

CRS Report for Congress

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Fair Conduct in Franchise Sales: H.R. 3308, 106th Congress

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Summary

Franchising is a contractual method for marketing and distributing the goods and services of a company through a network of distributors. For a number of years there has been congressional interest in enacting legislation concerning this important business relationship. Critics of the current franchising system believe that the franchisor has an unfair advantage in dealing with the often smaller and more dependent franchisee. In the 106th Congress Congressman Coble has introduced H.R. 3308 as an attempt to level the playing field. The bill has fourteen provisions and addresses such issues as unlawful franchise sales practices, standards of conduct, assignment and transfer of the franchise, and independent sourcing. The bill has been referred to the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law.

Description of the Bill

In 1990 the House Committee on Small Business stated in a committee print:

Franchising has been called the most dynamic business arrangement since the emergence of the corporation a century ago. It is heralded as a “dominating force” in the distribution of goods and services and the “wave of the future” for the U.S. marketplace. By the year 2000, according to Time magazine, franchising will be the “primary method of doing business” in America.¹

Research has not discovered whether this prediction has in fact proved true, but there is no question but that franchising is an extremely important method of doing business in the United States.

At its heart franchising is a method of distributing goods and services.

¹ House Committee on Small Business, 101st Cong., 2d Sess., Franchising in the U.S. Economy: prospects and Problems 1 (Comm. Print 1990).

From the legal standpoint, it is a contractual method for marketing and distributing the goods and services of a company (the franchisor) through a dedicated or restricted network of distributors (franchisees). Under the terms of the franchise contract, a franchisor grants the right and license to franchisees to market a product or service, or both, using the trademark and/or the business system developed by the franchisor. The contract imposes obligations on both parties: the franchisor must provide the product, a proven marketing plan or business format, management and marketing support and training; the franchisee brings financing, management skills, and a determination to own and operate a successful business.²

Currently, there is some state regulation of franchises; there is no federal statute which regulates franchises in general. There is, however, a federal regulation issued by the Federal Trade Commission which sets out certain disclosure requirements and prohibitions concerning franchising and business opportunity ventures.³ The franchisor must disclose such information as the business experience of the current directors and executive officers, whether these persons have been convicted of felonies, and whether they are subject to any injunction or restrictive order.

Congressional interest in regulating franchises has continued. In the 106th Congress H.R. 3308, introduced by Congressman Coble, would “establish minimum standards of fair conduct in franchise sales and franchise business relationships.” The bill, referred to the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, has fourteen sections.

Section 1 states that the short title of the Act is the Small Business Franchise Act of 1999 and provides the table of contents.

Section 2 states the congressional findings and the purpose of the Act. Among the congressional findings are that most prospective franchisees lack bargaining power and that franchisees may suffer substantial losses when the franchisor does not provide truthful or complete information. The purpose of the Act is stated to be “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.”

Section 3 sets out unlawful franchise sales practices. It is unlawful concerning the advertising, offering, sale, or promotion of a franchise for any person to use a device, scheme, or artifice to defraud; 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 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. Section 3 also forbids any misrepresentations in the required disclosures.

Section 4 makes it unlawful for a franchisor or subfranchisor in connection with the performance, enforcement, renewal, or termination of a franchise agreement to defraud

² Id.

³ 16 C.F.R. Part 436.

any person; to hinder, prohibit, or penalize the free association of franchisees for any lawful purpose; or to discriminate against a franchisee by imposing requirements not imposed on other franchisees or otherwise retaliate against a franchisee for membership or participation in a franchisee association. Section 4 also makes it unlawful for a franchisor to terminate a franchise agreement without good cause. A franchisor cannot prohibit any franchisee from engaging in any business at any location after expiration of a franchise agreement.

Section 5 sets out and defines standards of conduct for the parties to a franchise contract: good faith, due care, and a limited fiduciary duty.

Section 6 makes it unlawful for a franchisor to require a waiver by a franchisee of any provision of the Act.

Section 7 concerns actions by state attorneys general. A state attorney general can bring a civil action in federal court on behalf of its residents if there is reason to believe that the interests of the state's residents have been or are being threatened or adversely affected because any person has violated the Act.

Section 8 allows a franchisee to assign an interest in its franchise to a transferee so long as the transferee satisfies reasonable qualifications applied by the franchisor. Permissible and impermissible conditions of the transfer are stated.

Section 9 prohibits a franchisor from transferring its interest in a franchise unless it provides notice to every franchisee, the notice is accompanied by a description of the business and financial terms, and the entity assuming the franchisor's obligations has the business experience and financial means to perform the franchisor's obligations.

Section 10 prohibits a franchisor from restricting a franchisee from obtaining equipment, fixtures, supplies, goods, or services from sources of the franchisee's choosing. These independently sourced goods and services may be required to meet reasonable established quality standards.

Section 11 prohibits a franchisor from placing a new outlet for a franchised business in unreasonable proximity to an established outlet of a similar kind of business if the intent or probable effect would cause a diminution of gross sales by the established outlet of more than five percent in twelve months and the established outlet offers goods and services identified by the same trademark as the new outlet or has premises identified by the same trademark as the new outlet.

Section 12 concerns a private right of action. A party to a franchise who is injured by a violation of the Act has a right of action for rescission and restitution, for damages and injunctive relief, including litigation costs and attorneys' fees, against any person liable for the violation.

Section 13 applies the Act prospectively after the date of enactment, except that section 3, concerning franchise sales practices, shall take effect ninety days after enactment.

Section 14 sets out definitions used in the Act.

It is likely that supporters of the bill will argue that at the present time the playing field is tilted in favor of the franchisors and that, because of the lesser bargaining power of franchisees, the Act is needed to assure greater fairness to this important business relationship. Opponents of the bill may argue that the current Federal Trade Commission regulations are sufficient to assure fairness and that the bill unfairly favors the franchisee.

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