State law shall not be excluded, by virtue of an integration clause, any provision of a franchise agreement, or an agreement ancillary or collateral to a franchise, the parol evidence rule,

or any other rule of evidence purporting to exclude consideration of matters outside the franchise agreement.

## **SEC. 7. ACTIONS BY STATE ATTORNEYS GENERAL.**

(a) CIVIL ACTION- Whenever an attorney general of any State has reason to believe that the interests of the residents of that State have been or are being threatened or adversely affected because any person has engaged or is engaging in a pattern or practice which violates any provision of this Act, the State, as *parens patriae*, may bring a civil action on behalf of its residents in an appropriate district court of the United States to enjoin such violations, to obtain damages, restitution or other compensation on behalf of residents of such State or to obtain such further and other relief as the court may deem appropriate.

(b) **PRESERVATION OF POWER-** For purposes of bringing any civil action under subsection (a), nothing in this Act shall prevent an attorney general from exercising the powers conferred on the attorney general by the laws of such State to conduct investigations or to administer oaths or affirmations or to compel the attendance of witnesses or the production of documentary and other evidence.

(c) **VENUE-** Any civil action brought under subsection (a) in a district court of the United States may be brought in the district in which the defendant is found, is an inhabitant, or transacts business or wherever venue is proper under section 1391 of title 28, United States Code. Process in such action may be served in any district in which the defendant is an inhabitant or in which the defendant may be found.

(d) **NO PREEMPTION-** Nothing contained in this section shall prohibit an authorized State official from proceeding in State court on the basis of an alleged violation of any civil or criminal statute of such State.

## **SEC. 8. TRANSFER OF A FRANCHISE.**

(a) **IN GENERAL-** A franchisee may assign an interest in a franchised business or in a franchise to a transferee provided the transferee satisfies the reasonable qualifications then generally applied by the franchisor in determining whether or not a current franchisee is eligible for renewal. If the franchisor does not renew a significant number of its franchisees, then the transferee may be required to satisfy the reasonable conditions generally applied to new franchisees. For the purpose of this section, a reasonable current qualification for a new franchisee is a qualification based upon a legitimate business reason. If the proposed transferee does not meet the reasonable current qualifications of the franchisor, the franchisor may refuse to permit the transfer, provided that the refusal of the franchisor to consent to the transfer is not arbitrary or capricious and the franchisor states the grounds for its refusal in writing to the franchisee.

(b) **NOTICE OF PROPOSED TRANSFER-** A franchisee shall give a franchisor not less than 30 days written notice of a proposed transfer of a transferable interest, and on request shall provide in writing the ownership interests of all persons holding or claiming an equitable or beneficial interest in the franchise subsequent to the transfer or the franchisee, as appropriate.

(c) **CONSENT TO PROPOSED TRANSFER-** A transfer by a franchisee is deemed to have been approved 30 days after the franchisee submits the request for permission to transfer the franchise involved unless, within that time the franchisor refuses to consent to the transfer as evidenced in writing in accordance with subsection (a). A statement of the grounds for refusal to consent to the transfer is privileged against a claim of defamation.

(d) **CONDITIONS OF TRANSFER-**

(1) **PERMISSIBLE CONDITIONS-** A franchisor may require as a condition of a transfer that--

- (A) the transferee successfully complete a reasonable training program;
- (B) a reasonable transfer fee be paid to reimburse the franchisor for the franchisor's reasonable and actual expenses directly attributable to the transfer;
- (C) the franchisee pay or make reasonable provision to pay any amount due the franchisor or the franchisor's affiliate; or
- (D) the financial terms of the transfer at the time of the transfer, comply with the franchisor's current financial requirements for franchisees.

(2) IMPERMISSIBLE CONDITIONS- A franchisor may not condition its consent to a transfer described in paragraph (1) on--

- (A) a franchisee's forgoing existing rights other than those contained in the franchise agreement;
- (B) a franchisee's entering into a release of claims broader in scope than a counterpart release of claims offered by the franchisor to the franchisee; or
- (C) requiring the franchisee or transferee to make, or agree to make, capital improvements, reinvestments, or purchases in an amount greater than the franchisor could have reasonably required under the terms of the franchisee's existing franchise agreement.

(e) ASSIGNMENT- A franchisee may assign the franchisee's interest in the franchise for the unexpired term of the franchise agreement, and a franchisor shall not require the franchisee or the transferee to enter into a franchise agreement that has different material terms or financial requirements as a condition of the transfer.

(f) CONSENT TO PUBLIC OFFERING- A franchisor may not withhold its consent to a franchisee's making a public offering of its securities without good cause if the franchisee, or the owner of the franchisee's interest in the franchise, retains control over more than 25 percent of the voting power as the franchisee.

(g) CONSENT TO POOLING INTERESTS, OR TO SALE OR EXCHANGE- A franchisor may not withhold its consent to a pooling of interests, to a sale or exchange of assets or securities, or to any other business consolidation amongst its existing franchisees, provided the constituents are each in material compliance with their respective obligations to the franchisor.

(h) NONINTERFERENCE- The following occurrences shall not be considered transfers requiring the consent of the franchisor under a franchise agreement, and a franchisor shall not impose any fees, payments, or charges in excess of a franchisor's cost to review the relevant matter:

- (1) The succession of ownership or management of a franchise upon the death or disability of a franchisee, or of an owner of a franchise, to the surviving

spouse, heir, or partner active in the management of the franchise unless the successor objectively fails to meet within 1 year or the then current reasonable qualifications of the franchisor for franchisees.

(2) Incorporation of a proprietorship franchisee, provided that the franchisor may require a personal guarantee by the franchisee of obligations related to the franchise.

(3) A transfer within an existing ownership group of a franchise provided that more than 50 percent of the franchise is held by persons who meet the franchisor's reasonable current qualifications for franchisees. If less than 50 percent of the franchise would be owned by persons who objectively meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer.

(4) A transfer of less than a controlling interest in the franchise to the franchisee's spouse or child or children, provided that more than 50 percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications. If less than 50 percent of the franchise would be owned by persons who objectively meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer.

(5) A grant or retention of a security interest in the franchised business or its assets, or an ownership interest in the franchisee, if the security agreement establishes an obligation on the part of the secured party enforceable by the franchisor to give the franchisor simultaneously with notice to the franchisee, notice of the secured party's intent to foreclose on the collateral, and a reasonable opportunity to redeem the interest of the secured party and recover the secured party's interest in the franchise or franchised business by satisfying the secured obligation.

(6) A franchisor may not exercise any purported right of first refusal or right to purchase with regard to any franchise, or interest or assets of a franchisee, upon the happening of any event described in paragraphs (1) through (5).

(i) EFFECT OF CERTAIN COVENANTS-

(1) IN GENERAL- After the transfer of a transferor's complete interest in a franchise, a franchisor may not enforce against the transferor any covenant of the franchise purporting to prohibit the transferor from engaging in any lawful occupation or enterprise.

(2) EXCEPTION- This subsection shall not limit the franchisor from enforcing a contractual covenant against the transferor not to exploit the franchisor's trade secrets or intellectual property rights (including protection of trade dress) except by agreement with the franchisor.

## **SEC. 9. TRANSFER OF FRANCHISE BY FRANCHISOR.**

A franchisor shall not transfer, by sale or otherwise, its interest in a franchise unless--

- (1) the franchisor provides, not less than 30 days before the effective date of transfer, notice to every franchisee of the intent to transfer the franchisor's interest in the franchise or of substantially all of the franchises held by the franchisor;
- (2) such notice is accompanied by a complete description of the business and financial terms of the proposed transfer or transfers; and
- (3) upon the transfer, the entity assuming the franchisor's obligations has the business experience and financial means to perform all of the franchisor's obligations in the ordinary course of business.

## **SEC. 10. INDEPENDENT SOURCING OF GOODS AND SERVICES.**

(a) **IN GENERAL-** Except as provided in subsection (e) a franchisor, either directly or indirectly through any affiliate, officer, employee, agent, representative or attorney, shall not prohibit or restrict a franchisee from obtaining equipment, fixtures, supplies, goods, or services used in the establishment or operation of the franchised business from sources of the franchisee's choosing, except that such goods or services may be required to meet reasonable established uniform system-wide quality standards promulgated or enforced by the franchisor.

(b) **APPROVED VENDORS-** Without limiting the rights of the franchisee under subsection (a), if the franchisor approves vendors of equipment, fixtures, supplies, goods, or services used in the establishment or operation of the franchised business, the franchisor shall provide and continuously update an inclusive list of approved vendors and shall promptly and objectively evaluate and respond to reasonable requests by franchisees for approval of competitive sources of supply. In order to promote competition, the franchisor shall approve not fewer than 2 vendors for each piece of equipment, each fixture, each supply, good, or service unless otherwise agreed to by both the franchisor and a majority of the franchisees.

(c) **BENEFITS-** A franchisor, and its affiliates, shall fully disclose whether or not it receives any rebates, commissions, payments, or other benefits from vendors as a result of the purchase of goods or services by franchisees. All such rebates, commissions, payments, and other benefits shall be distributed directly to such franchisees.

(d) **REPORTING-** A franchisor shall report not less frequently than annually, using generally accepted accounting principles, the amount of revenue and profit it earns from the sale of equipment, fixtures, supplies, goods, or services to the franchisees of the franchisor.

(e) **EXCEPTION-** Subsection (a) does not apply to reasonable quantities of equipment, fixtures, supplies, goods, or services, including display and sample items, that the franchisor requires the franchisee to obtain from the franchisor or its affiliate, but only

if the equipment, fixtures, supplies, goods, or services are central to the franchised business and incorporate a trade secret, patent, copyright, or other intellectual property owned by the franchisor or its affiliate.

## **SEC. 11. ENCROACHMENT.**

(a) **IN GENERAL-** A franchisor may not place, or license another to place, 1 or more new outlets for a franchised business in unreasonable proximity to an established outlet of a similar kind of franchised business, if--

(1) the intent or probable effect of establishing the new outlets is to cause a diminution of gross sales by the established outlet of more than 5 percent in the 12 months immediately following establishment of the new outlet; and

(2) the established outlet--

(A) offers goods or services identified by the same trademark as those offered from the new outlet; or

(B) has premises that are identified by the same trademark as the new outlet.

(b) **EXCEPTION-** This section shall not apply with respect to an established outlet if, before a new outlet described in subsection (a) opens for business, a franchisor offers in writing to each franchisee of the franchisor of an established outlet to pay to the franchisee involved an amount equal to 50 percent of the gross sales (net of sales taxes, returns, and allowances) of the new outlet for the 1st 24 months of operation of the new outlet if the sales of the established outlet decline by more than 5 percent in the 12 months immediately following establishment of the new outlet as a consequence of the opening of the new outlet.

(c) **BURDEN OF PROOF-** A franchisor shall have the burden of proof to show that, or the extent to which, a decline in sales of an established outlet described in subsection (a) occurred for reasons other than the opening of the new outlet for goods or services concerned--

(1) if the franchisor makes a written offer under subsection (b); or

(2) in an action or proceeding brought under section 12.

## **SEC. 12. PRIVATE RIGHT OF ACTION.**

(a) **IN GENERAL-** A party to a franchise who is injured by a violation or threatened violation of this Act, or of section 438.1 of title 16, Code of Federal Regulations (relating to disclosure requirements and prohibitions concerning franchising and business opportunity ventures) as in effect on the date of the enactment of this Act, shall have a right of action for rescission and restitution, as well as for all damages and injunctive relief, including costs of litigation and reasonable attorney's fees and expert witness fees, against any person found to be liable for such violation.

(b) **LIABILITY**- Every person who directly or indirectly controls a person liable under subsection (a), every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions and every employee of a person so liable who materially aids in the act or transaction constituting the violation is also liable jointly and severally with and to the same extent as such person, unless the person who would otherwise be liable hereunder had no knowledge of or reasonable grounds to know of the existence of the facts by reason of which the liability is alleged to exist.

(c) **ALTERNATIVE DISPUTE RESOLUTION**- Except as otherwise provided in subsection (d), nothing contained in this Act shall be construed to limit the right of a franchisor and a franchisee to engage in arbitration, mediation, or other nonjudicial resolution of a dispute, either in advance or after a dispute arises, provided that the standards and protections applied in any binding nonjudicial procedure agreed to by the parties are not less than the requirements set forth in this Act.

(d) **STATUTE OF LIMITATIONS**- No action may be commenced pursuant to this section or this Act more than--

(1) 5 years after the date on which the violation occurs; or

(2) 3 years after the date on which the violation is discovered or should have been discovered through exercise of reasonable diligence.

(e) **VENUE**- A franchisee may commence a civil action, or arbitration proceedings, to enforce any provision of this Act within the jurisdiction wherein the applicable franchise business is located.

(f) **CUMULATIVE RIGHT**- The private rights provided for in this section are in addition to and not in lieu of other rights or remedies created by Federal or State law.

## **SEC. 13. SCOPE AND APPLICABILITY.**

(a) **PROSPECTIVE APPLICATION**- Except as provided in subsection (b), the requirements of this Act shall apply to franchise agreements entered into, amended, exchanged, transferred, assigned, or renewed after the date of enactment of this Act.

(b) **DELAYED EFFECT**- The requirements of section 3 of this Act shall take effect 90 days after the date of enactment of this Act and shall apply only to actions, practices, disclosures, and statements occurring on or after such date.

## **SEC. 14. DEFINITIONS.**

For purposes of this Act:

(1) The term `affiliate' has the meaning given the term `affiliated person' in section 436.2(i) of title 16 of the Code of Federal Regulations as in effect on January 1, 1998.

(2) The term `franchise' has the meaning given such term in section 436.2(a) of title 16 of the

Code of Federal Regulations as in effect on January 1, 1998, but does not include any contract otherwise regulated by the Federal Petroleum Marketing Practices Act (15 U.S.C. 2801 et seq.) except as to franchise relationships that do not involve the sale of petroleum products.

(3) The term `franchise broker' has the meaning given such term in section 436.2(j) of title 16 of the Code of Federal Regulations as in effect on January 1, 1998.

(4) The term `franchisee' has the meaning given such term in section 436.2(d) of title 16 of the Code of Federal Regulations as in effect on January 1, 1998.

(5) The term `franchisor' has the meaning given such term in section 436.2(c) of title 16 of the Code of Federal Regulations as in effect on January 1, 1998.

(6) The term `good faith' means honesty in fact and the observance of reasonable standards of fair dealing in the trade.

(7) The terms `material' and `material fact' includes--

(A) any fact, circumstance, or set of conditions which a reasonable franchisee or a reasonable prospective franchisee would consider important in making a significant decision relating to entering into, remaining in, or abandoning a franchise relationship; and

(B) any fact, circumstance, or set of conditions which has, or may have, any significant financial impact on a franchisor, franchisee or a prospective franchisee.

(8) The term `offer' or `offering' means any effort to offer or to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value.

(9) The term `outlet' means a point of sale, temporary or permanent, fixed or mobile, from which goods or services are offered for sale.

(10) The term `person' means an individual or any other legal or commercial entity.

(11) The term `State' means a State, the District of Columbia, and any territory or possession of the United States.

(12) The term `subfranchise' means a contract or an agreement by which a person pays a franchisor for the right to sell, negotiate the sale, or provide service franchises.

(13) The term `subfranchisor' means a person who is granted a subfranchise.

(14) The term `trade secret' means information, including a formula, pattern, compilation, program, device, method, technique, or process, that--

(A) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and

(B) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

*END*

**APPENDIX II TO REPORT ON  
SMALL BUSINESS FRANCHISE ACT**

**Submitted by the  
American Bar Association  
Section of Antitrust Law**

## **PRIOR SECTION POSITIONS ON FRANCHISE LEGISLATION**

Prior Section legislative positions and writings of most relevance to the subject matter of the SBFA include the following:

In February 1978, the Section adopted a resolution opposing passage of the then-pending Franchising Termination Practices Reform Act, “or any substantially similar legislation.” Because the SBFA contains many provisions that are substantially similar to the 1978 legislation, the Section’s analysis then has some application to the SBFA. The Section’s 1978 resolution opposed such legislation because it:

- (a) encompasses numerous industries that are not susceptible to uniform legislative treatment with respect to the subject matter of that Act;
- (b) defines the term “franchise” so broadly that the substantive provisions of the Act would be made applicable to numerous commercial relationships which do not fall within any commonly accepted definition of franchising;
- (c) contains overly restrictive and rigid rules for termination and non-renewal of franchise agreements;
- (d) could perpetuate inefficiency by deterring franchisors from terminating incompetent franchisees;
- (e) may force franchisors to integrate vertically, or to enter into franchise arrangements only with large, well-established business entities;
- (f) may cause a franchisor to withdraw from a particular marketing area for a substantial period of time in order to terminate an unsatisfactory relationship with a single franchisee, thereby significantly reducing inter-brand competition in that marketing area; and
- (g) would make major fundamental changes in the application of basic contract law to franchise relationships without full consideration of the impact on distribution systems in many industries, and ultimately on consumers.

The Section’s position on this legislation was adopted by the House of Delegates of the American Bar Association at its 1978 Mid-Year Meeting.<sup>38</sup>

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<sup>38</sup> *Resolutions and Reports on the Franchise Termination Practices Reform Act*, 46 Antitrust L.J. 1181 (1978).

In 1987, the Section went on record in favor of a proposal by the National Conference of Commissioners on Uniform State Laws (the “NCCUSL”) under which franchise agreements would be subject to an implied duty of good faith and fair dealing. This position was approved by the American Bar Association pursuant to its rules on blanket authority.<sup>39</sup> However, the implied duty of good faith and fair dealing contained in the NCCUSL Model Franchise Act was more narrowly defined than that contained in the SBFA.

In 1990, the Section published a monograph surveying the law and public policy issues underlying legislative restrictions on terminating franchises as well as “encroachment” legislation, which restricts the establishment of additional franchises.<sup>40</sup> This monograph took no position on any pending legislation but rather provided a general assessment of the arguments for and against the two principal forms of franchise protective legislation.

Finally, the Section in 1992 submitted comments to the Federal Trade Commission supporting a modification of the Commission’s Franchise Disclosure Rule so that it would preempt state law dealing with franchise registration and disclosure. The Section’s reasons for this position included the following:

Among those states which regulate the offer and sale of franchises through the registration of franchise offerings, there is in fact a significant variation from state to state in disclosure requirements, registration procedures and substantive franchise provisions which may be permitted in registered offerings. Such variations result in unneeded costs and delays, even for those larger, well-established franchisors who have the resources to deal with individual state idiosyncrasies, and serve as significant impediments to small franchisors’ entry into registration states. Inconsistencies among registration states, and the related costs, delays and confusion in the franchise offering process, cannot be justified by any purported benefit to actual or prospective franchisees.<sup>41</sup>

In commenting on franchise industry legislative proposals, the Section has consistently articulated the values and policies described in the Report that are derived from the federal antitrust laws.

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<sup>39</sup> American Bar Association Section of Antitrust Law Report to the House of Delegates on Franchise and Business Opportunities Act (November 1987).

<sup>40</sup> ABA Antitrust Section, Monograph No. 17, FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND THE ESTABLISHMENT OF ADDITIONAL FRANCHISES (1990).

<sup>41</sup> Report in Support of, and Record Evidence for, Advance Notice of Proposed Rule Making, FTC File No. E011007 (August 1992).