

The Socioeconomic Consequences of the Franchise System of Distribution

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The author explores and evaluates both the functional and dysfunctional consequences of a system of distribution which accounts for approximately 25% of total consumer goods' expenditures in the United States.

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ALL systems of distribution must have both economic and social sanctions in order to survive. Some systems of distribution have been specifically outlawed by federal antitrust legislation, such as cartels; other systems have been subjected to government regulation, such as the "natural" monopolies; while still others have either vanished or have seen their market position greatly reduced as an economic consequence of new forms of marketing. Examples are trading posts, yankee peddlers, general stores, and general-merchandise wholesalers.

Although much has been written about the advantages and disadvantages of franchising from both the franchisees' and the franchisors' perspectives, no research has viewed franchising primarily from a socioeconomic perspective.¹ Since franchised businesses account for approximately 25% of consumer goods' expenditures,² an inquiry into the socioeconomic implications of franchising seems imperative.

This article comments briefly on a definitional problem in franchising, and then evaluates some of the social and economic consequences of franchising as a system of distribution. The data resulted from a two-year investigation of "fast food," convenience grocery, and laundry/dry cleaning franchising which was funded by a grant from the Small Business Administration.³ The study employed a probability sample of approximately 1,000 completed questionnaires from franchisees. In addition, 151 franchise contracts and 146 completed questionnaires from franchisors were used in the study.

1. Sam A. Preston, "Pro-Why, How, Advantages," and Lawrence E. Singer, "Con-Why Company-Owned Units," in *Franchising Today*, Charles L. Vaughn, ed. (New York: Matthew Bender, 1967), pp. 15-33; Jan Cameron, *The Franchise Handbook* (New York: Crown Publishers, Inc., 1970); and Robert M. Dias and Stanley I. Gurnick, *Franchising: The Investor's Complete Handbook* (New York: Hastings House, 1969).

2. Senator Philip A. Hart, *Congressional Record* (Washington, D.C.: Proceedings and Debates of the 92nd Congress, First Session), Vol. 117, No. 124.

3. Urban B. Ozanne and Shelby D. Hunt, *The Economic Effects of Franchising* (Washington, D.C.: U.S. Government Printing Office, 1971).

What is Franchising?

The absence of an unambiguous definition of a franchise has been one of the problems which has plagued researchers of franchising.⁴ The present study employed the following definition to denote a franchise relationship:

1. A contract exists which delineates the responsibilities and obligations of both parties.
2. A strong continuing cooperative relationship exists between them.
3. The franchisee operates the business substantially under the trade name and marketing plan of the franchisor.

This definition would encompass manufacturer-retailer franchisors (the automobile and oil companies), manufacturer-wholesaler franchisors (the soft-drink companies), wholesaler-retailer franchisors (the voluntary chains in food retailing), and the service sponsor-retailer (fast food systems).

Purported Favorable Consequences of Franchising

Franchising advocates claim many favorable consequences of the franchise system of distribution. A review of the literature suggests that the following favorable consequences are most often attributed to franchising.

1. *Franchising greatly increases the opportunities for individuals to become independent businessmen.*

Two issues arise: (a) Are franchisees "independent" businessmen; and (b) what percentage of franchisees would be independent businessmen if franchising did not exist?

Some writers have asserted that a franchisee "[Has] that pride of independence which accompanies being his own boss to a greater than a lesser extent."⁵ Others claim that little distinction exists between the independence of a franchisee and the branch manager of a chain store.⁶ Prior to 1966, the Small Business Administration (SBA) had standards of independence which precluded most franchisees from SBA assistance. However, since 1966 most franchisees fall within the scope of the SBA's definition of independence and, hence, are eligible for financial assistance.⁷

4. E. Patrick McGuire, *Franchised Distribution* (New York: The Conference Board, 1971), p. 3; and Report of the Minister's Committee on Franchising (Ontario, Canada: Department of Financial and Commercial Affairs, 1971), p. 36.

5. David B. Slater, "Some Socio-Economic Footnotes on Franchising," *Business Review*, Vol. II (Summer, 1964).

6. Jerome Shuman, "Franchising—*Quo Vadis?* The Future of Franchising and Trade Regulation," *Franchise Legislation*, hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate (Washington, D.C.: U.S. Government Printing Office, 1967), p. 514.

7. Same reference as footnote 3, p. 150.

The present study concluded that franchisees *believe* they are independent businessmen since they perceive themselves to have primary responsibility for six out of seven key operating areas, such as determining hours of operation, book-keeping, local advertising, pricing, standards of cleanliness, and number of employees.⁸ Only in "determining additions and deletions to the product line" did franchisees indicate that the primary responsibility belongs to the franchisor.

Even if franchisees are to be considered independent businessmen, the claim that franchising creates new businesses would not be valid if a high percentage of franchisees would have gone into business for themselves without a franchising arrangement. This study provided several estimates of the net effect of franchising on the creation of new businesses. The mean of these estimates was 52%;⁹ that is, if franchising did not exist, approximately 52% of those franchisees studied would not be self-employed. The data suggest that franchising does make a substantial contribution to the creation of small new businesses. Since owning their business has long been a legitimate aspiration of a large segment of the population; since the entry of large numbers of competitors in various industries heightens competition; and since much of the stated national policy favors small businesses (as exemplified by the Small Business Administration, programs to save the family farm, and the intended purpose of such legislation as the Robinson-Patman Act), a distribution system which encourages the formation of new businesses would seem desirable.

2. *Franchised businesses have lower failure rates than other businesses.*

In a "mixed" free enterprise economic system the discipline of the marketplace results in the survival of the most efficient members. However, business failures bring about wasted resources, economic disruption, and at least temporary unemployment. If franchising does lower the business failure rate by increasing marketing efficiency through superior management techniques, this would be both a socially and economically desirable outcome.

Although a low failure rate for franchised businesses has been frequently cited,¹⁰ the only "hard" evidence comes from a study conducted by Atkin-

8. Same reference as footnote 3, p. 152.

9. Same reference as footnote 3, p. 114.

10. Harry Karsh, *The Franchise Boom* (New York: Prentice Hall, 1969), p. 49; J. A. H. Curry et. al., *Partners For Profit* (New York: American Management Association, Inc.), p. 94; "Franchising—No End to its Growth," *Printer's Ink*, Vol. 20 (August 13, 1965), p. 3; and Alfred R. Oxenfeldt and Donald N. Thompson, "Franchising in Perspective," *Journal of Retailing*, Vol. 44 (Winter, 1968-69), p. 6.

son.¹¹ Unfortunately, an intensive analysis of the Atkinson research revealed such serious methodological and data-interpretation errors¹² that the monograph has been withdrawn from circulation.¹³ Consequently, no conclusive evidence exists that franchised businesses have lower failure rates than other businesses.

3. *Franchising decreases economic concentration by providing a viable alternative to completely integrated vertical chains.*

This position is advocated by Zeidman who believes:

Franchising may well be the only feasible alternative to the increasing vertical integration of so many segments of our economy. It may well be one of the most promising hopes for the preservation of the independent small businessman in our society.¹⁴

It does appear that economic concentration would be greater if franchisors owned all their currently franchised units. For example, if the automobile manufacturers owned all their dealerships, their assets would increase by the substantial sum of \$4 billion.¹⁵ However, the major issue is whether franchising is a *permanent* form of distribution or whether firms use franchising as a *temporary* system of distribution in order to raise enough capital to form completely integrated chains. Some theorists have postulated that franchise systems will ultimately become wholly owned chains,¹⁶ and the "buy-back" policies of many fast food franchisors suggest that they may not view franchising as a permanent form of distribution.¹⁷ The National Association of Automobile Dealers has expressed concern over the forward integration of automobile manufacturers into automobile retailing:

Manufacturers have assured their dealers and NADA that they have no inclination or desire to

supplant their franchisees with direct retail outlets of their own. Let me point out, however, that an alarming number of manufacturer-owned retail establishments have been set up in various metropolitan areas throughout the country. Since the great majority of new motor vehicles are sold in these population centers, the manufacturer can, by increasing his direct sales outlets, control the major markets.¹⁸

The present research indicated that the ratio of franchised units to company-operated units in fast food franchise chains diminished from 81 to 1 in 1960 to only 10 to 1 in 1970 despite the fact that these were years of rapid growth for franchising. New restrictive legislation at both the state and federal levels may also push many franchisors toward company-operated units.¹⁹ This legislation, which forces franchisors to submit to time-consuming and expensive state registration procedures and which regulates the provisions of the franchise contract (with special attention to termination provisions), may convince many franchisors that franchising is a less desirable method for expansion than company-operated units. If the trend toward company-operated units continues, the benefit of decreasing economic concentration may prove largely illusory.

4. *Franchising provides opportunities for minority group members to own their own business.*

Franchising appears to offer potential business opportunities to minority group members because of the substantial advantages of franchise systems, such as well-known trade names, training programs, capital assistance, and continued management counseling. Unfortunately, this is reflected more in future promise than present reality. The present study showed that minority group members hold only 1.5% of fast food franchises, although they make up about 16% of the total population. Other studies have also demonstrated the low participation of minority groups in franchising.²⁰

Although special industry and government programs²¹ have attempted to spur the development of minority group (particularly black) franchises, results to date have been nominal. Reasons for

11. J. F. Atkinson, *Franchising: The Odds-On Favorite* (Chicago: International Franchise Association, 1968).

12. Same reference as footnote 3, pp. 96-98.

13. Private communication from Jerry Opack, executive vice-president, International Franchise Association, August 20, 1971.

14. Statement of Philip F. Zeidman, Washington Counsel, I.F.A., *The Impact of Franchising on Small Business*, hearings before the Subcommittee on Urban and Rural Economic Development (Washington, D.C.: U.S. Government Printing Office, 1970), p. 142.

15. Statement of Lyman Slack, Chairman, Industrial Relations Committee, National Automobile Dealers Association, *Franchise Legislation*, hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, Senate (Washington, D.C.: U.S. Government Printing Office, 1967), p. 233.

16. Alfred R. Oxenfeldt and Anthony O. Kelly, "Will Successful Franchise Systems Ultimately Become Wholly Owned Chains?" *Journal of Retailing*, Vol. 44 (Winter, 1968-69), pp. 69-83.

17. "The Chains Profit by Buying the Links," *Business Week* (June 27, 1970), p. 55; and "Franchising, Troubled Dream World," *Fortune*, Vol. 35 (March, 1970), p. 121.

18. Same reference as footnote 15, p. 235.

19. See the "Franchise Investment Law," Division 5, Added to Title 4 of the Corporation Code of the state of California, operative on Jan. 1, 1971. Also Senate Bill No. 755 regulating franchising in the state of Washington, and Senate Bill No. 784 regulating franchising in Wisconsin.

20. Arthur McZier, "Minority Franchising: Its Development, Prospects, and Problems," paper presented before the Sixth Annual International Management Conference on Franchising, Boston College, April 3, 1970.

21. John Y. Brown, Jr. and Brady Keys, "Forum: All-Pro, KFC Announce Joint Innerscity Venture," *Fast Foods*, Vol. 69 (October, 1970), p. 10 ff.; Leonard Karot and Thomas W. Bell, "Two Plus You: A Case Study of Minority Business Development," *Fast Foods*, Vol. 69 (July, 1970), p. 16 ff.; and same reference as footnote 3, p. 188.

this lack of success appear to be financial, educational, and cultural:

(a) Blacks frequently do not have the financial resources necessary to purchase a franchise, and franchisors customarily do not have the financial capacity to subsidize large numbers of black franchisees. Also, franchisors have experienced long delays in obtaining governmental assistance in financing minority group franchisees.²²

(b) Blacks frequently lack basic managerial skills, and the typical two-week training program of most franchisors would not be adequate to teach these skills.²³

(c) Success among blacks has frequently centered on the professions of law, medicine, teaching, and the ministry. Blacks frequently do not respond to franchising advertising because they simply do not *aspire* to be independent businessmen.²⁴

5. *Franchising assists consumers by providing standardized products to an increasingly mobile public.*

Franchisees,²⁵ franchisors,²⁶ and academicians²⁷ have all suggested that the uniform quality of products of franchise systems constitutes a benefit to the mobile consumer. However, two questions frame this issue: (a) Do consumers really *want* the standardized products of franchise systems; and (b) if consumers do want standardized products, can other systems of distribution provide them? The financial success of hundreds of franchise systems yields impressive evidence that large segments of the population desire standardized products, and thus the marketplace has resolved the first question.

The issue of alternative systems is not so easily resolved. Certainly, corporate chains with their company-operated units can provide standardized products. Uniformity of business operation is, in fact, easier to obtain with company-operated units than with a franchise system; franchisees must be persuaded to promote uniformity, whereas company managers can be *told* to do so. This has caused some firms to avoid franchising:

Better management control is another reason that we have company-owned stores. I saw a recent situation where a franchise competitor

wanted to change his prices and he went through considerable turmoil in order to convince his franchise operators to go along with the price increase. He ended up changing some of the prices, not all of them, and he is still working on the problem of raising prices. Policies, graphics, advertising, merchandising, quality control, remodeling repairs—how do you convince a franchise dealer that even if a store is only ten years old, he must invest more of his money for remodeling?²⁸

Therefore, although consumers apparently want standardized products conveniently available, the franchise system of distribution offers no particular advantage in this regard vis-à-vis corporate chains with company-operated units. However, many firms lack the capital to expand via company-operated units, and franchising may promote standardized products by providing these firms with a low-cost method for expansion.

Purported Unfavorable Consequences of Franchising

Not all commentators on franchising are favorable. Franchising critics purport that there are numerous unfavorable aspects to franchising. Many of their diverse criticisms can be grouped under the three major dysfunctional consequences which follow.

1. *Franchising is an anticompetitive system of distribution.*

Two elements basic to franchising are the *cooperation* between franchisor and franchisee, and the *control* the franchisor exerts over the franchisee's activities. When does *legal* cooperation become *illegal* collusion, and when do franchisor assistances become anticompetitive, promonopoly controls? Tying agreements, territorial restrictions, and pricing policies have all been focal points for charges that franchising is anticompetitive.

Four court decisions address the issue of whether a franchisor's control over his franchisee's purchasing decisions constitutes an illegal tying agreement. In the *Brown Shoe*²⁹ case, Brown's plan of offering valuable business assistance, such as architectural plans and inexpensive group insurance, to its dealers in exchange for their concentration on the Brown Shoe line was held to be an illegal tying agreement. Similarly, the Supreme Court held in *Atlantic Refining*³⁰ that Atlantic could not force its independent dealers to carry Goodyear TBA—tires, batteries, and accessories. However, in *Carvel*³¹ the FTC held that

28. Singer, same reference as footnote 1, p. 25.

29. *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962).

30. *Atlantic Refining Co. v. Federal Trade Commission*, 381 U.S. 357 (1965).

31. *Carvel Corp. et al.*, F.T.C. Dkt. 8574, CCH Trade Reg. Reporter, 1965-1967, Transfer Binder, § 17, 298 (Commission Decision, July 29, 1965).

22. James M. Nicholson, "Some Observations and Reservations about Franchising," paper read before the Institute of Continuing Legal Education, Ann Arbor, Michigan, April 26, 1969.

23. Same reference as footnote 3, p. 134.

24. Brady Keys, "New Direction—The Ghetto Markets," *Fast Foods*, Vol. 69 (May, 1970), pp. 150-152.

25. Statement of James O'Hanlon, franchisee of Mr. Donut of America, same reference as footnote 14, p. 240.

26. Statement of Al Lapin, Jr., chairman and president of International Industries, same reference as footnote 14, p. 267.

27. Charles L. Vaughn, "Growth and Future in Franchising," in *Franchising Today—1969* (Lynbrook, N.Y.: Farnsworth Publishing Co., 1969), p. 271.

since Carvel franchised an entire soft ice cream business, it could reasonably require its franchisees to buy all ingredients of the end product from Carvel or Carvel-designated sources in order to insure quality control and to protect the trademark. Nevertheless, the quality control defense was rejected in the *Chicken Delight*³² case because the court reasoned that any competent manufacturer could produce the paper goods that the Chicken Delight franchisees were required to purchase from their franchisor.

Two cases buttress the anticompetitive charge concerning territorial restrictions. In the *Schwinn*³³ case, a bicycle manufacturer required its franchised distributors to sell only to franchised retailers in assigned territories. In turn, the franchised retailers were not allowed to sell to other retailers; e.g., discount houses. The court held the practice illegal *per se*, since it objected to "the making of any sales to retailers upon any condition, agreement, or understanding limiting the retailer's freedom as to whom he will resell the products."³⁴ Similarly, in the *General Motors*³⁵ case the court held that GM could not collude with its dealers in the Los Angeles area to prevent certain franchised dealers from selling to nonfranchised (discount) outlets since this represented a classic conspiracy in restraint of trade.

Price-fixing charges against franchising gain support from *Albrecht and Sealy*.³⁶ In *Albrecht*, the St. Louis *Globe-Democrat's* policy of specifying the maximum price at which its franchised dealers could sell its newspapers was held illegal *per se*. A similar *per se* violation was the agreement between Sealy, a bedding trademark owner, and its franchisees to establish uniform prices.

Practices similar to those discussed above, and which may be in violation of antitrust statutes, remain commonplace in franchising. For example, 50% of 117 responding fast food franchisors in the sample indicated that they *did* "specify the prices of the franchisee's products." Similarly, 28% required the franchisee to purchase his paper goods from the franchisor, and 85% assigned an exclusive territory to their franchisees.

The vigorous prosecution of purported anticompetitive practices in franchising has prompted some commentators to forecast doom:

The ultimate consequences of this decision [Schwinn] are yet to be realized. It may well

32. *Harvey Siegel and Elaine Siegel, et al., v. Chicken Delight, Inc.*, CCH ¶73, 146 (D.C.V. Col., April, 1970); BNA ATRR No. 458 (April 21, 1970), A-1, X-1.

33. *United States v. Arnold Schwinn & Co.*, 388 U.S. 365 (1967).

34. Same reference as footnote 33, p. 378.

35. *United States v. General Motors*, 234 F. Supp. 85 (S.D. Col. 1964), reversed 384 U.S. 127 (1966).

36. *Lester J. Albrecht v. The Herald Co.*, 389 U.S. (decided March 4, 1968), and *United States v. Sealy Inc.*, 35 U.S. Law Week 4571 (decided June 12, 1967).

cause many larger manufacturers to vertically integrate their distribution channels in order to retain control over the manner in which their products compete with other, similar products. . . . This movement could leave many small manufacturers at a decided competitive disadvantage, and could dry up the source of supply for many distributors and retailers. This concept of competition, currently fashionable in Washington, could cause serious injury to the very types of business it seeks to protect. The socioeconomic effect on ultimate consumers of increased intrabrand competition, or, at the opposite extreme, increased vertical integration, is conjectural.³⁷

Franchisors go to great lengths to substantiate the claim that franchisees are not employees, but rather "independent businessmen."³⁸ Of the 121 fast food contracts sampled, 64% specifically stated that the franchisee is neither an agent nor an employee of the franchisor. Antitrust laws generally restrict groups of independent businessmen from certain activities that are routine in employer-employee relationships; e.g., setting uniform prices. Franchising advocates apparently want it both ways; they want franchisees to be considered independent and, at the same time, request special treatment under the antitrust laws. The courts have shown and probably will continue to show no tendency to accord such special treatment to franchising.

2. Franchise agreements are one-sided in favor of protecting the prerogatives of franchisors.

As evidence that franchise agreements are unfair, critics cite franchise termination clauses which allow the franchisor to put the franchisee out of business because of trivial violations of the agreement.³⁹ The present study found that over half of the franchise contracts incorporated as a part of the agreement the operating manual (a manual detailing specific procedures for operating the business). Since the provisions of the operating manual can be changed at the prerogative of the franchisor, the franchisees find themselves in the tenuous position of being bound to a contract that can be modified *unilaterally* by the

37. Louis W. Stern and John R. Grabner, *Competition in the Marketplace* (Glenview: Scott, Foresman and Co., 1970), pp. 137-138.

38. Robert L. Grover, "Current Legal Problems in Franchising as Seen by the Franchise Industry," in *Franchising Today* (Lynbrook: Farnsworth Publishing Co., 1969), pp. 163 and 169.

39. Harold Brown, "Franchising: Legislating Full Disclosure, Good Faith and Fair Dealing," *Boston Bar Journal*, Vol. 15 (September, 1971), p. 18; Philip F. Zeidman, "The Franchise Agreement—Its Achilles' Heel," *Franchise Legislation*, same reference as footnote 6, p. 521; and statement of Robert M. Dias, same reference as footnote 14, p. 112.

franchisor. Grounds for termination are limitless under such circumstances.

Similar charges of unfair agreements stem from "covenants not to compete," which prohibit the franchisee from practicing his trade for a specified time period within a specific geographical area after his franchise is terminated.⁴⁰ Sixty percent of the sample contracts had such clauses. Other clauses cited as onerous include requiring the franchisee to buy supplies and equipment from the franchisor, severely restricting the franchisee's right to sell the franchise, prohibiting the franchisee from joining any association (union) of franchisees, and the lack of arbitration clauses (only 23% of the agreements studied had procedures for arbitrating disputes between franchisee and franchisor).⁴¹

Franchising advocates point out that franchisees and franchisors are businessmen, and, as such, they should be free to negotiate any contract—even one which is strongly one-sided. They contend that the doctrine of sanctity of contract remains valid, and that the courts have upheld and will probably continue to uphold the provisions of contracts entered into freely.⁴²

Critics counter that franchise agreements, far from being *negotiated* contracts, are actually contracts of *adhesion* where the potential franchisee must agree to adhere to the standard contract if he wishes to buy a franchise.⁴³ Critics view franchise agreements as comparable to insurance policies which, similarly, are *sold*, not *negotiated*.⁴⁴ Many franchisors can offer the franchise contract on a "take it or leave it" basis because (1) potential franchisees have been presold on franchising through numerous "rags to riches" articles in the popular press; (2) the potential franchisee is at an extreme negotiating disadvantage in not knowing which of the franchisor's claims about the profitability of the franchise are fact and which are puffery; and (3) the franchisor's lawyers are likely to be much more sophisticated at drafting franchise agreements than the franchisee's attorney. Frequently, franchisees are not represented by counsel at all; almost 40% of the sample of franchisees had *not* consulted a lawyer before signing the agreement.

3. Franchisors employ unethical techniques in selling franchises.

40. Harold Brown, *Franchising: Trap for the Trusting* (Toronto: Little, Brown and Co., 1969), p. 27.

41. Same reference as footnote 40, pp. 14, 25, and 26.

42. Statement of Ernest Gellhorn, "Panel Discussion," in *The Franchising Phenomenon*, James Rice, ed. (Ann Arbor: The Institute of Continuing Legal Education, 1969), pp. 228-229.

43. Statement of Joel N. Simon, same reference as footnote 42, p. 229.

44. Robert F. Corliss, "Franchising: Time for a New Beginning?" *Boston Bar Journal*, Vol. 15 (September, 1971), p. 10.

Three types of unethical selling practices have occurred in franchising: (a) "Pyramid" distribution schemes; (b) the use of a celebrity's name in promoting a franchise; and (c) misrepresenting the potential profitability of the franchises. A pyramid distribution scheme is a contemporary business variant of the chain-letter device. Investors purchase the right to sell subdistributorships. These subdistributors, in turn, sell other distributorships. Often, very little of the product ever changes hands since the real profit lies in the sale of distributorships. Representatives of the U.S. Post Office Department claim:

The pyramid-type chain promotion in the fraudulent sale of franchises is perhaps the most insidious devised to date. It provides schemers with a limitless sucker list and can reach enormous proportions in a minimum length of time. Its most thoroughly vicious feature is, of course, its self-perpetuating nature. An honest victim once ensnared might well, in turn, become dishonest and sell to others in order to recoup his losses, and on and on it goes.⁴⁵

The Federal Trade Commission has expressed growing concern over pyramid schemes,⁴⁶ and the Province of Ontario's *Report of the Minister's Committee on Franchising* has recommended legislation to regulate such schemes.⁴⁷ Similarly, Wisconsin has declared "chain distributor schemes" to be an unfair trade practice; consequently, they are prohibited.⁴⁸

Franchising critics charge that using a celebrity's name to promote the sale of a franchise also represents an unsavory practice in selling franchises:

In many cases the companies involved either sponsor or are sponsored by leading personalities in the entertainment or sports worlds. The franchisee is likely to believe that such persons would not lend their names to endeavors unless they were sound and respectable ones. Again such is not the case.⁴⁹

Problems with celebrity franchisors prompted the Select Committee on Small Business, U.S. Senate, to recommend:

Much recent controversy has centered around the use of a public figure or celebrity to promote the sale of a franchise. . . . It should be

45. Statement of William J. Cotter, chief postal inspector, U.S. Post Office Department, same reference as footnote 14, p. 465.

46. Statement of John V. Buffingham, general counsel, Federal Trade Commission, same reference as footnote 14, p. 313.

47. *Report of the Minister's Committee on Franchising* (Ontario, Canada: Department of Financial and Commercial Affairs, 1971), pp. 21-35.

48. Chain Distributor Schemes, Wisconsin Administrative Code, section Ag. 122, p. 327a.

49. Statement of Robert M. Dias, president, National Association of Franchised Businessmen, same reference as footnote 14, p. 111.

incumbent upon a franchisor who promotes the sale of his franchise by wide-spread publicity which associates the franchise with a public figure or celebrity to fully disclose the nature of any financial or business relationship between the franchisor and the public figure prior to any sale of the franchise.⁵⁰

The widespread use of the celebrity franchise system seems to have waned. Few new celebrity systems are being started, and many of the present systems which have relied heavily on the drawing power of a celebrity name have experienced severe financial problems.⁵¹ One reason for the decline of celebrity franchising is that potential franchisees are now wary of buying a celebrity franchise as a result of numerous articles in the popular press which have widely publicized the problems associated with this kind of franchise.

The third charge of unethical selling practices relates to franchisors misrepresenting the potential profitability of their franchises. Although there have been many allegations of misrepresentation⁵² and some specific actions taken by the Federal Trade Commission against individual franchisors,⁵³ until now there has been little evidence of widespread, systematic misrepresentation.

The present study obtained the pro-forma income statements which 67 fast food franchisors show to prospective franchisees as profit projections. The study also had detailed profit data from 282 franchises associated with chains who use the pro-forma income statements in sales promotions. The results were dramatic: 73% of the franchisees had incomes *below* the minimum projected by the pro-forma statements; 92% had incomes below the average projected figures; and 99% had incomes below the maximum projected incomes. Little doubt remains that many franchisors are systematically misleading prospective franchisees as to the potential profitability of their franchised businesses.

Summary

Significant evidence exists that franchising has a net positive effect on the creation of new busi-

nesses. Franchising decreases economic concentration, but this positive advantage may be fleeting if the trend toward company-operated units continues. Similarly, although franchising provides standardized products for mobile consumers, corporate chains with company-operated units can often accomplish the same result. No "hard" evidence supports the assertion that franchised businesses have lower failure rates than other businesses. Although franchising may in the *future* bring significant numbers of minority group members into the mainstream of economic activity, present and past performance in this regard has been nominal.

On the negative side, many common practices in franchising, such as price collusion and tying agreements, have been struck down by recent court decisions as violations of antitrust statutes. Under current antitrust legislation, the franchise system of distribution is unlikely to receive special exemption.

The onerous provisions in many franchise agreements provide powerful evidence that they are one-sided contracts of adhesion rather than balanced, negotiated agreements. The legitimate grievances of franchisees in this area may be partially redressed by both state and federal legislation.⁵⁴ Although many franchising critics have articulated the need for *general* "good faith and fair dealing" legislation,⁵⁵ the proposed federal legislation is restricted primarily to protecting the franchisee from arbitrary termination by the franchisor.

Substantial evidence also exists that franchisors are not disclosing adequate information about their franchises in order for potential franchisees to carefully evaluate franchise offerings. In particular, many franchisors are systematically misleading prospective franchisees as to the potential profitability of their franchised businesses. Once again, both state and federal legislation has been proposed to require franchisors to make full disclosure of all pertinent information to potential franchisees prior to the signing of the agreement.⁵⁶

On balance, the net socioeconomic consequences of the franchise system of distribution appear to be positive. There remain abuses and dysfunctional consequences associated with franchising, but these are amenable to resolution through the courts or through new legislation. A closing *caveat*, however; proposed remedial legislation must be carefully drafted to prevent the crippling of a system of distribution which plays such a major role in our economy.

50. *Impact of Franchising on Small Business*, report of the Select Committee on Small Business, United States Senate (Washington: U.S. Government Printing Office, November 13, 1971), pp. 16-17.

51. "Fullback Brown Gets Thrown for a Loss," *Business Week* (January 10, 1970), p. 58. Also "Athletes Fail to Carry Success on the Field into Business Ventures," *The Wall Street Journal* (January 4, 1971), p. 1; and "Franchises Often Just Use Names," *Wisconsin State Journal* (January 22, 1971), p. 3.

52. Statement of Robert M. Dias, same reference as footnote 14, p. 112; Harold Brown, same reference as footnote 41, p. 17; and statement of Victor J. Nitti, D.D.S., New Jersey dentist and an "A to Z Rental" franchisee, same reference as footnote 14, p. 409.

53. "FTC Announces Order Against Barton's Candy," *The Wall Street Journal* (March 9, 1971), p. 3.

54. Senate Bill No. 755, state of Washington, and United States Senate Bill No. 2472, *Fairness in Franchising Act*.

55. Harold Brown, same reference as footnote 41, pp. 15-23.

56. Same reference as footnote 19, and *Franchise Full Disclosure Act of 1970*, U.S. Senate Bill No. S.3844.