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FTC's Franchise Rule Requires Private Right of Action to be Effective

In a hearing held June 25, 2002 before the U.S. House of Representatives Subcommittee on Commerce, Trade and Consumer Protection congress was told that a private right of action was needed to put teeth into an outdated and ineffective Federal Trade Commission (FTC) Franchise Rule. There was broad agreement among witnesses and congressional representatives alike that disclosure as a way to protect the franchisee consumer had become ineffective. The growing prevalence of franchising in the U.S. economy coupled with corporate franchisor lawyers' predilection for writing franchise contracts designed to hide the facts from prospective franchisees caused the Subcommittee to question the FTC both on the increase in the number of complaints to the agency and on its record of Franchise Rule enforcement. All assembled agreed on the need to update and amend the FTC's Franchise Rule.

"The end result is that twenty-three years later we have a weak Rule with even weaker enforcement."

- Susan P. Kezios, AFA President

Subcommittee Chairman Cliff Stearns (R-FL) opened the hearing by stating, "The Rule that regulates one of the fastest growing and most important fields of private enterprise—franchising—has not changed since its inception in 1979. Many argue that through creative and sometimes not-so-creative interpretation of the 1979 Rule, franchisors have avoided disclosing important facts and practices to prospective franchisees creating cause for consternation years later. Both the franchisee and the FTC are powerless to effectively address them."

The ranking minority member at the hearing, Congressman Bobby Rush (D-IL) stated, "The relationship between franchisees and franchisors is unique among American businesses. As franchising becomes more prevalent in our nation's economy the nature of that relationship should be explained and examined much more closely by both the FTC and Congress."

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Congressman John Shimkus (R-IL) talked about the need for franchisors to operate in good faith with franchisees; "With as many as 8 million Americans employed by franchises it is important to ensure that franchisors abide by a code of fairness and truthfulness in dealing with their franchisees."

The most chilling fact to come out in the hearing was that while the FTC continues to concentrate its enforcement efforts on *pre*-sale franchise issues most of the problems faced by franchisees are *post*-sale--after the contract is signed, i.e., encroachment, sourcing of supplies, etc. Susan P. Kezios, President of the American Franchisee Association (AFA) stated, "It [the Franchise Rule] was crafted to address the dysfunctions of franchising during the 1960's." She went on to discuss how in the 1960's the dysfunctions were mostly in the *pre*-sale process, before the consumer signed the franchise contract. But today she explained, "the problems faced by franchisees are virtually all *post*-sale."

"What is still missing at the Federal level, however, is a private right of action under the Franchise Rule."

- Dale Cantone, Esq.
  Maryland Attorney General's Office

Ms. Kezios went on to explain why franchisees today have no faith either in the federal government or the FTC's enforcement of the outdated Franchise Rule. First, she said, "Franchise disclosure documents are written to totally circumvent the spirit and intent of the Rule." A second reason offered by Ms. Kezios for the franchisee investor lack of confidence in the FTC is that, "Corporate franchisor attorneys write franchise agreements in such a way that they can be changed arbitrarily by the franchisor *post*-sale--after the franchisee has sunk costs invested in the business."

This lack of legal certainty was further commented on by Congressman Shimkus when he stated, "I'll tell you one thing that many of us feel, especially those of us that support small or large businesses across the board, is the old basic principle of legal certainty. I find it really ridiculous that a franchisor would offer a contract to a franchisee that could change. I mean, how in the heck could somebody have legal certainty for a period of time to try to project capitol investment, costs and return on their investment?"

Mr. Shimkus went on to discuss the changing nature of the problems faced by franchisees. Based on the findings of the July 2001 General Accounting Office's (GAO) Audit of the FTC's enforcement of the Franchise Rule Mr. Shimkus pointed out that, "Among its findings were that complaints by franchisees to the FTC had risen dramatically and that 90% of these complaints were about the post-sale relationship. However, the FTC repeatedly complains about lack of resources and authority to address post-sale relationship issues."

While Chairman Stearns agreed that the issues that now plague the franchise industry are primarily post-sale issues he said, "Nevertheless, I wonder to what extent these post-sale problems can be avoided or lessened with a better disclosure Rule?" Chairman Stearns went on to state the obvious; "If the federal Franchise Rule is not made more effective, that is, responsive to problems that plague franchisor or franchisee relationships today then the call by some for a federal law governing aspects of post-sale relationships will not subside. After all, in the past Congress has enacted post-sale franchise relationships statutes applicable to two of the largest industries in the franchising world, the automobile and gasoline retailers."

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LEGAL BRIEF

JURY FINDS HOLE IN DUNKIN' DONUTS CASE AGAINST PITTSBURGH FRANCHISEE

In what Dunkin' Donuts' Assistant General Counsel described before the start of the trial as its banner case in its loss prevention efforts towards its franchisees, a Pittsburgh jury on June 17, 2002 returned a verdict in favor of a Dunkin' Donuts franchisee who was alleged to have underreported his gross sales to Dunkin' Donuts, Inc. and its subsidiary, Seventh Dunkin' Realty, Inc. Notably, the same jury of eight also found that Dunkin' Donuts, Inc. breached the franchise agreement by failing to adequately assist its franchisee in the operation of his shop.

In *Dunkin' Donuts, Inc. et al. v. Chris Romanias, et al.*, Case No. 00-1886, U. S. District Court for the Western District of Pennsylvania, Chris Romanias, a Dunkin' Donuts franchisee, along with his uncle, were alleged to have intentionally underreported their gross sales to Plaintiff Dunkin' Donuts, Inc. As part of a scheme to underreport gross sales intentionally, Dunkin' Donuts, Inc. alleged, among other things, that Mr. Romanias failed to ring sales into the register properly, failed to prepare and maintain financial documents required under the terms of the franchise agreement, failed to report numerous wholesale accounts, and misrepresented the gross sales of his restaurants on weekly fee cards submitted to Dunkin' Donuts, Inc. In addition to claims for breach of contract, Dunkin' Donuts, Inc. sought punitive damages against Mr. Romanias and the other Defendants for fraud, and also sought to regain possession of Mr. Romanias' Dunkin' Donuts shop. In defense of these claims, Mr. Romanias alleged that Dunkin' Donuts, Inc. breached the franchise agreement by failing to adequately assist him in the operation of his shop.

In support of these claims, Dunkin' Donuts, Inc. relied in part on the findings of CIS Investigative Services, an outside private investigation firm routinely retained by Dunkin' Donuts, Inc. to uncover evidence of underreporting. The investigation against Mr. Romanias resulted in several covert surveillance videos shown to the jury, purporting to show that Mr. Romanias intentionally underreported his gross sales. Dunkin' Donuts, Inc. also sought to rely on the findings of a Retail Sales Analysis (RSA), a cost accounting tool used by Dunkin' Donuts, Inc. to determine what it believes the gross sales of a Dunkin' Donuts shop should be for a three year period, after considering the amount of product purchased in a 13 week time period unilaterally chosen by Dunkin' Donuts, Inc.

The jury found no credibility in the testimony of the private investigator retained by Dunkin' Donuts, Inc., whose testimony contradicted various written documents and the testimony of Dunkin' Donuts own employees. The jury also found little or no credibility in the findings of the RSA, which--in addition to having been prepared by an employee of Dunkin' Donuts, Inc. who had absolutely no education in cost accounting -- failed to take into account numerous factors that have a significant effect on the business of each and every Dunkin' Donuts franchisee, including couponing, discounting, local throw-away rates, and free give-aways. Perhaps most damaging to Dunkin' Donuts, Inc. was the testimony of its own employees, who, besides contradicting each other, testified that they receive significant monetary bonuses based on the amount of revenue received by Dunkin' Donuts, Inc. through its loss prevention investigation cases. The same employees also testified that they were specifically instructed to avoid Mr. Romanias' shop during the pendency of the action, a fact readily admitted by Dunkin' Donuts, Inc.'s counsel at the time of closing.

Franchisees in this action were represented by Robert Zarco, Esq. and Robert F. Salkowski, Esq., of Zarco, Einhorn & Salkowski, P.A., a Miami, Florida law firm. Contact Messrs. Zarco and Salkowski by calling (305)374-5418 or via e-mail at Zarcolaw@Zarcolaw.com. ?

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Congressman Shimkus summed up the mood of the committee: "We're in agreement here on this panel. We're looking at amendments to the 1979 Rule. There have been no amendments [since then] and for us that's very, very unacceptable."

Discussion included various amendments that might improve the Franchise Rule's ability to protect the franchisee consumer. These included adding mandatory earnings claims to the disclosure documents, having the FTC require that the documents be simplified and requiring franchisor CEOs to warrant and certify the information presented in the disclosure documents.

It was also pointed out that the FTC does not collect and compile data on franchising practices. In fact, no government agency has been charged with collecting data on franchising since the U.S. Department of Commerce ceased its collection of franchise data in 1988. Further, the GAO's audit of the FTC noted that the agency itself does not keep accurate data on the opening and closing of investigations into franchisee complaints. Additionally, the Subcommittee was informed that the FTC does not read or review franchise disclosure documents before the franchisor is allowed to offer franchises for sale to consumers.

> " ... [we went to the] FTC and the Justice Department with complaints and we were told, 'you have an action here for a lawsuit; sue 'em'. We weren't looking to sue."
>
> - Jerry Rizer, DQOA President

To address these issues Ms. Kezios recommended that the U.S. Department of Commerce or some other federal agency be required to collect comprehensive and accurate statistical information about franchising and franchise practices. The data should then be analyzed and reports written and made public. She also recommended that all franchise disclosure documents be filed nationally with the federal government.

Most witnesses agreed that these changes alone would not completely address the key post-sale issues faced by franchisees. Speaking on behalf of the North American Securities Administrators Association (NASAA), Dale Cantone, Esq., Deputy Securities Commissioner and Chief of the Franchise and Business Opportunities Unit of the State of Maryland Attorney General's Office, Securities Division stated, "What is still missing at the Federal level, however, is a private right of action under the Franchise Rule. Without a private remedy injured franchisees must rely on the already strained resources of government agencies for redress."

Jerry Rizer, President of the Dairy Queen Operators Association (DQOA), expressed the frustration felt by many when he stated, "The FTC's Franchise Rule is woefully deficient. Federal law does not allow franchisees who are injured by franchisors' blatant violation of the Rule through deceptive mis-disclosure or omission of material information or even outright fraud to bring a legal action to recover their losses caused by the violation. The Rule is a paper tiger."

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In response to a question regarding the comparatively small number of franchisee complaints to the FTC, Mr. Rizer said, "You asked a question about FTC complaints by franchisees and I'm surprised you have *any*. I really don't have time to call and complain to somebody else--let alone the government--which I really don't see as being the place to solve my problems."

However, Mr. Rizer went on to tell the Subcommittee how he and his fellow Dairy Queen franchisees were rebuffed when, as a last resort, they went to the federal government and the FTC for help. "We had our Executive Director go to the FTC and the Justice Department with complaints and we were told, 'you have an action here for a lawsuit; sue 'em'. We weren't looking to sue. We wanted a good relationship with our franchisor but we were told we had to sue to get any redress to our grievances."

As the hearing neared its conclusion Chairman Stearns asked the witnesses what amendments they would suggest to the FTC's Franchise Rule. Mr. Rizer stated, "I'm not a lawyer, so I don't what to suggest other than what I've suggested in my statement--the private right of action would be very helpful." Congressman Rush asked Mr. Rizer, "If you had a private right of action, what would that do for franchisees that you can't do now? Just having the private right of action, do you think that would have helped influence your franchisor to come in and make some kind of settlement with you earlier?" Mr. Rizer responded, "Having a big stick to wave around is a wonderful thing. You don't have to use it. It's just that they [franchisors] know it's possible and they'll come and talk to you. At the present time there's no recourse."

In summation, Ms. Kezios reminded the Subcommittee that FTC staff fully expected Congress to provide a private right of action under the Franchise Rule when it was promulgated in 1979: "FTC staff is on the record back then as saying, and I quote, 'The Commission believes that the courts should and will hold that any person injured by a violation of the Rule has a private right of action against the violator under the Federal Trade Commission Act as amended'." She further explained, "Certain franchisors and their lawyers worked to hobble the promulgation of the Franchise Rule in 1979 and when the Rule's enactment was inevitable, they worked against providing a private right of action to the American consumer." "The end result," stated Ms. Kezios, "is that twenty-three years later we have a weak Rule with even weaker enforcement." ?