



**FRANCHISE INFORMATION ASYMMETRY IN THE U.S: LESSONS FOR NIGERIA**

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## **DEDICATION**

This thesis is dedicated to God almighty who has been orchestrating my life's journey thus far and has made my life so beautiful... I owe it all to HIM.

## **ACKNOWLEDGEMENT**

First and foremost, I would like to thank God for the strength and wisdom to write this academic literature and to all my academic mentors who have contributed immensely to the successful completion of this thesis.

Special thanks goes to my Supervisor, Prof. Tibor Tajti for his patience and constant guidance in the process of writing this thesis. All consultation with him on this thesis has been an eye opener to this unexplored area of business in my country. He is really an exceptional and charismatic imparter I must confess.

My love and gratitude goes to my Best friend for life, my Husband – Oluseye Isiade, for his sacrifice, support and succor throughout my study period at the Central European University. I hourly get inspiration and motivation to soar and be the woman of my dreams from him. But for him releasing me for this programme, this thesis would not have come to the fore, I dedicate this thesis to him.

The mothers in my life Mummy Popoola and Isiade you are the best models of motherhood this generation can have. I love you. Warm thanks goes to my always loving Father-In-law Daddy Isiade. To the younger mummies who have shown their care to me throughout this programme, Bolutife Agboola, Titilayo Samuel, Temitope Falade, you are irreplaceable, I love the great mums you have become and I am proud of you. To the Fathers I have in my brothers, the ‘Popsons4’ (Ebenezer, Ife, Toyin and Sola,) I bless God for giving you all to me and your wonderful wives.

Appreciation goes also to Lexfin Partners and its principal partner, Kelly Mogbo from whom I draw passion for career, academic excellence and perfection. His unrivalled support towards my decision to have my study outside the shores of Nigeria crucial when he gave it.

The church I fellowshipped, RCCG Budapest and her new parishes.

Special thanks goes to the CEU Alumni worldwide, for granting me the alumni scholarship which helped to sustain me throughout my programme at the Central European University and I am most glad I took the chance to come this great journey to academic excellence.

Special thanks everyone else who have one way or the other influenced the success of this thesis. I wouldn’t have asked for a better support and without your insight or contributions, portions of this thesis may not have been possible.

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## Abbreviations

<b>Art</b>	Article
<b>CFR</b>	Code of Federal Regulation
<b>FDI</b>	Foreign Direct Investment
<b>NOTAP</b>	National Office for Technology Acquisition and Promotion
<b>FTC</b>	Federal Trade Commission
<b>FDD</b>	Franchise Disclosure Documents
<b>FPR</b>	Financial Performance Representation
<b>U.S</b>	United States
<b>US C</b>	United States Code
<b>UFCA</b>	Uniform Fraudulent Conveyance Act
<b>UNCITRAL</b>	United Nations Commission on International Trade Law

## **FRANCHISE INFORMATION ASYMMETRY IN THE U.S: LESSONS FOR NIGERIA**

### **ABSTRACT**

This thesis is set out to evaluate the current legal framework of franchise in Nigeria as well as compare it with what is obtainable in the United States on the franchise-specific legal issue of information asymmetry. The goal of this research is to provide a variety of solutions for Franchise business in Nigeria and help to contribute to economic growth, spreading of entrepreneurship in small and mid-scale enterprises, tapped from the US position as a model in order to protect the weaker party (generally the franchisee) in franchise agreement from deceptive and opportunistic practices by exploiting information asymmetry. Furthermore, the focus is also to establish the need for a unified and predictable system to govern the franchise agreement and relationship while sustaining a balance of interest between the franchisor and a prospective investor in the franchise.

To achieve the above stated goal, this thesis will do three things. Firstly, evaluate existing regulations (in brief) in the US (state and federal) affecting disclosure, registration and licensing, rules on arbitration and encroachment in franchise business. Secondly, it will look into business practices and norms in franchise regulation in the U.S, with the aim of finding out how both federal and state levels as well as the industry have successfully established working rules governing disclosure, management and control of information asymmetry in Franchise relationship. Thirdly, considering the level of economic development in Nigeria and other idiosyncratic factors, cherry-picking of some U.S regulatory forms in the regulation of franchise businesses could be done on one hand or on the other hand, if it will be best to adopt wholly the U.S operational systems.

Finally, recommendations will be made for Nigeria on the best practices to adopt (if any) especially on information asymmetry as it affects Franchise.

# INTRODUCTION

Owing to the significant role played by franchise as a business format in the economic development of a highly industrialised country like the U.S, Nigeria as a developing country has over the years recognized this successful business model and keyed into it. Franchise as a business model has gained strong footing in Nigeria through domestic franchising.

Black's Law Dictionary defines franchise as a license from the owner of the trade mark or trade name permitting another to sell a product or service under that name or mark. Franchise is a legal relationship which transfers rights from the franchisor to the franchisee; it is a marketing channel for the expansion of business.

In the US, franchising has a federal and state definition. While the federal the FTC has the Federal definition to franchise, various states have the definition to franchise in their state rules. According to the FTC Rule, a relationship that lacks any of the three elements mentioned in its scope of definition of franchise will not be covered by the rule. States in the U.S have a similar definition of franchise as is given by the FTC Rule. States also have three elements in defining franchise but one of the elements differs in scope in states that requires either marketing plan or systems as prescribed by the franchisor or a 'community of interest'.<sup>1</sup> Franchise is therefore a continuing commercial relationship from the offer of sale of contract to its termination.

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<sup>1</sup> *Cooper Distributing Co., Inc. v. Amana Refrigeration, Inc.* 63 F.3d 262C.A.3 (N.J.), 1995. August 22, 1995 gave a state definition franchise in New Jersey that as franchise exists under the New Jersey Franchise Practices Act if: (1) there is a "community of interest" between the franchisor and the franchisee; (2) the franchisor granted a "license" to the franchisee; and (3) the parties contemplated that the franchisee would maintain a "place of business" in New Jersey

### ***Economic Role of franchise***

The economic benefit of franchise in the development of a country's economy cannot be overemphasized, hence, the need for its regulation. *In* the U.S for example, the labour market has enjoyed job creation for over 8million people from over 3,000 franchisors in the U.S. In the Small and Medium business, franchising is the fastest growing kind of small business in which opening of a new franchise creates 8-14 new jobs and in an average of eight minutes per business day, a new franchise is created providing over 300,000 jobs per year.<sup>2</sup> In Nigeria, which has a developing economy, franchising is one of the recognised mediums of technology transfer through Foreign Direct Investment (FDI).

### ***Benefits of franchise to the key players of franchise franchisor***

To the major players in the franchise industry (the franchisor and the franchisee) the benefits of each of the parties may not be easily quantified but there are obvious benefits enjoyed by the parties which explain why the industry experienced great success so far.

To a franchisee, he has the benefit of owning his own business, enjoys the opening support from the franchisor (selection of business location, building design and construction, business trainings), the franchisee receives ongoing support (promotion and advertisement, operational assistance, business trainings, management support) from the franchisor, enjoys the ease of marketing an established product or services with a recognised brand, easy access to a ready market, established

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<sup>2</sup> John Reynolds, 'special report: Economic Impact of Franchising', (MARCH 2005)VOL. 2  
<http://www.franchise.org/special-report-economic-impact-of-franchising-vol-2>

clientele and the possibility of market expansion etc.<sup>3</sup> The economic certainty on adopting a proven method of doing business reduces the risk of business failure an entrepreneur/prospective franchisee would have encountered if venturing into a new business. The franchisor in a franchise relationship has the benefit of having his company/ business expand quickly through their franchisees than they would ordinarily have done by themselves. Franchising affords the franchisor the opportunity to grow his business on less investment cost (labour and capital) in the franchisee's business. The franchisor is also at liberty to select his business promoters (franchisees/managers). He can therefore sell his franchise to only motivated and serious minded business men in order to keep ensure smooth running of the business and keep his brand intact.<sup>4</sup> Consumers also enjoy a guaranteed level of quality and consistency from franchises businesses.

### ***Meaning and Risk Inherent to Information Asymmetry***

As interesting and befitting franchise business seems to appear, it has its downsides which are usually threats to its success. Before the creation of a franchise outlet, the prospective franchisee needs sufficient information (as much as the franchisor knows) on the franchisor's business. Information is crucial to the formation and continuation of franchise relationship, but sometimes the franchisee is carried away by the excitement of owning a business and pays little attention to the detailed information on the business. The franchisor however has the tendency to disclose only what is in the "franchisor's interest in the *dissemination of information only about the sunnier aspects of the sector* is due not only to their motivation to avoid further scrutiny and intervention by regulators but also , and perhaps more importantly to their interest in marketing franchising to

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<sup>3</sup> John Reynolds, "On the Benefits(Advantages and Disadvantages of Owning a Franchise)" : <http://www.franchise.org/what-are-the-advantages-and-disadvantages-of-owning-a-franchise> Accessed on 17 March 2015

<sup>4</sup> Arthur G. Sharp, on "The Benefit of Franchising" <http://www.referenceforbusiness.com/encyclopedia/For-Gol/Franchising.html> Last visited 3/18/2015

potential franchisee.”<sup>5</sup> Meanwhile, the shady undisclosed aspect of the franchisors business when discovered by the prospective franchisee gives rise to dispute in the future of the business. This is a typical situation of asymmetry.

Information asymmetry is a relationship imbalance between the franchisor and the franchisee in a franchise relationship. Asymmetry results from business information being unequally distributed between the franchisor and franchisee. This places the franchisor in a more advantageous position (than the franchisee) as a result of his knowledge which gives room for unfair practices which is to the franchisees detriment. Marketing relationships such as franchise has a common characteristic of information asymmetry in that the franchisor possesses more information (about the business to be franchised) than the franchisee<sup>6</sup> Information asymmetry is control mechanism or power acquired as a result of information imbalance.

Other market conflicts that lead to information asymmetry are such as lack of sufficient supply of qualified franchisees, franchisee’s limited source of information for proper referencing, franchisor’s pressure on the franchisee to commit to a franchise relationship, miscommunication between the franchisor and the franchisee caused by recruitment professionals,<sup>7</sup> inability to access legal professionals by the franchisee, franchisee naive approach to franchise business, franchisees

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<sup>5</sup> Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010), at page 65.

<sup>6</sup>Debi Prasad Mishra, Jan B. Heide and Stanton G. Cort ‘Information Asymmetry and Levels of Agency Relationships’ *Journal of Marketing Research* Vol. 35, No. 3 (Aug., 1998), pp. 277-295 Stable URL: <http://www.jstor.org/stable/3152028>. Last visited on 3/19/2015

<sup>7</sup> Scott Weaven, Lorelle Frazer and Jeff Gidding ‘How Can Regulation be Enhanced? New Perspectives on the Causes and Continuation of Franchising Conflict in Australia’ (2009) < <http://researchhub.griffith.edu.au/display/n61212c61916ef4a0b410c5ff427026dd>> Last visited 1/19/2015

dependence on the franchisors expertise etc., often lead to a conflict in franchise relationship.<sup>8</sup> The franchisee is more at the receiving end where there is information imbalance and therefore needs to be protected from unfair practices that may spring from information asymmetry.

In the US after nine years of investigation, the FTC came up with its findings in 1979 and concluded that the abuses in franchise selling is attributable to informational imbalance between the franchisor and the franchisee accompanied by economic disparity between the parties.<sup>9</sup> For this reasons, there have been legal responses by the FTC Rule aimed at checking franchising formation agreement and selling practices.

In Nigeria however, there are no records yet on any form of investigation on the abuse of franchise. As a matter of fact, nothing much has been done to give an in-depth regulation to franchise. One can therefore conclude that information asymmetry has not been contemplated or projected as a likely problem in franchise relationship. Franchise registration with an agency of the government NOTAP (National Office for Technology Acquisition and Promotion) is the only recognition given to franchise in the country and states are far from having regulations for franchise business as well. Hence the need for a proper regulatory system cannot be overemphasized in order to ensure uniformity and predictability.

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<sup>8</sup> Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010), at 64-67. On (market conflicts that may lead to information asymmetry)

<sup>9</sup> Rochelle and Mark. B. Forseth in Barkoff and Selden's, Franchise Registration, '*Fundamentals of franchising*' (2<sup>nd</sup> edition, 2004) at page 127. Book available at: [https://books.google.hu/books?id=yE3UIKDTxyUC&pg=PA127&lpg=PA127&dq=barkoff+and+selden,+on+informational+imbalance+between+the+franchisor+and+the+franchisee&source=bl&ots=G1qpAGHUBR&sig=6q5\\_OewG7y94CICITstAZ3FVpDk&hl=en&sa=X&ei=rgKVcDiHMjVPa2WgMgE&ved=0CB8Q6AEwAA#v=onepage&q=barkoff](https://books.google.hu/books?id=yE3UIKDTxyUC&pg=PA127&lpg=PA127&dq=barkoff+and+selden,+on+informational+imbalance+between+the+franchisor+and+the+franchisee&source=bl&ots=G1qpAGHUBR&sig=6q5_OewG7y94CICITstAZ3FVpDk&hl=en&sa=X&ei=rgKVcDiHMjVPa2WgMgE&ved=0CB8Q6AEwAA#v=onepage&q=barkoff)

It is often argued that there cannot be a successful franchise without asymmetry because what is generally termed to be asymmetric is a measure of control in the hands of the franchisor towards whom the scale tilts - the franchisor. This control is often abused by the franchisor by acting in an opportunistic way to exploit the franchisee. Although in some low rules of law countries, the franchisee may also abuse his rights (where there is a presumption of equality) as the franchisor will not be in the position to enforce his rights. In irony, it is observed that that while in the U.S, where there is a high rule of law index ,it is the franchisors abuse that matters more and in countries with lower rule of law index (e.g. Nigeria) franchisee abuse might also be a meaningful reason for regulating the industry.

The U.S has over the years devised several regulations to protect the weaker party in most cases the franchisee in franchise relationship. The FTC Rule provides compulsory disclosure rules for the franchisor at the federal level the same Rules are also adopted by states. But states are free to create stricter laws in the interest of the prospective franchisee. This explains the state's disclosure, registration and licensing rules. Although it is argued that in an attempt to protect the weaker party in the franchise relationship, the franchisor is also limited in information which is also an asymmetric situation.<sup>10</sup>

While there is need to ensure protection on the weaker party, in a developing economy, there is also need to encourage the new investors by making regulations investors friendly. Hence the need for balanced interest in formulated regulations has to be reached to ensure equality in the

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<sup>10</sup> Kabir C. Sen ,' Information Asymmetry and the Franchise Decision'  
<[www.tandfonline.com/doi/abs/10.1300/J049v08n01\\_05#.VN0uzPnF8eF](http://www.tandfonline.com/doi/abs/10.1300/J049v08n01_05#.VN0uzPnF8eF)>in Journal of Marketing Channels, 2001.

interest of the parties.<sup>11</sup> The U.S can be looked upon to have achieved all round success in that functional areas, with regulatory bodies existing at the federal, states and at the industry level to regulate franchise relationships.

Predictions about the future of franchise in Nigeria can be made looking through the eyes of the cradle of franchise business in the U.S and being a country with a developed system in the field of franchise. Positive steps can be taken into consideration by the Nigerian legislators in the drafting of regulations that will govern franchise relationship in the future. All these will be addressed in this thesis, each chapter referring to what is existing and what should be in Nigeria.

Two pivotal questions to be asked are; what level of information asymmetry should be tolerated by a country that is yet to adopt specific laws for franchising? Which policy will best suit a developing country as Nigeria in the implementation of regulations to govern the franchise ‘mom and pop’ relationship from abuse of information asymmetry? While trying to adopt a regulatory system for Nigeria, this thesis will consider the danger of a hasty adoption of the regulatory forms in the U.S (federal, state or industry specific rules). The main issues which will be of more value to Nigeria now which should be how franchise can be regulated for its development like what is obtainable in the U.S but avoiding its pitfalls since we have been able to identify the major conflicts areas that can hinder the growth to franchising.

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<sup>11</sup> “§ 680. *Legislative findings and declaration of policy* 2006 New York Code – Laws: General Business: (680 – 695) Franchises, text available at [http://law.justia.com/codes/new-york/2006/general-business/idx\\_gbs0a33.html](http://law.justia.com/codes/new-york/2006/general-business/idx_gbs0a33.html) last visited on February 2, 2015.

## **ROADMAP TO THE THESIS**

The first chapter in this thesis will introduce us to franchise in general and address franchise as a business format in the U.S and in Nigeria, comparing both systems.

The second chapter deals with the core issues in a franchise relationship – information asymmetry. In this chapter, the effectiveness of regulating information asymmetry as a weapon of control will be considered alongside the control rights of the franchisor. The U.S approach will also be examined with what is obtainable in Nigeria with respect to the controls available.

The third chapter evaluates the U.S panacea in regulating information asymmetry and their operations at various levels –Federal Trade Commission (FTC) disclosure rules, State franchise regulatory systems, Merit based registration system and other mixed systems and how they interface with the Federal laws to protect the weaker party and as well sustain the interest of the franchisor.

The fourth chapter provides recommendations for Nigeria based on its peculiarities from the U.S. Other section in the thesis examine the, pros and cons of the non-merit-based disclosure system and the likely challenges a developing system like Nigeria will experience in adopting the federal regulatory or state registration system in addressing the issues of information asymmetry. It finally concludes on a recommendation that will likely suit Nigeria based on its current status in franchise regulation.

# CHAPTER ONE

## FRANCHISE BUSINESS

As a business concept, franchise originated between the 1950s and 1970s in the United States and has since then experienced wide expansion as a result of the existence of an enabling social economic environment that fostered its growth. Thus the general definition of ‘franchise’ emanates from the ‘lead’ regulatory body governing U.S franchise the Federal Trade Commission (FTC) Federal Trade Commission (FTC) defines ‘franchise’ “as a business arrangement whereby, for a fee from the franchisee to the franchisor,(a) the franchisee sells goods or services that are either identified by the trademark or where the franchisee operates under the franchisors trade name, are required or advised to meet the franchisors standards; and (b) the franchisor exerts or has authority to exert significant degree of control over the franchisees business or gives significant assistance to the franchisee’s business or give significant assistance to the franchisee (c) as a condition of obtaining or commencing operations of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.”<sup>12</sup>

The FTC also answers the questions on what form of relationship actually existed between the parties<sup>13</sup>.But in a more and explicit term as expatiated by Elizabeth Crawford Spencer, for a business relationship to be termed ‘franchise’, it must contain three elements:

“**First**, the franchisor must license a trade name and trademark that the franchisee operates under, or the franchisee must sell products or services identified by this trademark. **Second**, the franchisor must exert significant control over the operation of the franchisee or provide

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<sup>12</sup> Jeffery A. Schneider , Robert J. NYE . ‘Business Franchise Law, Cases and Materials’ 2003.

<sup>13</sup> FTC rules [16 C.F.R. Section 436(2)(a)(3)(iii)] The FTC determines whether a relationship is a franchise based on a three-part test. A franchise exists under FTC rules.

significant assistance to the franchisee. **Third**, the franchisee must pay at least \$500 to the franchisor at any time before or within the first six months of operation.”<sup>14</sup>

States in the U.S also have various definitions on franchise and relationships are thus classified if they possess the elements as provided by the state regulations irrespective of the intentions of or definition given to such relationships by the parties. <sup>15</sup>

Over the years franchise has evolved in its mode of operation as compared to what franchise is today because of its dynamic mode of operation.<sup>16</sup> Legal and economics theorist have been able to define it in a word “federated” combining different levels of businesses which ranges from large scale businesses to small scaled traditional retail distribution then internationally.<sup>17</sup>

Franchisors and franchisees alike are drawn to adopt franchise mode businesses for different business reasons. However divergent their business motives are, they still have an ultimate goal of making profit through business success. Franchising still appears to have the best ease for an entrepreneur because of the privilege of entering into a functional business system and for the

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<sup>14</sup> Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010),

<sup>15</sup> *Instructional Systems, Inc. v. Computer Curriculum Corporation*, 130 NJ 324 (1992) [340]The New Jersey Supreme Court has cited with approval the FTC's compliance rules which state that no matter what parties call a relationship, if it meets the “definitional elements” of a franchise, it will be recognized as a franchise.

<sup>16</sup> Donald W. Hackett ‘The International Expansion of U. S. Franchise Systems: Status and Strategies’ *Journal of International Business Studies*, Vol. 7, No. 1 (Spring, 1976), pp. 65-75 < Stable URL: <http://www.jstor.org/stable/154360>>accessed 20March 2015.

<sup>17</sup> Oliver E. Williamson , *Markets and Hierarchies: Analysis and Antitrust Implications*. by Review by: William Ouchi *Administrative Science Quarterly* Vol. 22, No. 3 (Sep., 1977), pp. 540-544

franchisor, it is the best and easiest way to expand his business both domestically and internationally. Andrew Terry <sup>18</sup> has summarised the good in franchise when he said:

Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small business operation but bad franchising is so much worse.

Franchising has been an area of interest to legislators of the US because compared to other business forms (among SME's), it has experienced growth than other forms of business; it has also impacted other non-franchised business- it stimulates other businesses thereby causing a positive economic spill over and economic impact of franchising to be highly significant in the society which cannot be left untended <sup>19</sup> i.e. without regulation.

Being a lucrative business method, conflicts are bound to arise because of the need for parties (franchisors and franchisee) to have maximum return on investment. While the franchisor is focused on maximising revenue, the franchisee is interested in maximising his unit or territory he covers according to the agreement with the franchisor. The franchisor therefore controls the

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<sup>18</sup>As cited in House of Representative Standing Committee on Industry , Science and Resources , Finding a balance: towards fair trading in Australia (1997)83 Read more on (finding the balance towards fair trading in Australia) at [http://www.aph.gov.au/parliamentary\\_business/committees/house\\_of\\_representatives\\_committees?url=isr/fairtrad/report/contents.htm](http://www.aph.gov.au/parliamentary_business/committees/house_of_representatives_committees?url=isr/fairtrad/report/contents.htm). Last visited February2/ 10/2015. Also cited by Elizabeth Crawford Spencer, *the Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010), at 64-67.

<sup>19</sup> report on the Economic Impact of Franchised Businesses by International Franchise Association at [http://www.franchise.org/uploadedFiles/Franchisors/Other\\_Content/economic\\_impact\\_documents/EconImpact\\_Vol\\_2\\_HiLights.pdf](http://www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/EconImpact_Vol_2_HiLights.pdf). Last visited 2/11/2015

ambitions of the franchisee through the franchise agreement which the franchisee is bound to and does everything within his powers to avoid the consequence of a breach of any of such rules as stated in the contract.

There are different forms of franchise. The simplest which is the first recognised form of franchise is the product franchise (which adopts retail with the franchisor as the distributor and the franchisee the retailer with exclusive right to sell the retailed products.) The second form of franchise is processing or manufacturing (it has the element of product franchise) where the franchisor provides the recipe and specifications for production. The third is the business format franchise (which the franchisor provides the franchisee with a comprehensive operative system which the franchisor must comply with or loose the franchise). Business format franchise is the most commonly practice in franchising today.

While the franchisor at all times has justifiable reasons for holding control in a franchise relationship, his powers to abuse of the control to information that he possess are regulated by various laws in order to protect the franchisee from his likely opportunistic behaviour which is common to a franchise relationship. Various regulations have therefore been put in place to settle these conflicts as they arise and in some cases as preventives.

### **1.1. Franchise business in the U.S**

In the United States, franchise business has experienced significant expansion and growth within the last decade. Franchised business has not only been strengthened within its borders, it has had

a beneficial direct economic output and other sectors have been more productive as a result of some of its output.<sup>20</sup>

While the reason for the development of franchise vary from time to time as the industry expands, some reasons have been stable prices, increased competition for market shares, high level of consumer optimism among others are usually mentioned<sup>21</sup>. Little attention is sometimes paid to the benefits of the necessary legislations that have made franchising worth the while. Operational models (the regulatory, industry standards and private laws) have been distinguished as existing and functioning in the U.S as a result of its level of recognition of the impact of franchising in its economic development. While these models exist in isolation in some states, other states have developed impressive regulations to govern franchise as a result of the combination of models which has been able to solve one of the most challenging problems of franchise relationships - information asymmetry.

In a significant number of countries the main source of franchise law is a form of industrial self-regulation – codes of conduct or codes of ethics – drafted by the industry itself (i.e., trade associations).<sup>22</sup> This is then supplemented by general private and commercial law. What makes the US special is that it has in addition to these industry laws, it also has federal plus state-level regulations imposing rules that aim, indeed, to counter-balance the asymmetry. For example, the enforcement of these regulations is entrusted to established federal or state-level agencies that

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<sup>20</sup> More information on the impact of Franchise in the US economy  
[http://www.franchise.org/uploadedFiles/Franchisors/Other\\_Content/economic\\_impact\\_documents/EconImpact\\_Vol\\_2\\_HiLights.pdf](http://www.franchise.org/uploadedFiles/Franchisors/Other_Content/economic_impact_documents/EconImpact_Vol_2_HiLights.pdf) last visited 2/13/2014.

<sup>21</sup> Alex S. Konigsberg Q.C. *International Franchising* –Third edition at pages 11-15 on ( The Impact of Franchising).

<sup>22</sup> On Models of franchise specific legislation. See, Elizabeth Crawford Spencer, *the Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010), at page 221.

monitor the disclosure of information at various levels of the agreement both at registration and during the actual relationship.<sup>23</sup> Franchise in the US is regulated at different levels, the federal, state and industry.

## 1.2. Franchise business in Nigeria

As a form of business, franchise was introduced into Nigeria between 1960's and 1980 not too long after franchise was established in the U.S and has ever since had a crawling growth. It can be described as crawling if compared to the United States. Although, domestic franchising has been thriving in Nigeria and there has been a few of international franchise from its market.

Nigeria has the largest market in West Africa which could make it a gate way for Franchising and a platform for franchise development. According to the 2012 World Investment Report by the United Nations in a Conference on Trade and Development, Nigeria is Africa's biggest destination for Foreign Direct Investment in 2011 with \$8.92bn and records over 20 percent of the total FDI to Africa.<sup>24</sup>With such significant impact franchise has in Nigeria so far, predictions of what the future of franchising in Nigeria would be can be project and where there are such predictions, there should be alongside adequate protection for future participants. It is true that entrepreneurs are yet

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<sup>23</sup> See FTC Rule, Item 17 Table (u). Also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities. Available at <http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&rgn=div5&view=text&node=16:1.0.1.4.55&idno=16> last visited on Feb 2, 2015

<sup>24</sup> More information available on : <http://www.nasdaq.com/article/market-growth-opportunity-for-us-franchises-in-nigeria-cm225983#ixzz3R5v8LxgG>

to explore franchise as a form of business in Nigeria (because of inadequate knowledge of the form on the field), a few investors have been invested in this field through product franchising.<sup>25</sup>

Franchise is regulated In Nigeria, under the laws regulating the transfer of technology. This is a general provision for all forms of business, distribution or technology that comes into Nigeria. National Office for Technology Acquisition and Promotion (NOTAP)<sup>26</sup> is the federal agency responsible for a franchisor needs only to complete and submit the respective necessary forms as notice / application, along with the requisite filing fees. Franchising in Nigeria is governed by its Sales law under the British common law system.

A look into the regulatory system existing in Nigeria shows that Nigeria is a Notice state with a simple straight forward approach to franchise business. For Nigeria to succeed like in the US, a single form of regulation may not be sufficient enough for franchising to operate at its best.

Unlike the United Nations, Franchise as a business model is in its developmental stage and there are a few expertise in the field. While the industry at the moment suffers from experts with in-depth knowledge about franchise and other related subjects that can help to enhance the industry (Trademarks, Antitrust, and Contract laws) also suffer the same deficiency." International franchisors have not expanded into Nigeria largely because of lack of sufficient information of

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<sup>25</sup> On Nigeria as a market growth for U.S franchising see: Doing business in Nigeria: 2010 country commercial guide for US companies' International copyright, US & foreign commercial service and US department of state, 2010. More information is available at <http://www.nigerianfranchise.org>

<sup>26</sup> Section 4(1) (d) of the National Office for Technology Acquisition and Promotion Act.No.70, 1979 provides that the National Office (NOTAP) shall carry out the following function – “the registration of all contracts or agreements having effect in Nigeria on the date of coming into force of this Act, and of all contracts and agreement shereafter entered into, for the transfer of foreign technology to Nigeria parties; and without prejudice to the generality of the foregoing, every such contract or agreement shall be so registerable if its purpose or intent is, in the opinion of the National office, wholly or partially for or in connection with the specifications. <http://www.nlipw.com/national-office-for-technology-acquisition-and-promotion-act-> last visited 2/14/15

immense market opportunities in Nigeria and the absence of a franchise-specific legal and regulatory framework."<sup>27</sup> Franchise industry in Nigeria is very porous because of its lack of a proper regulatory frame work. In order to encourage investors and prospective franchisors, there is need for a distinctive regulation of franchise regulation other than its grouping as done by the existing regulatory body NOTAP. This will give certainty to protection of the franchisee and will increase the willingness to invest. Also giving room for ta possibility of the franchisor to spread his business and create a strong chain I of business in different parts of Nigeria since Nigeria has a good soil for the growth of Franchise and a proper institution for its regulation will act as fertilizer.

Franchise in Nigeria has helped to boost foreign participation. The legal regime in Nigeria for foreign participation through franchising is the most liberal compared to the United States. As long as a prospective franchise business is not in the negative list, foreign companies established can be established in Nigeria through agency, distribution or franchising. The Nigerian Investment and Promotion Commission (NIPC) eliminated the barriers to foreign investment in Nigeria and created a more liberal environment to foreign business in Nigeria. Incentives and reliefs granted and permitted by the NIPC Act encourages investors to participate in investing in Nigeria through Foreign direct investment (which franchise business falls under): investors through registered companies which may have been registered in their home country if not, the company will be formed and registered in Nigeria except if granted an exemption on registration by the regulatory bodies. FDI is the most resourceful form of foreign participation various sectors are involved ranging from the oil and gas, telecommunication to production and manufacturing industries which

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<sup>27</sup> The words of Dr. O.A. Okongwu. Former D.G National Office of Technology Transfer (NOTAP) Read more: <http://www.nasdaq.com/article/market-growth-opportunity-for-us-franchises-in-nigeria-cm225983#ixzz3RATZsu1c>

has aided in the economic development in Nigeria. Other forms are Portfolio investment and unregistered exempted companies.

NOTAP regulates the transfer of technology into Nigeria and franchise business are part of its scope of registration. Before technology is transferred into Nigeria, a registration must be first carried out by filling the relevant documents as provided by NOTAP after which, The Agency NOTAP, issues a Certificate of approval or certificate of refusal if it fails to meet the requirements of NOTAP. the application for registration must therefore be accompanied by the following documents Application fee, Memorandum and articles of association of the company, two CTC of the Agreement to be registered, Two copies of duly completed Questionnaire (Revised from NOIO2-84) a copy of relevant visibility study, Annual submission of audited accounts, the statement of affairs of the company accompanied with the certificate of incorporation. NOTAP also vets the agreement in order to determine conformity with its evaluation criteria. Upon approval, the applicant is advised on the fees to be paid as registration fees. Certificates of approval / registration are issued within two – six months and lasts for a period between one to ten years.

The obligation to register is on both the transferor and the transferee in any case, the franchisor or the franchisee and must be within sixty (60) days of execution of contract.

The director of NOTAP reserves the authority to refuse registration on certain grounds stated in S.6 (2) NOTAP Act (availability of same technology in Nigeria, the price is not commensurate with the technology to be acquired).

S.4 (d) NOTAP Act states contracts which must be registered with NOTAP:

- a) Every contract/ Agreement entered into by any person in Nigeria with another person outside Nigeria involving the transfer of technology to Nigeria partners.

- b) An agreement that involves the transfer of technology if its purpose or intent is the supply of machinery and plant: and
- c) The provision of operating staff, managerial assistance and training personnel
- d) The use of trademarks:
- e) The right to use patented inventions
- f) The supply of technical expertise in the form of technical assistance of any description whatsoever
- g) The supply of detailed engineering drawings;

Failure to register with NOTAP does not render a contract void but royalties, profits, repatriation fees will be disallowed through the Central Bank of Nigeria (CBN) unless on the presentation of certificate of registration with NOTAP<sup>28</sup>

### **1.3. Franchise in the United States vs. franchise in Nigeria**

It is important to state these differences on a fresh note in order to emphasize the level of development of franchise both countries and have an insight on the workings and the possible working of information asymmetry in Nigeria though not fully documented or published as findings in the United states or in other countries. This will help in the later part of this thesis to make necessary recommendations to Nigeria which intends to draw lessons from the US.

Compared to the US, Nigeria has done poorly in franchising. Although, this assertion can be attributed to the fact that the country is in her developmental stage in all ramification (economically, socially, politically to mention a few). Little has been published about this sector in Nigeria which makes it difficult to establish more analytical facts about the subject. However

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<sup>28</sup> See by Nelson C. Ogbuanya NOTAP Act S. 7. Essentials of corporate Law practice in Nigeria

one can adopt what is existing in the US as a standard (though not perfect) to see what is clearly lacking in Nigeria and what needs to be put in place to have a record of success in the industry.

While in the US, legal restrictions to information asymmetry exist at both federal and state levels, franchising in Nigeria does not appear to have envisaged information asymmetry as a problem. This explains the reason for its shallow provision for franchise related business. Franchise is still regulated under the received sales laws from the British common law meanwhile, there are more laws that have direct connection to franchise relationship such as Intellectual Property, Agency and distributorship, Labor Laws and many others which are not or if at all covered, in an insignificant amount.

For a regulation to be successful there has to be a proper review of existing legislation governing the system. The US has at various points passed through revolutionary reviews which has led to the establishment of gap fillers at various levels and has caused valid changes which has led to its success story in franchising for example the disclosure rules of the FTC.<sup>29</sup> Nigeria is yet to have a review of its regulations given that so many areas of law requires review. At the moment, franchise is majorly overseen by (NOTAP) is an agency of the Federal Ministry of Science and Technology which has the mandate to promote and develop franchising in Nigeria. How well spelt out the duties of this agency is remains a subject to be figured out because nothing much has been reported from this parasternal so far.

It is also important to say that the US has been able to provide an enabling environment for franchising business through the provision of important information on franchising to investors even though it's sometimes difficult to access the industry because of the control rights the

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<sup>29</sup> The 1979 Federal Trade Commission (FTC) rule on disclosure and prohibitions concerning franchising and business opportunity ventures was replaced with the new FTC Rule in 2007, Effective 1 July 2008

franchisor has towards information about his business. Efforts have been made through disclosure laws which has prevented investments that would have failed if such information was not made available before entering into the agreement. Franchisors have been compelled by the provisions of the regulating franchising to make known necessary information on a franchise and in some states where merit based system is adopted, the franchisor's disclosure of information is not sufficient as such information is still subjected to the scrutiny of delegated agencies to see that what is registered is true. The system provided by the parastatal in charge of franchising in Nigeria majorly sees to the registration of any franchise business entering into the Nigerian market. There is no scrutiny as claimed because the industry lacks experts in Franchising compared to the US. Compared to the US too, the weak judicial system has not helped franchising in Nigeria. Franchising can said to be a system that is not transparent enough to entice entrepreneurs or investors therefore a few investors are willing to tread on this zone for uncertainty the same applies to the franchisors which is not the case in the U.S.

Nigerian Legislators need to pay more attention to encouraging entrepreneurs in the country by looking into the existing regulatory frame work for franchising in Nigeria especially Disclosure laws which will make provision for safeguarding the franchisee in the area of information asymmetry as existing in the US.

## Chapter 2

### Information asymmetry in franchise agreements

It is difficult to define franchise without power dependence, they are both inseparable.<sup>30</sup> Franchisors utilise control powers over franchisees in order to maintain the goodwill of their business as well as trade mark which is commercially reasonable. The assumption of power gives rise to some unscrupulous practices by franchisors and brings out the opportunistic nature of parties in the franchise relationship especially the franchisors.<sup>31</sup>

Information asymmetry is a relationship imbalance between the franchisor and the franchisee in franchise relationship. Asymmetry results from a business information being unequally distributed between the franchisor and franchisee. This results in the placing the franchisor in a more advantageous position (than the franchisee) as a result of the knowledge he has over the franchisee which gives room for unfair practices to the franchisees detriment.

The US franchise rules have helped to curb some of these unfair practices caused by information asymmetry by checking the sharing of information between parties to a franchise in order to create a conducive environment for franchise business. At different levels of a franchise relationship

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<sup>30</sup> Courtenay Atwell & Jenny Buchan, 'The Legal System's Contributions to Research about Power and Control in Business Format Franchising' *Journal of Marketing Channels*, 21:3, 180-195, <<http://dx.doi.org/10.1080/1046669X.2013.840715>> accessed 20 March 2015

<sup>31</sup> Courtenay Atwell & Jenny Buchan Williamson's, 'The Legal System's Contributions to Research about Power and Control in Business Format Franchising', *Journal of Marketing Channels*, 21:3, 180-195, (Williamson, 1971) helps clarify relations between franchisors and their franchisees. For him, all participants in any interaction are innately selfish. Concealed, selfish motivations can be a precursor of uncertainty in any business relationship, including those between franchisors and franchisee. **To cite this article:** (2014) The Franchise Fulcrum: The Legal System's Contributions to Research about Power and Control in Business Format Franchising, *Journal of Marketing Channels*, 21:3, 180-195,

therefore, depending on the state, the control powers of the franchisor among other things are checked through regulations.

### ***2.1. Control rights of franchisor***

Courts in the US have justifiably approved of the franchisor's protection on proprietary right and confidential information, intellectual property and trade secrets, under the umbrella of reasonable confidentiality covenants. Franchisors protect themselves through their control rights which sometimes are over stretched to the detriment of the franchisee. The franchisee sometimes understands that "owning a franchise allows you to go into business for yourself, but not by yourself" but sometimes is more interested in the business freedom than being concerned about its implication. It is true that franchise provides franchisees with a certain level of independence.

The need for uniformity gives the franchisor a huge amount of control over the franchisee. A franchisee too after significant investment of capital, also has the duty of making the business profitable in order to justify the licence period granted to him by the franchisor before it expires.

While it may be argued that the coercive control powers of the franchisor has a legitimate effect on the franchise, it should be used as a last resort in business where non compliance by the franchisor is detected by the franchisor because the excessive use of coercive powers can damage the relationship between the franchisor and the franchisee. Scholars alike have buttressed the need for the option of non coercive powers by the franchisor in the conduct of business with the franchisee in the area of information exchange, and other pertinent areas of control.<sup>32</sup> Where the

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<sup>32</sup> Burton & Goldsby, 2005. 'Highlight the positive effects of non-coercive power' It mimics the Golden Rule: an ethical standard that calls on people to "do unto others as you would have them do unto you." Studies (Frazier & Summers, 1986; Gaski, 1984; Quinn & Doherty, 2000)

franchisee is not in fear of retributive effect of non compliance, he is most likely to be at his best in maintaining a healthy relationship with the franchisor and achieve business success.

After a franchise is sold to the franchisee, there is a power reversal although the franchisee may seem naive at the commencement of the business hence the need to be protected by regulatory bodies. Whilst the franchisor is interested in breaking even on investment upon achievement of this goal, the power equilibrium begins to swing in between the franchisor and the franchisee by the franchisee's power to determine the reallocation of the franchisor's investment in choosing whether to renew his contract with the franchisor or not. The franchisor is then left with the challenge of analysing whether to renew his agreement with the franchisor or the cost of getting a new franchisor.

Where they can operate their business because franchise provides the franchisee with an established product or service which may already enjoy widespread brand-name recognition.<sup>33</sup>

Parties in a franchise relationship premeditate the actions of each other to know which step to take and what step to take next in order to be in power or to have control.

Control of the franchisee can be by continually checking on the franchisor disposition and conduct.

While the powers based rights as claimed by the franchisor involves the the franchisor endeavour to maintain the brand by maintaining a command over the franchisees .

In contractual agreement, parties are generally expected to deal with each other in good faith. In a franchise relationships are not expected to fall short of this requirement as the golden rule in business should also apply in franchise relationship. Most courts in the US have also applied the

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<sup>33</sup> G. Sharp on 'Benefits of Franchising' < <http://www.franchise.org/what-are-the-advantages-and-disadvantages-of-owning-a->accessed> 23March 2015

principle of good faith in franchise agreements that parties must be conscious in the performance of their contractual obligation in a way that it is not inconsistent with the business reasonable expectations of the other party which will prevent him from making profit.

Courts in most states have consistently held that an implied covenant of good faith and fair dealing exists in commercial contracts, including franchise agreements. Franchisees however have reservations about interpretation of covenants by court because they claim that the discretion to deal with one another in fair terms is being abused by franchisors (introduction of new practices in the franchise agreement or in interpretation of the agreement as well as disclosure of vital information that are key to the business).

## ***2.2. Information asymmetry as a weapon of control***

According to Macauley and Williamson 1975, opportunism is a major contributor to the threat of business failure. Due to the inherent selfish nature in any business organization, different laws apply to regulate this selfish behaviour of the parties which are enforced by courts.<sup>34</sup> The business instincts of businessmen have the tendencies to use loops holes in business agreements in their best interest (to ensure that they grow and stay in business). A simple relationship like franchise can become complex by an attempt of a franchisor to over protect his interest by taking undue advantage of the franchisees ignorance. Franchise business may appear very simple, but its complex and unpredictable nature comes to the lime light when power and control become visible. Control powers in franchise business are not just limited to the franchisor, the franchisee too,

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<sup>34</sup> Cited in *The Foundations of Investment Law, Bringing Theory into Practice* Edited by Zachary Douglas Joost Pauwelyn and Jorge E. Vinuales  
<https://books.google.hu/books?id=1cUuBAAAQBAJ&printsec=frontcover#v=onepage&q&f=false>

tends to exhibit some business powers after successful establishment of his franchise outlet. There is an interplay of power between the forces that determines the fate of franchise. The law encourages this interplay between the franchisor and franchisee by helping them enforce their obligations towards one another.

Regulations set to govern franchise relationships have recognised and justified strategic areas of control a franchisor should have over his business such as advertising strategy, choice of suppliers, terms of lease, etc. These scope of control cannot be questioned because they cannot be left in the hands of the franchisee for determination as they are crucial to the determination of the future of the franchisor's business.<sup>35</sup>

Generally, there is an assumption that only the franchisor has control powers in a franchise relationship, this is not often the case. After an agreement has been reached between the franchisor and the franchisee, the franchisee during the relationship starts clamoring for an exercise of control. Both parties continue to clamor for power and control and each of the parties face the possibility of being abused by the other party. This goes on and on until there is a deadlock between parties and then they will seek redress by attempting to settle their dispute. In such instances, what keeps the parties in a franchise relationship varies, for the franchisee, the money invested and for the franchisor, the good will of his license. Apart from enabling opportunistic behaviours the control powers of a franchisor can lead to an instability in franchise relationship.<sup>36</sup>

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<sup>35</sup> (Felstead 1991) Although, the franchisee has a free hand to operate his business without close supervision, he has a duty to comply with the detailed procedure of the franchisor's business which is subject to unilateral change or risk termination by the franchisor.

<sup>36</sup> According to Earl and Potts, 2001 a preeminent deterrent to opportunism is the franchisor's power to switch between alternative transactors in the event that such conduct is observed. Meanwhile this option may not be available to the franchisee for lots of obvious reasons.

### 2.3. Regulating information asymmetry, the US approach

Private governance has failed in the regulation of power imbalance and unfair and unequal distribution of risk through knowledge imbalance in franchise contracts. Franchisors see contractual agreements as a documents to be drawn from the drawer only when there is a dispute. The FTC concluded after nine years of investigation in 1997 that the abuses in franchise selling practices were attributable to informational imbalance between the franchisor and franchisee, usually all accompanied by economic disparity between the parties and the legal response has been aimed largely at franchising selling practices and on the formation of agreement<sup>37</sup>. The role played by contract is insignificant in franchise arrangement. Franchising does not practically bear the risk of both the franchisor and the franchisee. The franchisor can easily define his risk through a well drafted franchise contract agreement but the franchisee cannot have his risks addressed in a contract agreement with the franchisor. This makes it very easy for the franchisor to transfer his risks to the franchisee. The risks of franchise are reinforced by the parties through their attempt to regulate franchise privately. The franchisor continues to draft franchise agreement without proper professional or legal consultation and the franchisee keeps agreeing to the agreements of the franchisee blindly and legislators keep addressing such issues in court and the court keeps trying to interpret them. . The inefficiencies that this may result in may have to be settled by an external force that comes through regulation.

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<sup>37</sup> . Barkoff and Selden , *Fundamentals of Franchising* (2<sup>nd</sup> ed, 2004)

## CHAPTER 3

### The United States Panacea to information asymmetry

Information asymmetry is one of the major hindrances to the growth of franchise business relationship and the industry at large. Because of the import role information plays in business relationships and developments, every attempt to regulate franchise addresses the issues on information either directly or indirectly. In the US, regulation issues on information are tackled at all levels of regulation Federal (FTC), State rules and through industry regulations.

A franchise relationship is only established when a franchisor permits the franchisee to use his license in business operations as permitted by law. This gesture gives the birth to some level of control by the franchisor over the franchisee and the commonplace control tool to a franchisor is information. In order to prevent franchising from turning into a master servant relationship (where the servant is not fully informed on activates of his master or of the details of what his assignment), regulations have been put in place to prevent the franchisor from having the latitude to assume such position. This rationalizes the perquisite disclosure requirements to be met by the franchisor which in actual fact are in favor of the franchisee in order to protect the franchisee.<sup>38</sup>In order to cure the looming unfair practices by franchisors, the FTC established rules to guide the franchisee in making informed decision before entering a franchise agreement. Franchisors are thus subjected to making cocksure disclosures to the franchisee before getting into franchise relationships. The federal laws require the franchisor to make pre sale disclosures to the prospective franchisee.

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<sup>38</sup> See more in **Jeffery Freedman –Brown Freed and Gesner, Boston** in *the international franchise option* by Mark Abel on protection of the franchisee through disclosure laws by the FTC.

Federal and state franchise and business opportunity laws provides that franchise disclosure documents FDD be prepared by the franchisor and in states where registration is required, registered with the relevant authorizes in the state before such franchise is offered, negotiated or sold to for franchisee.

### **3.1. Regulation at the federal level: FTC disclosure laws**

The most important mechanism that has helped in eliminating malpractice in franchise operations in the US is the pre-sale disclosure rule. Nineteen (19) within the US have adopted disclosure rules since 1970 in the US. At the federal level, franchise businesses are regulated by FTC through disclosure laws.<sup>39</sup> According to the provision of the rules, the franchisor must make certain disclosures as required by the rules before the completion of franchise sale. These rules do not apply to existing franchise relationships but pre-franchise agreements only. It also does not require filing or registration of such disclosure documents. The FTC disclosure rules contains the Standard rules for franchise business both within the US and for international franchising outside the US that involves the US. It further defines what franchise is irrespective of what the parties call it.<sup>40</sup> The application of the FTC rules starts from the inception of the franchise business (the pre contractual stage) till the franchise is sold and handed to the franchisee. According to the FTC

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<sup>39</sup> The FTC also has Business Opportunities Rule that does apply in the relatively rare situation where there is no written franchise agreement or where the total of the required payments or commitments to make a required payment to the franchisor or an affiliate of the franchisor that are made at any time from before to within six months after commencing operation of the franchisee's business is less than US\$540. Since it is rare that a franchise programme falls within the FTC Rule definition of a business opportunity venture

<sup>40</sup> In connection with the offering of a franchise, as "franchise" is defined in the Franchise Rule, 16 C.F.R. § 436.2(a),

disclosure requirements, the franchisor is expected to make complete and accurate disclosure must be made by the franchisor to the franchisee<sup>41</sup>.

In procedure for making pre-contractual disclosure, the FTC does not preclude the franchisor from making “legible written documents” in a single disclosure or prospectus.<sup>42</sup> He cannot incorporate into the disclosure documents additional information except if demanded under state laws (which does not preempt the FTC Rule)<sup>43</sup> The FTC rules has its pre-disclosure format which franchisors must comply with. Franchisors are allowed to make presale disclosure electronically (through direct download from website, e-mail or CD-ROM) if they will comply with the rules stated for such pre-disclosure. Any accepted system of pre-disclosure must be made must be done 14 days before the franchisee signs the agreement with the franchisor or his broker. It could also be earlier than 14 days if the franchisor has requested for it. Certain states as well require earlier pre-sale disclosures than FTC rule.<sup>44</sup>

The FTC Rule requires a twenty category information in the disclosure documents from the franchisor (parent companies and or its directors)<sup>45</sup> these are

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<sup>41</sup> **FEDERAL TRADE COMMISSION, (Plaintiff) v. IMALL, Inc., a corporation, CRAIG R. PICKERING, an individual, and MARK R. COMER, an individual, Defendants.** Where the court after establishing the existence of franchise relationship between the franchisor and the franchisee, established the quality of information that must be provided for the franchisee before the completion of sale of franchise, a franchisor must provide prospective franchisees with a complete and accurate basic disclosure statement.

<sup>42</sup> 16 C.F.R. §436.1(a), (a)(21) on disclosure procedure.

<sup>43</sup> FTC Rule. 16 C.F.R. §436.1(a)(21).

<sup>44</sup> A franchisor will be considered to have furnished a disclosure document if:

- a copy of the document was hand-delivered, faxed, e-mailed or otherwise delivered to the prospective franchisee by the required date;
- directions for accessing the document on the internet were provided to the prospective franchisee by the required date; or
- a paper or tangible electronic copy (for example, computer disk or CD-ROM) was sent to the address specified by the prospective franchisee by first-class United States mail at least three calendar days before the required date

<sup>45</sup> Documents for disclosure by the franchisor at .16 C.F.R. §436.1(a)(1)-(20)

- (1) the name, trade name and marks used by the franchisor and its parent firm or holding company;
- (2) the business experience, principal occupations and employers of directors and executive officers;
- (3) the business experience of the franchisor and its parent;
- (4) litigation information, including (a) felony convictions for certain dishonesty or restraint of trade, (b) civil actions for the same and any actions by franchisees that involved their franchise relationship, and (c) state or federal orders or applications for orders involving the same;
- (5) information about bankruptcies;
- (6) a factual description of the franchise being sold;
- (7) the fees payable to commence operations;
- (8) any recurring fees the franchisee must pay;
- (9) the identities of any persons affiliated with the franchisor with whom the franchisee is required to do business;
- (10) a statement of certain property the franchisee will be required to buy or rent and the names of any persons from whom the lease of purchase must be made;
- (11) information about the calculation and amount of any consideration payable to the franchisor or its affiliates for goods the franchisee is required or advised to obtain from them;
- (12) information on any financing arrangements in which the franchisor or its affiliates are involved;
- (13) material facts regarding limitations on the franchisee, such as territorial restrictions;
- (14) a statement of any personal participation in the business that is required of the franchisee;
- (15) a description of certain terms and conditions of the franchise agreement and related agreements;
- (16) information about the franchise system and company-owned stores;
- (17) the range of time between signing of the franchise agreement and (a) site selection

- and (b) commencement of business;
- (18) disclosures about initial training programs;
- (19) information about public figures recommending the purchase of the franchise or involved with the management of the franchisor; and
- (20) financial information.

In the absence of any of the required information, the franchisor is expected to make known to the franchisee such absence and reasons for it as additional information.<sup>46</sup> The franchisor is also not under obligation to make financial disclosures (financial claims) if however he does, then he must make additional information.<sup>47</sup> Where the franchisor intends to make financial representations to the prospective franchisee 'financial performance representations' (FPR), he must strictly comply with the provision of the FTC rules and state rules (if applicable) for such disclosure to be made.<sup>48</sup> It is either the franchisor complies with applicable authorities by making full disclosure than making partial disclosure of FPR as partial disclosure is not acceptable by

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<sup>46</sup> FTC Act, 16 C.F.R. § 436.1(b)-(e); The Franchise Rule additionally requires: (1) that the franchisor give prospective franchisees a document disclosing the material basis (or lack of such basis) for any oral, written, or visual earnings or profit representations it makes to a prospective franchisee, and (2) that the franchisor, in immediate conjunction with any generally disseminated earnings claim, disclose the number and percentage of prior purchasers known to have earned as much or more than the amount claimed, and include a warning that the earnings claim is only an estimate. 16 C.F.R. § 436.1(e)(3)-(4).

<sup>47</sup> *FEDERAL TRADE COMMISSION, (Plaintiff) v. IMALL, Inc* FTC No. 972-3224 , (1998)., Judgment was in the favor of the plaintiff where it was established that the defendants have made earnings claims within the meaning of the Franchise Rule and failed to disclose the unhealthy financial state of the franchise., 16 C.F.R. § 436.1(b)-(e), but have failed to give prospective franchisees the earnings claim document required by the Franchise Rule, thereby violating Sections 436.1(b)-(e) of the Franchise Rule, 16 C.F.R. § 436.1(b)-(e), and Section 5(a) of the FTC Act, 15 U.S.C. § 45(a).

<sup>48</sup> 16 C.F.R. § 436.1(e)(3)-(4) Generally the franchisor is prohibited from making FPR to a franchise except in cases where a reasonable reason exists for the franchisor making the FPR, the franchisor provides a substantiation of the FPR at presentation of the document, and the FPR is included by the franchisor in the disclosure documents.

both state and FTC rule.<sup>49</sup> These give the franchisee an insight to relevant information about the franchise, its potential risk and enables him make judged decision on the franchise<sup>50</sup>

Franchise regulations and laws give certain exemption and exclusion to its rules certain arrangements such as lease (where an independent retailer sells his goods from the leased premises of the larger retailer premises), where there is an oral franchise arrangement, fractional franchise arrangements and where a fee of \$540 is required to be paid by the franchisee within the first six (6months) of operation.<sup>51</sup> Petroleum marketers are also exempted under the FTC rule because they are covered by the Petroleum Marketers Act. Large investment exemption (franchise sales whose initial investment is US\$1,084,900,exclusive of franchisors financing and unimproved land); large franchise exemption (where sales to ongoing entities with at least US\$5,424,500 net worth and five years of prior business experience; and insider exemption where the purchasers of at least 50% ownership in the franchise at least 60 days of the sale and for at least two years been a general partner, director , officer, finance officer, or manager charged with the responsibility of sales of the franchisors franchise or owned at least 25% of the franchisors business within the 60days of the sale, for at least two years. These categories of exemption are regarded as the ‘Sophisticated investor exemption’.<sup>52</sup>Most of the FTC exemptions do not have correlating exemptions under state disclosure laws. Some state disclosure laws however have similar exclusion and

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<sup>49</sup> The FTC Rule defines an FPR as ‘any representation, including any oral, written or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits.’

<<http://www.nationalfranchise.com/financial-performance-representation>>

<sup>50</sup> Pursuant to Section 18(d)(3) of the FTC Act, 15 U.S.C. 57a(d)(3), and 16 C.F.R. § 436.1, in violation of Section 5(a) of the FTC Act, 15 U.S.C. § 45(a).A franchisor will be guilty of unfair or deceptive acts or practices in or affecting commerce .

<sup>51</sup> [https://www.ftc.gov/sites/default/files/documents/federal\\_register\\_notices/16-cfr-part-436-disclosure-requirements-and-prohibitions-concerning-franchising-final-rule/120613franchisefrn.pdf](https://www.ftc.gov/sites/default/files/documents/federal_register_notices/16-cfr-part-436-disclosure-requirements-and-prohibitions-concerning-franchising-final-rule/120613franchisefrn.pdf) last visited 3/18/2015.

<sup>52</sup> Disclosure Requirements and Prohibitions Concerning Franchising:Craig Tregillus, Franchise Rule Coordinator, Division of Marketing Practices, FTC, 600 Pennsylvania Avenue NW., Washington, DC 20580, (202) 326–2970,

exemptions which are of interest to the franchisor<sup>53</sup>State exclusion and exemption are not available in all states. Often times, they only apply to registration and not disclosure. This makes sense because FTC rules binds all states within the US and even if a franchisor is granted exemption under state exclusion, he is not relived of same under the FTC Rule.

Any act of a franchisor in breach of any of these Rules on franchise disclosure constitutes deceptive unfair or deceptive practices. In instances on breach of FTC Rules, where breach is in connection with the offering of a franchise, and the defendants have failed to provide prospective franchisee with a complete and accurate basic disclosure document thereby violating Section 436.1(a) of the Franchise Rule, 16 C.F.R. § 436.1(a), and Section 5(a) of the FTC Act, 15 U.S.C. § 45(a), actions are not brought individually by the affected consumers or franchisee but by the FTC for claims on consumer injury. Injunctive reliefs can also be granted where it is established that the franchisor has been unjustly enriched by his unlawful practice as such injunctive relief will deter from such practices and the interest of the public will be protected in the future unlawful practices. A franchisor must comply with the applicable laws both disclosure requirements and state requirements before offering a franchise to the franchisee. In cases of sub franchising, the FTC provides that the sub-franchisor is jointly responsible with the franchisor to comply with pre-disclosure laws. The liability of disclosure violation under the FTC rule implies a joint responsibility on the franchisor and the sub-franchisee on the violations of the sub franchisee. Officers and directors of corporate franchisors, as well as share holders may also be liable for

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<sup>53</sup> Some of the exclusions and exemptions provided by state disclosure laws includes but limited to:

- large franchisors or experienced franchisors who exceed a specified net worth and who have had a minimum number of franchisees for a minimum period of time;
- offers or sales that are renewals, extensions, or substantially similar to franchises already owned by the franchisee;
- certain sales of a franchise by a franchisee or a sub-franchisor; and
- offers or sales to a financial institution or life insurance company

violations of the FTC rule to the extent to which they participated in the violations but failed to stop them.<sup>54</sup>

The FTC also requires that any material and unilateral alteration of the basic terms of franchise or related documents attached to franchise agreement must be disclosed to the franchisee an act of offering for sale without making available to the prospective franchisee is in violation of the FTC Rules. In order not to constitute a breach, a copy of amended terms of franchise agreement in order not to constitute a breach should be made available to the prospective franchisee at least seven days before he signs the agreement in its revised state. However changes that arise out of negotiations by a prospective franchisee will not require the seven-calendar-day notice. Although the FTC Rule pre-empt state regulations that may be inconsistent, states are allowed by FTC to make and impose disclosure laws of higher standards or making additional disclosure requirements. Franchisor must update FTC disclosure documents upon any occurrence for material changes as soon as they are made.<sup>55</sup>

The franchisor therefore is in a routine of preparing disclosures documents with modifications to suit the rules of each states (where he intends to extend his franchise) additional mandated disclosure requirements. Disclosure documents must be updated 120 days before the end of the franchisors fiscal year according to the FTC Rule. States with registration rules, the franchisor must update disclosure documents either 90, 110, 120 days after the franchisors fiscal year ends,

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<sup>54</sup> *FTC v. Value Investments, Ltd.*, 1993-1995 Bus. Fran. Guide (CCH) ¶10,404 (M.D. La. 1994); *FTC v. National Business Consultants*, 1990 U.S. Dist. LEXIS 3105, 1990-1 Trade Cas. (CCH) ¶68,984, 1989-1990 Bus. Fran. Guide (CCH) ¶9594 (E.D. La. 1990).

<sup>55</sup> A material change is defined as: *Any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchised business or which has any significant financial impact on a franchisee or prospective franchisee*

or within one year of effective date registration.<sup>56</sup> Amendments made by the franchisor to the disclosure documents after the initial disclosure has been made must be delivered before the franchisee before the final sale of the franchise to the prospective franchisee.

Once the franchise relationship has been established, there is no further obligation on the franchisor to disclose information to the franchisee because the purpose of franchise disclosure laws is to help the franchisee make precise decision. Franchisor however may be subject to make continuing disclosure to the franchisee subject to certain exemption or exceptions. An existing franchisee that is renewing his franchise contract, purchasing additional franchise with the franchisor may require additional information.

Government agencies enforce disclosure requirement mostly through their established authorities. FTC is responsible for the enforcement of its disclosure laws upon investigation (some states have special investigators), enforcement actions can further be taken (usually upon court order) with injunctive provisions to stop the erring franchisor from continuing such violation.

The remedies available under the FTC for a franchisors breach includes; administrative actions to obtain cease and desist orders as provided by the FTC<sup>57</sup>; civil actions in federal courts for penalties of up to \$10,000 per violation (each day being a separate violation) for knowing violations of the rule;<sup>58</sup> civil actions in state or federal court under for redress on injuries to

Consumers or other persons as well as claims for rescission, reformation, refunds, damages, and public notification of the violation.<sup>59</sup>

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<sup>56</sup> The North American Securities Administrators Association and the states have effectively adopted the FTC Rule as is, but may elect to impose minimal additional requirements. Some states do, in fact, have a relatively small number of additional requirements.

<sup>57</sup> FTC enforcement rules §5(b), 15 U.S.C. §45(b)

<sup>58</sup> §5(m), 15 U.S.C. §45(m)

<sup>59</sup> §13, 15 U.S.C. §53

In instances where the franchisees rights are violated by the franchisor, the franchisee cannot by him seek legal remedies under the FTC rule. Only the FTC itself can maintain civil actions (seeking injunctive reliefs, monetary penalties and consumer redress etc.) against the franchisor for breach of disclosure rules. The FTC can also request for damages or payment of refunds, reformation or recession and in some cases a combination of these requests. Cease and desist orders can also be issued by the FTC to a franchisor who has failed to comply with the FTC Rules.<sup>60</sup>

This is however at the federal level, some states in the US require more than mere compliance with the FTC rules if a franchisor intends to do business within such states. Where franchise falls within a state that has its own regulations, the franchisor has both the federal rules to contend with as well as state franchise rules (which are in most cases stricter than the FTC rule). The FTC pre-disclosure are also adopted by states in the US is one of the fundamental guide to check franchisors from unfair practices.

### **3.2. State franchise regulatory system in the US: Disclosure and Merit based Laws**

In the US, states are permitted to enact laws that suits franchise business within them as long as they do not preempt Federal laws. Knowledge in the practices of franchise rules of a state gives an insight into what to expect in other states. Many states have franchise disclosure laws as well as registration laws and relationship laws. Some states have adopted the franchise disclosure laws/registration laws alone while others a combination of both disclosure / registration and relationship laws are required. 14 states have laws regulating pre contractual arrangements in

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<sup>60</sup> Civil penalties in federal actions allow for recovery of up to US\$11,000 per day for each violation

franchise relationship(offer and sale) requiring the filling of the pre-offer or its registration while the disclosure requirements remains constant.<sup>61</sup>

State statute will apply in any or in a combination of situation when: the offer originates within the state; the offer is received within the state; the offer is directed by prospective franchisor to a prospective franchisee within the state or to a resident of the state; where the franchise operation is operated in or partially within the territory of the state; the meeting between he the franchisor and the prospective franchisee occur within the state.; or the franchised business will be operated within the state. The criteria for the application of state rules differs from state to state and it is the duty of the be fully aware of situations when state laws will apply as well as the combination of regulations applicable to states in which they intend to do business in . A franchisor may be exempted from some state registration rules if his trade mark licensed is registered within such state.

New York State Franchise Act declares a franchise agreement to be highly “unlawful and prohibited” if it is not entered into by well-informed parties, with the seller having to first register with the department of Law and “offering prospectus” that contains specific information about the franchise and the franchisors background. Under the FTC disclosure rules, the period of time within which the facts about the franchise agreement must be disclosed differs from the period of

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<sup>61</sup> 14 states have laws regulating the offer and sale of, and requiring pre-offer filings or registration of, franchises, as well as imposing pre-offer and pre-sale disclosure requirements. They are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Oregon regulates offers and sales, but requires no filing. In addition, 21 states, as well as the District of Columbia, Puerto Rico, and the US Virgin Islands, have statutes that regulate the terms of the franchisor–Franchisee relationship. These states are: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

disclosure as provided by the state. This also includes re-registration or renewal of franchise agreement.

The Act also states the time in which the prospective franchisor must receive certain information after which the franchisor will be deemed to have violated the act on disclosure. The franchisee is entitled to receive information at the earlier of:

- a) the first personal meeting with the franchisor or its agent and prospective franchisee.
- b) at least ten business days prior to the execution of the binding franchise or other agreement
- c) at least ten days prior to the receipt of any consideration in connection with the sale or proposed sale of franchise.

Most states notify the franchisor on the contents of the disclosure document before it is accepted for registration. Where franchisor fails to meet with the pre-disclosure requirements, his application may be delayed for months until he meets the requirements for registration by the state authorities for lack of compliance by the franchisor and the state ensures compliance suggesting modifications to suit the concerns of the state towards franchise.

An erring franchisor cannot be excused by laying claim to compliance to the federal rules on disclosure by neglecting to comply with state provisions of the state because state laws are far more stringent.<sup>62</sup>

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<sup>62</sup>. In **Paghman Chicken Inc. V. Loghar Restaurant Corp.** (N.Y Supreme Court, 1986) Franchise Business Guide (CCH) 8994 it was held that even if the NY laws permits the use of the FTC disclosure rules, documents are required to be tailored according to state rules because they are more detailed and exact. The court would therefore not have considered the FTC disclosure documents even if they had existed and were submitted. The franchisors failure to comply with the requirements of the act was considered “wilful and material”, the franchisee is therefore entitled to damages pursuant to GBL S619, subdivision 1.

In many states, State franchise rules are as well designed to govern sub-franchising. State Franchise rules are more explicit and direct in who bears the liability of non-compliance with disclosure laws. The liability is expressly imposed jointly and severally on the employees, (who aid violation), directors, all partners, and controlling persons of the franchisors principal officers.

At about 30 exemptions to FTC and state registration laws exists but they are limited in various ways, as most of these exemptions are only limited to state filing and not in compliance with the FTC disclosure rules. These exemption are also not uniform among states and cannot be predicted as to what to expect in various states. The FTC exemption is only to a few states and not applicable in all the states.<sup>63</sup>

States establish various enforcement procedures to its disclosure and registration laws. State administrators are empowered to investigate and prosecute, issue ex parte orders to erring franchisors until hearing is conducted. Private rights of action as well as criminal sanctions are also are catered for and enforced through the office of the attorney general in some states. Criminal penalties are used by some states but this is a rare tool used by states.

Unlike the FTC laws, franchisees can bring actions privately against the franchisor for breach. The state administrators are also authorized to bring direct actions against the franchisor or through then attorney general on behalf of the people of the state in order to ensure compliance to state laws. State remedies include revocation of state franchise registration, consumer redress (actual or

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<sup>63</sup> Leonard Polsky, Luciana Bassani, Philip Colman, Gary Duvall, *Pros And Cons Of Using a Uniform International Disclosure Document*.

<http://www.dannemann.com.br/dsbim/uploads/imgFCKUpload/file/Uniform%20international%20disclosure%20document%20-%20pros%20and%20cons.pdf> accessed 23 March 2015

consequential damages, rescission) civil penalties, injunctions, and criminal sanctions for wilful violations. States have passed what is sometimes referred to as ‘little FTC Act’ which is the Deceptive trade practices Act (DTPAS). DTPAS prohibits deceptive and unfair practices in the conduct of commerce or trade by providing for private cause of action even where FTC rules or the general principle of laws have failed to provide covering against such practices. In some states, violation of FTC rule is per se violation of DTPAS while in other states, it is an evidence of violation. Majority of the states permits courts to award punitive damages or triple damages as minimum damages.

Although disclosure laws do not apply to relationships between the franchisor and franchisee, immediate termination is permitted under certain conditions and provided the franchisor includes such clauses in his disclosure documents. This differs from state to state and the provision of the states must be included in the disclosure documents.

A violation of Franchise Relationship laws in states which results in any harm suffered by then franchisee entitles the franchisee to damages, cost of litigation with reasonable attorney fees from the franchisor. The franchisee could also be awarded other equitable reliefs as injunctive and other appropriate remedies. Once it is established to that an action against the franchisor falls within the state laws, the plaintiff is entitled to remedy as provided by such state laws.

### **3.2.1. Franchise registration states**

Notwithstanding that all franchise sale in the US are subject to the FTC Rule, not all states regulate franchise by adopting one form of regulation or the other. Eighteen 18 states in the US regulate franchise sale either by disclosure rules and or with registration rules. Franchisors within these

states allow the franchisor to adopt the UFOC 1993 version. Four states (Arkansas, Florida, Mississippi, and Oregon) among the regulating states have adopted the Federal disclosure Rule without registration requirements.

In registration states, separate registration is required by the franchisor of the sub-franchise rights and a separate registration by the sub franchisors offering sub franchisees.

Notes: the Uniform Franchise Circular (UFOC) was developed by the North America Securities Administrators Association (NASSA) in an attempt to create a uniform disclosure document, meeting the requirements of multiple state disclosure laws and the FTC disclosure rules. The format is accepted by all of the Franchise “disclosure “states (with minor variations) and is approved by the FTC disclosure rules. The UFOC provides an effective and efficient means of preparing uniform offering materials for use in the sale of franchise throughout the United States and actions can be brought against a defendant for its breach.<sup>64</sup>

In registration states, separate registration is required by the franchisor of the sub-franchise rights and a separate registration by the sub franchisors offering sub franchisees.

### **3.2.2. Franchise non registration states**

In some states in the US, state franchise laws also regulate the relationship between franchisors and franchisees by simply adopting the FTC disclosure rules and in addition to the FTC disclosure laws other subjects as franchise terminations, non-renewals, transfers, supply arrangements, good

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<sup>64</sup> *The People of State of California v. Speedee Oil Change Systems Inc.*(Cal Superior Court of Los Angeles, 1997)Business Franchise guide (CCH)11, 544 where an action against the defendant for the people of California by the corporations Commissioner(DOC) for alleged violation of Franchise Investment Code section 3100, *et seq...*I for the breach on failure to disclose material facts as the UFOC provides

faith and fair dealing and other matters. These laws are not usually stable as they are frequently changed or modified.

In Louisiana for example, though no legislation has been passed, the new bills introduced regarding franchising passed in 1995 indicates the recognition for the need of franchise regulation.

Louisiana in the US is a state that has not adopted any form of franchise regulation (either disclosure or registration). Although, attempts have been made by the Legislature to pass a form of regulation but it was unsuccessful and no legislation has been passed in the state since then. Franchisors are however expected to be familiar with and comply with the laws of other states in which franchises are intended to be sold. They may also be disclosure requirements if franchise is merely sold to the residents of such regulated states not considering whether the franchise is located within such states.<sup>65</sup> Where the franchisor fails to comply with the requirements of the states, he is liable to civil actions against him as criminal action as such state provides<sup>66</sup>

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<sup>65</sup> 2012 c 121 § 2; 1991 c 226 § 2; 1971 ex.s. c 252 § 2. Washington State Legislature. RCW 19.100.020 Unlawful in certain instances to sell or offer to sell franchise if unregistered or not exempt <http://apps.leg.wa.gov/rcw/default.aspx?cite=19.100.020> >LAST VISITED ON 24/3/2015

<sup>66</sup> Examples of Criminal Penalties in states- Hawaii : Haw. Rev. Stat. § 482E-10.6 : Hawaii Statutes - Section 482E-10.6: Criminal penalties. <http://codes.lp.findlaw.com/histatutes/2/26/482E/482E-10.6>> last visited on 24/03/2015

## Chapter 4

### **Lessons for Nigerian Legislators from the cradle of business format franchise -United States.**

Taken away from analyses drained in the previous chapters, by examining regulation of franchise in the U.S have been centered on the effectiveness of the system so far. There is however a swindle off these rosy effectiveness in this chapter which Nigerian legislators can learn from. As no perfect system of regulation has been discovered yet, all studied the regulatory systems have their pros and cons, and we also bear in mind that the regulation of franchise in a country is inevitable. What is difficult to determine may be how to regulate? What system is the approach for the legislation to adopt? Of course, the goal for any regulation that will be operational in Nigeria is to ensure effectiveness and efficiency which is good for franchise business, its stake holder's interest, competitiveness of the industry.

#### **1.1. The pros and cons of the non-merit-based disclosure laws**

Although regulation thorough merit based disclosure has its own benefits to the parties in the regulation of franchise agreement as creating market interaction, by ensuring that the franchisee has an all encompassed information he needs to have his desired products and the information are not diminished by the franchisor, to standard by the proposition of the franchisor to the franchisee. One major problem in the merit non- merit based disclosure is that there is a statutory imposition on the franchisee at the commencement of the franchise relationship prescribing the standard of documents to be disclosed but there are no regulatory checks on the information provided by the

franchisor whether they are accurate or not. The accuracy of the disclosed document is only verified when dispute arises. This reveals the porosity of the non-merit disclosure laws of the FTC. Secondly, there are no federal franchise relationship laws that affect the franchise relationships under the non-merit disclosure rule. Although some self-regulated industries (such as the petroleum Marketing Practice Act) which governs the franchise relationships in the petroleum industry) have working relationship laws, these continuous regulation is only applied in the areas within their jurisdiction.

Foreign/international franchise is in most cases treated equally the same way domestic franchises are treated in compliance with the law. A foreign franchisor has the duty to comply with both federal and state disclosure laws as well as state relationship laws (if any). Foreign franchisors are not generally treated in the differently from domestic franchisors when it comes to the application of federal laws on disclosure. An international franchisor may encounter some challenges when required to present financial statements together with disclosure documents. Financial statements prepared in the U.S are based on the accepted accounting standards accepted in the U.S (Securities and Exchange Commission) this may be problematic for the franchisor mother company is in a foreign country.

Another disturbing fact about the non-disclosure laws is the period for review given to the franchisee of the disclosed documents. The 14 days review period given to the franchisee is rather too small to make a decisive decision (the average US FDD without exhibits is about 50 pages, and with exhibits is about 150 pages, Many exceed 300 page) even when it is being reviewed externally by professionals. Moreover, the franchisee may not be able to afford the services of a professional or a legal practitioner.

Franchisors exporting their system of disclosure a foreign franchisee country where there are no disclosure laws may create disclosure documents with the help of local professionals or counsel in that jurisdiction in order conforms to the prevailing laws. But in real practice, franchisors from countries with disclosure laws do not provide disclosure laws to foreign countries where no such laws exist. This may be reasonable because any of such disclosure may only cause confusion to the franchisee. In any case, the franchisee remains ignorant of the franchisors business which does not sound helpful. The situation may however be different where the US franchise disclosure laws is to be applied to countries without specific disclosure rules, the franchisee can take advantage of the excessive information disclosure the FTC provides for by making a reverse claim when the franchisor adopts the US disclosure rules. The franchisee may make claims on the absence of certain information required to be disclosed in the by the Franchisor under the FTC disclosure which is not necessarily a requirement under the franchisees country laws and make claims against the franchisor for taking undue advantage on him by withholding substantive information.

Disclosure rules of the FTC lacks the provision for standardization of contract which creates the problem of uniformity of operational procedure. Franchise contracts under the non-merit disclosure rules lacks the effect of conformity of standard which a franchisor may want to exercise in a franchise relationship as it can help the franchisor monitor the compliance of the franchisee to operational requirements and for the franchisee especially where language poses a challenge to the in-house counsel of the franchisor.

Because of the volume and the resulting complexities of the FDD and its required information to be divulged by the franchisee, some professionals or counsel advise the franchisor not to or just to give few details on the FDD because supplying the franchisee with too much information may be

confusing to the franchisee. While the franchisor can be advised to cut on the FDD, he cannot limit the amount of information that will be required by the state laws where the franchise will be established.

#### **4.2 The pros and cons of adopting the merit-based registration system**

Generally, states are said to have stricter rules in the regulation of franchise than federal laws. State laws on merit based registration varies in definition and scope from state to state (some are broad like the FTC disclosure rules and some are narrow) but they maintain their similarity in the FTC rules. In the New York for example, there is broader coverage because no trademark license is required. In about 10 business opportunity states, coverage is much broader than the FTC Business Opportunity Rule because it applies to any sale of a business opportunity where a marketing plan is sold or provided.

Fourteen states (14) states in the US have registration and disclosure laws meant to protect the prospective franchisee. The disclosure documents required for registration forms the bases of the agreement between the parties, and the franchisor must get approval from the franchise state. The prospective franchisee is likely to get the latest or updated franchise information for use, as part of his tool for due diligence before signing franchise documents. Franchisees are also to get the respective documents disclosure within the required period by state laws. The disadvantage of this system is that the franchisor has too much to comply with. After having to comply with broad federal laws, the franchisee is faced with possibly more laws than he has dealt with at the federal level at the state level. This may be a discouraging factor for a prospective franchisor investor.

Where the franchisor has failed, the first option available under the state laws for a franchisee or a consumer's redress is a law suit filed by the state attorney, and remedies such as settlement document, rescission (the franchisee gets money back) and some recovery for the state may be achieved.

In addition to laws or government agencies that specifically govern franchise relationships, the franchisee may take other actions against the franchisor aside these statutory causes of action. Common law actions which are related to sale of franchise can be brought by the franchisee against the franchisor. Misrepresentation or false statements are causes of action (with direct remedy) available under the state common law and statutory fraud principle of the state. However in this cause of action, the franchisee may not be able to obtain attorney's fee unlike when an action is brought under the franchise statute. Still under state laws, common law duty of good faith and fair dealing can be added to franchise specific statutes and made binding on the franchisor and franchisee. Franchisees have been able to receive redress on unfair acts of franchisors in conducting franchise sale (before and during the sales of franchise)

Some private franchise associations have codes of conducts for their members but they do not have the backing or force of the law.

#### **4.3. Implication of solving the problems of information asymmetry wholly adopting the United States system of regulations in Nigeria.**

It is easy to get the franchisee on board but when a problem which is common to the franchise arises, not only does the franchisee go down, other people are also affected including the franchisor and most irredeemably the consumers.<sup>67</sup>

Although there are lots of bottle necks looming the business environment, especially places like the U.S. Some areas of business Nigeria which have adopted strict regulations have been able to record remarkable success though not significant enough if juxtaposed with the U.S. If Nigeria adopts a wholesome regulatory system, then the bottlenecks which are obvious in the larger economies (such as high cost, long delays, too long and complicated procedure) will also be a future challenge to battle with. This may also bring out some strengths that are possible in the business regulated sector.

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<sup>67</sup> The Ins and Outs of Franchising business EIU. Uploaded on Dec 21, 2011. A video presentation about the ins and outs of franchising and what you need to know.  
<https://www.youtube.com/watch?v=EPI6ef29CDE> las visited 18/03/2014

## Recommendation and Conclusion

Franchise is the fastest growing business organizations in the world and one of the best business models for entrepreneurs to get established in business. It is also a medium through which a country can grow economically through foreign direct investment FDI.

Franchise is one of the most complex relationships. In a practice it is not as simple as it appears and as old as this form of business is, there has been a difficulty in getting a perfect regulatory framework that will be a one size fit all in every country or even within the US. It is therefore important to know that the regulatory frame work for franchise is not a universal one and no country can boast of a perfect regulatory framework for franchise not even the US which seem to have a rich regulatory frame work for franchise.

There has been compelling argument for the unification or harmony of franchise regulation internationally to the extent that it is feasible and practicable. The consistency in private law provides a legal frame work of private rights as a foundation of social interaction<sup>68</sup>. An international legal regime facilitates transactions and enhances credit facilities and reduces borrowing cost.<sup>69</sup> In order to benefit in such harmonization, regulation should be understood and applied consistently as it is practicable.

The major actors –the franchisors and the franchisees are however skeptical on the effect new regulations will have on their business. This mistrust in regulation is as a result of the cost involved

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<sup>68</sup> Elizabeth Crawford Spencer, *The Regulation of Franchising in the New Global Economy* (Edward Elgar, 2010), at page 29.

<sup>69</sup> Ibid.

and yet some do not achieve the stated aim as there are scarce records of tangible results achieved in some countries where much has been invested on setting up regulatory frame works.

For the legal system to regulate franchise laws, first, there should be a careful review of the current legal systems by legislators and stakeholders. Existing laws governing other forms of contract and affecting business in the country must first be examined to understand with their effectiveness and strength. When regulations are made, there has to be a ready mechanism for its enforcement. In the case of Nigeria, enforcement mechanisms have to be first worked upon and dealt with. Whether at this stage of Nigeria's development Nigeria should have franchise specific laws has no hasty answer to it since having franchise specific legislation is not the best or only way to see to franchise dealings in a country. A country like the U.S which most countries set as a standard was able to arrive at its current regulatory system by consistent review of its laws as the need arose and then the franchise regulation.

For franchise regulation to be effectively regulated, there must be an in-depth understanding of the market interaction of its key players (the franchisor and the franchisee).

The challenge on a review of existing laws is that franchise may not be a priority on the table of review, being a new (not really explored) form of business. Other aspects of law have more specific problems troubling the legal system and since no systemic problems have been drawn yet from franchising yet, it may not be a priority on the list of review for the legislators.

With projections on the future impact of franchising on the economic development of Nigeria as a whole, laws can be passed to fit into the future projection and all the areas of development it foresees to affect such as intellectual property laws, labor laws corporate social responsibility, local content etc. Market governance can be improved and made more transparent. SME should

be encouraged by creating an enabling business environment by tackling issues that has to do with market instability, market uncertainty, regulatory transparency ,m poor judicial system etc. like what similar to emerging economies in are trying to achieve while attempting to establish regulation. Lessons can be learnt from other developing countries who are also adopting regulations to their market development such as India, Brazil, and China by making franchise regulations

There may be some bitter aspects to insisting on a country having regulation which have been argued by scholars from different perspectives. Regulations can in the long run become restrictive to investors and discourage prospective franchisors thereby making franchise an unattractive business adventure to a business man. Prospective franchisees may feel too secured by working regulations and neglect their duties and due diligence in the franchise relationship. Suggested steeps for Nigeria therefore is to take will first make a comprehensive of its existing laws, subject the review to putting the right questions on the table for determination whether the industry is facing certain challenges and what best solution to tackle such problems. Though it seems the country is not facing any problem associated because there are no records (which is one of the challenges of information asymmetry). From the World Bank's report on Nigeria in 2015<sup>70</sup>, it is clear that because certain regulations are not in place and those in place are not duly enforced, the current problems in franchising cannot be fully reflected. But with the drastic change in the country's business performance, one can insist that Nigeria still has enabling legal environment

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<sup>70</sup> On the World Bank ranking of doing business in Nigeria. Though there has been an improvement of hat franchising use to be in 2014. The improvement from 138/183 in 2014 to 129 in 2015 and though insignificant to a business man shows that conscious effort are made to create a better business environment for business generally in Nigeria. More information available at : <http://www.doingbusiness.org/~media/giawb/doing%20business/documents/profiles/country/NGA.pdf> >last visited 3/21/2015.

for franchising if the rules are followed to the later. There is room for improvement. The goal of franchise regulation should be well defined (to prevent corrupt and unfair practices between the franchisor and franchisee), not be obviously favoring one party over the other as regulations in the US seem to appear. This will make franchise remain attractive form of business for both the prospective franchisor and the franchisee. Thirdly, in the course of deliberation by Nigeria's Legislators and stakeholders, a wholesome adoption of the regulatory form in the US should be completely avoided. The whole process will be futile if the deliberators insist on an "all or nothing" approach to any legal form that is suggested. Apart from the US, there are countries focused on only disclosure laws, some on registration laws some on relationship issues. Nigeria should therefore have a gradual approach to adopting regulations for franchising otherwise having too much on her plate may end up in a complex system that could ruin the future of franchise.

It may be best to recommend the U.S disclosure laws to Nigeria at the stage it is now. Disclosure laws are broad in scope and will be able to address broader structural regulatory issues as they arise and later in the future make narrower or more specific regulations. Since what is available at the moment resembles the U.S disclosure laws, it will be easy to transcend from what is available to compulsory disclosure laws. This will also keep the attraction of franchising to investor franchisor and prospective franchisee also considering the fact that this form of business is still new in the country, it will also encourage the emergence of more professionals in the field of franchising since there are very few specialized legal practitioners who are well-versed in the<sup>71</sup>

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<sup>71</sup> Franchising Law in Nigeria—Part II FRANCHISING LAW: Does Nigeria Need One? Do other countries have them? Dr. Uche Eweluka Ofodile, LL.B. (Nig.), LL.M (London), LL.M. (Harvard), SJD (Harvard), Professor, University of Arkansas School of Law [http://www.nigerianfranchise.org/images/NiFA\\_Newsletter\\_03\\_05\\_14.pdf](http://www.nigerianfranchise.org/images/NiFA_Newsletter_03_05_14.pdf)

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