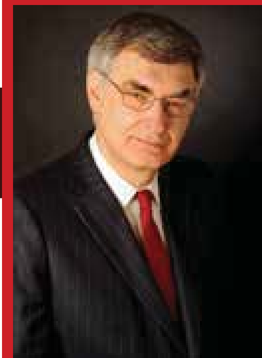
FRANCHISE LAW:
MYTH & REALITY

By Stanley M. Dub



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Franchising is an American concept with global reach. By some measures, it accounts for 15-20 percent of all business activity in the United States. Yet law school courses in franchise law are rare and relatively few attorneys specialize in the area. Not surprisingly, misconceptions abound. This article will examine a few of these franchise law *myths*.

MYTH #1: THE FEDERAL TRADE COMMISSION REGULATES FRANCHISE DISCLOSURE.

While sale of franchises is subject to a trade rule of the Federal Trade Commission (FTC), there is no private right of action for violation of it. The FTC has not brought an enforcement action under this rule for several decades. The rule requires franchise sellers to provide buyers with a franchise disclosure document (FDD) and the document itself urges buyers to report violations to the FTC, but the FTC routinely declines to take enforcement action for violation of the rule. In practice, enforcement of franchise disclosure rules relies on state law.

State franchise disclosure laws fall into three groups. In about one third of the states, franchise sellers are required to register the FDD with a state agency, which reviews the document for compliance with disclosure rules. Another third of the states have no law relating to franchise disclosure. In those states, a franchise buyer complaining about disclosure violations must resort to common law remedies, such as a suit for fraud.

The remaining states, including Ohio, have laws regulating franchise disclosure and generally provide a private right of action where disclosure rules are violated, but do not require that the FDD be registered with a state agency. Even though no state review of the document is required, the consequences of non-compliance can be severe. Under Ohio's law, RC 1334 et seq., violation can entitle a buyer to rescind the transaction, recover attorney fees and recover up to three times its damages.

MYTH #2: UNREASONABLE TERMS IN A FRANCHISE AGREEMENT ARE NOT ENFORCEABLE.

Franchise Agreements typically contain non-compete clauses and we've come to expect that these will only be enforced to the extent that they are reasonable in geographic scope and duration. However, a recent federal court decision suggests franchisees could be required to live with the agreements they sign regardless of their reasonableness.

In *Rodriguez v. Tropical Smoothie* U.S. Dist. LEXIS 750 (2012), the plaintiff signed an agreement to operate a fruit smoothie franchise near Dayton, Ohio. The plaintiff purchased the franchise based on impermissible earnings representations made to him by a Tropical Smoothie franchisee. The plaintiff was not told the franchisee would receive a share of plaintiff's franchise fee as compensation for finding another franchise buyer. The franchisee urged him to sign the franchise agreement without spending money on a legal review, arguing that the franchisor would not agree to make changes anyway, the agreement was reasonable, and that he himself had signed it without making any changes.

The plaintiff's business quickly failed causing him to lose his entire life savings. He brought suit for violation of Ohio's franchise disclosure law, but the franchise agreement required that claims be arbitrated in Atlanta with three arbitrators and that plaintiff advance the full cost of the arbitration proceeding. The defendant filed a motion to dismiss based on the arbitration clause and the plaintiff argued the clause was unconscionable and should therefore not be enforced. Applying Florida law, a U.S. district court agreed that the full payment requirement was unreasonable, but nonetheless granted the defendant's motion to dismiss because the plaintiff had not read the arbitration language or hired an attorney to review it before signing. Despite the plaintiff's argument that, "Americans are constantly bombarded with lengthy agreements on such subjects as software licenses, credit cards, internet and cellphone services, many of which do not generally get read," the court created a different rule for franchise agreements, stating, "a franchise agreement is a significant business venture and with it comes significant financial risk and responsibility." On appeal, the 6th Circuit Court of Appeals affirmed without issuing an opinion.

MYTH #3: OUT OF STATE CHOICE OF LAW PROVISIONS ARE ROUTINELY ENFORCED.

What good is a state law regulating franchise disclosures if it can be defeated by a contract clause selecting a different state's law? Few state laws would afford Ohio franchisees the same protections afforded under Ohio's law and in many states there would be no franchise law at all or the law might apply only to franchises located in the state. Ohio's franchise law has always included language invalidating out of state choice of law provisions, but until recently, this provision was frustrated by a court decision rendering it ineffective. *See Tele-Save Merchandising Co. v. Consumers Distrib. Co.*, 814 F.2d 1120 (6th Cir. 1987).

With the passage of the 2012 amendments to the Ohio law, the rationale cited in *Tele-Save* to disregard the Ohio law, should no longer apply (Compare language of the amended Ohio Act with *Cottman Transmission Systems v. Consumers Distrib. Co.*, 492 F.Supp2d 461 (ED Pa 2007)). After these amendments, Ohio's franchise law should apply to Ohio franchisees, even if their franchise agreements specify that a different state's law applies.