

Full Disclosure Laws in Franchising: An Empirical Investigation

*What effects have the full disclosure laws had
on the franchise system of distribution?*

FRANCHISING is a system of distributing goods and services that has three distinguishing characteristics: (1) one party (the franchisor) grants to another party (the franchisee) the right to distribute or sell certain goods or services; (2) the franchisee agrees to operate his business according to a marketing plan substantially prescribed by the franchisor; and (3) the franchisee operates his business substantially under a trademark or trade name owned by the franchisor. The franchise system of distribution annually creates new business opportunities, new services, new jobs, and new export opportunities. Although the system dates back at least to the early 1900s (with automobile, tire, and petroleum products), about 90% of all present franchisors started their businesses since 1953. Growth has been primarily in such areas as fast foods, convenience groceries, business services, hotels and motels, recreation, entertainment, and travel.¹ The franchise system of distribution accounts for nearly one-third of total retail sales in the United States, and it provides employment for approximately three million people.²

With this rapid growth, however, franchising has increasingly come under the scrutiny of federal and state governments. An important recent development is the passage by ten states (as of 1975) of full disclosure laws aimed at controlling

unfair practices in the selling of franchises. Under these laws, franchisors must give ample unbiased information to franchisees to help them make wise investment decisions.

This article examines the issue of full disclosure laws in franchising by first reviewing some of the legal problems in franchising and discussing some legislative remedies. Then the results of an empirical study of the effects of the full disclosure laws on franchising are presented. Finally, the costs and benefits of the full disclosure laws are evaluated.

Legal Problems in Franchising

Franchising represents a viable alternative to completely integrated corporate chains. Without franchising, thousands of small businessmen would never have had the opportunity to own their own businesses, and hundreds of small entrepreneurs with little capital would not have been able to take an idea and build from it a large multiunit organization. Although "the net socioeconomic consequences of the franchise system of distribution appear to be positive,"³ in recent years franchising has been inundated with legislation pitting franchisee against franchisor.

One critic of franchising has identified over 60 prominent franchisors who are, or recently have been, involved in franchise litigation.⁴ Jerrold G.

1. U.S. Department of Commerce, *Franchising in the Economy, 1972-1974* (Washington: U.S. Government Printing Office, 1974), p. 3.

2. Same reference as footnote 1.

3. Shelby D. Hunt, "The Socioeconomic Consequences of the Franchise System of Distribution," *JOURNAL OF MARKETING*, Vol. 36 (July 1972), p. 38.

4. Harold Brown, *Franchising—Realities and Remedies* (New York: Law Journal Press, 1973), p. 6.

Van Cise has noted that most of the litigation in franchising stems from three major types of deceptive practices used by franchisors:⁵ (1) deceptive practices in the *granting or selling* of the franchise, (2) deceptive practices in the *operation* of the franchise,⁶ and (3) deceptive practices in the *termination* of the franchise. To these must be added the fourth legal problem of franchisors' imposing vertical territorial restraints on franchisees. This article will focus on deceptive practices in the *granting or selling* of franchises.

In 1970, the attorney general of New York declared: "Thousands of people are being bilked of hundreds of thousands of dollars by glib salesmen and misleading literature selling worthless franchises. . . . In almost every instance, the franchise-offering literature was either inadequate, misleading, wholly lacking or blatantly false as to material facts necessary to make an intelligent investment decision."⁷ Concluding that "franchising literally abounds with deceptive selling practices," previous research by one of the authors identified six deceptive practices that cover most of the major kinds of misrepresentation in selling franchises.⁸ These practices include franchisors' (1) misleading prospective franchisees about the potential profitability of their franchises, (2) refusing to show actual profit and loss statements to potential franchisees, (3) having "hidden charges" in the prices franchisees are charged for services and supplies, (4) using a celebrity's name to deceptively promote the franchise, (5) overpromising on their aids to franchisees, and (6) using high-pressure tactics in closing the sale of a franchise. These deceptive practices have prompted the state

legislatures, Congress, and the Federal Trade Commission to take action. Since 1970 a plethora of laws, rules, and regulations have been passed or are being considered.

Legislative Actions

State laws regulating the franchise industry are predominantly of the "full disclosure" variety, aimed specifically at unfair practices in the granting or selling of the franchise. Designed to protect prospective franchisees from misrepresentations by franchisors, the laws require franchisors to provide potential franchisees with sufficient unbiased information to enable them to make sound investment decisions. Full disclosure laws have been passed (as of 1975) in the legislatures of California, Illinois, Hawaii, Michigan, Minnesota, Oregon, Rhode Island, South Dakota, Washington, Wisconsin, and the Province of Alberta, Canada.

Most of the proposed and enacted state legislation on full disclosure closely follows the California statute, which became operative on January 1, 1971.⁹ The general provisions of the California model are:

1. Regulation of full disclosure for franchising is carried out by the state commissioner of securities.
2. Franchisors must register a prospectus with the Office of Securities. Exempted from the registration requirement are large franchisors (net worth greater than \$5 million) who have had a minimum of 25 franchises at all times during the preceding five years.
3. A sample of the items that must be included in the prospectus are:
 - a. Disclosure of the background of the principals involved with the franchisor (especially any felonies committed by the principals)
 - b. Recent financial statement
 - c. Sample franchise contract
 - d. Policy of the franchisor concerning franchise fees, royalties, and supplies
 - e. Contract termination provisions
 - f. Terms and conditions of any financial arrangements
 - g. Substantiation of any profit projections in *pro forma* statements
 - h. Disclosures relating to using the name of a public figure
 - i. Number of franchises presently operating and proposed to be sold
 - j. Territorial protection given to the franchisee
4. All franchisors must show the preceding prospectus to all potential franchisees at least 48 hours

5. Jerrold G. Van Cise, "The Boston College Center's Special Committee on Unfair and Deceptive Practices in Franchising. The Chairman's Final Report," in *Franchising Today—1969*, Charles L. Vaughn, ed. (Lynbrook, N.Y.: Farnsworth Publishing Co., 1969), pp. 185-192.

6. See Shelby D. Hunt and John R. Nevin, "Tying Agreements in Franchising," *JOURNAL OF MARKETING*, Vol. 39 (July 1975), pp. 20-26.

7. Statement by New York Attorney General Lefkowitz to Committee on Franchise Licensing of the New York Legislature, September 28, 1970. See "Staff Report in Franchising to N.Y. Attorney General," January 7, 1970.

8. Shelby D. Hunt, "Full Disclosure and the Franchise System of Distribution," in *Dynamic Marketing in a Changing World*, Boris W. Becker and Helmut Becker, eds. (Chicago: American Marketing Assn., 1973), pp. 301-304.

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9. Franchise Investment Law, Division 5, Added to Title 4 of the Corporation Code of the State of California by Stats. 1970, Ch. 1400, operative on January 1, 1971.

before signing the agreement (or receiving any consideration).

5. All advertisements for franchisees must be registered with the commissioner at least three business days prior to publication of the advertisement.

The California law has a limitation that may seriously weaken its impact. While large companies must give comparable information to prospective franchisees, they are exempt both from the public filing of their offering circulars (the disclosure statements) and from registering their advertisements. Brown has suggested that perhaps for the first time in regulatory history, "bigness is equated with honesty."¹⁰ The Wisconsin Franchise Investment Law, in contrast, is *not* subject to this potential limitation. It requires that even if a franchisor meets the registration exemption requirements, to sell or offer a franchise in Wisconsin he must still file an application and an offering circular with the commissioner of securities. Wisconsin's law also requires that exempted franchisors file a copy of any advertising used in the state of Wisconsin.¹¹

In the federal arena, two full disclosure measures were pending in the U.S. Senate as of 1975: S.3844 (The Franchise Full Disclosure Act) and S.2870. Although Senate Bill 3844 closely parallels the California law, it is national in scope and would require that all franchisors engaged in interstate commerce register a uniform disclosure prospectus with the Securities and Exchange Commission. Senate Bill 2870 is a modified version of S.3844 that also includes a provision that the full disclosure requirements would be preemptive and would thus supersede any inconsistent material in state legislation. Also pending in the Federal Trade Commission is a trade regulation rule that would likewise require full disclosure. Of these three measures, passage of the FTC trade regulation rule is the most likely.

Research Questions

The present article will explore four research questions concerning the state full disclosure laws: (1) To what extent are franchisors complying with the requirements of the full disclosure laws? (2) How successful have the full disclosure laws been in preventing franchisors from misleading prospective franchisees concerning the potential profitability of their franchises? (3) How influential have the full disclosure laws been on

the investment decisions of prospective franchisees? and (4) What effects have the full disclosure laws had on the advertising and sales of franchises by franchisors?

To obtain the information necessary to explore these four research questions, two research methods were used: a mail survey of franchisors and franchisees, and a before-after experimental design that incorporated a nonrandomly selected control group. Three groups of franchisors were included in the survey population: (1) all franchisors registered in Wisconsin, (2) all franchisors with an exempt status in Wisconsin, and (3) a systematic sample of franchisors listed in the *Franchise Opportunity Handbook*¹² who were neither registered nor exempt in Wisconsin. All franchisees in Wisconsin who had purchased a franchise from either a registered or an exempt franchisor since the Wisconsin Franchise Law was passed were also included in the survey population. Forty-eight percent of the 208 franchisors in the survey population completed and returned the mail questionnaire. The response rate for the 102 franchisees was 45%. The final sample was composed of 102 franchisors (52 registered, 19 exempt, and 31 nonregistered, nonexempt) and 45 franchisees (34 registered and 11 exempt).

The before-after experimental design examined newspaper advertising to determine the effects of the full disclosure laws on franchisor efforts to solicit franchisees. The experimental group consisted of a major newspaper from each of two full disclosure states: the *Los Angeles Times* and the *Milwaukee Journal*. The control group consisted of a major newspaper from each of two non-full-disclosure states: the *Chicago Tribune* and the *Detroit News*. The Sunday editions of these four newspapers were used in measuring franchisor advertising, because the largest number of classified ads appear on that day and because franchisors who advertised in the daily editions also advertised in the Sunday editions.

Effects of Full Disclosure Laws in Franchising

Extent of Compliance

The Wisconsin full disclosure law requires that: (1) all franchisors (except certain large franchisors that are exempt) register a prospectus with the Office of Securities before they can either advertise or sell franchises in the state; and (2) registered

10. Same reference as footnote 4, p. 257.

11. Wisconsin Franchise Investment Law (Wisc. Gen'l. Laws, Chap. 553; Chap. 241 of the Laws of 1971), effective July 1, 1972.

12. U.S. Department of Commerce, *Franchise Opportunities Handbook* (Washington: U.S. Government Printing Office, 1973).

franchisors show potential franchisees a prospectus, and exempt franchisors show potential franchisees a disclosure statement, before any agreements are signed.

The first research question asks: *To what extent are franchisors complying with the requirements of the full disclosure laws?* The study found that almost one-fourth (7 of 31) of the nonregistered, nonexempt franchisors admitted to advertising for prospects in the state of Wisconsin and, therefore, were violating the law. Further, 21% (4 of 19) of the nonregistered, nonexempt franchisors who were aware of Wisconsin's law admitted to advertising in Wisconsin, and two of these franchisors even admitted to having sold franchises in Wisconsin. Therefore, some of the nonregistered, nonexempt franchisors are admittedly not complying with the full disclosure law in Wisconsin.

Ninety-four percent (33 of 34) of the franchisees who purchased a franchise from a registered franchisor remembered being shown a prospectus, while only 73% (8 of 11) of the franchisees who purchased a franchise from an exempt franchisor remembered being shown a disclosure statement. Registered franchisors' compliance with the full disclosure law appears to be greater than that of exempt franchisors. However, this conclusion must be tempered because personal interviews in the exploratory phase of the research revealed that some franchisees may have simply forgotten that they were shown a prospectus or disclosure statement.

Misleading Franchisees on Potential Profitability

Previous research conducted prior to the passage of state full disclosure laws concluded that "many franchisors systematically mislead prospective franchisees about the potential profitability of their franchises."¹³ This conclusion was based, in part, on the finding that 37% of the franchisees in that study indicated that their franchisors had overestimated, and only 7% indicated that they had underestimated, their potential profits during negotiations for the franchise. Thus, the second research question asks: *How successful have the full disclosure laws been in preventing franchisors from misleading prospective franchisees concerning the potential profitability of their franchises?* The present results show that only 15% of the franchisees indicated that their franchisors had overestimated, and none indicated that they had underestimated, their potential profits during contract negotiations. Therefore,

the full disclosure laws appear to have greatly reduced the incidence of franchisors misleading prospective franchisees concerning the potential profitability of their franchises. Nevertheless, there still seems to be some continuing misrepresentation in this area.

Influence on Investment Decisions of Prospective Franchisees

The full disclosure laws are designed to require franchisors to provide prospective franchisees with unbiased information to assist them in making sound investment decisions. The third research question asks: *How influential have the full disclosure laws been in the investment decisions of prospective franchisees?* Only about one-fourth of the sample of franchisees indicated that some of the information on the prospectus greatly influenced their decision to buy the franchise. Most franchisees did not perceive the prospectus to be of great value. Specific items reported to be of greatest value included: (1) the geographic area covered by the franchise, (2) annual profit projection, (3) financing help, (4) costs of equipment, (5) officer background, (6) methods of operating and merchandising policies, and (7) franchisee fees, royalties, and start-up costs. Franchisees differed considerably as to what information, if any, in the prospectus greatly influenced their decisions to buy franchises.

Advertising and Sale of Franchises by Franchisors

The fourth research question asks: *What effects have the full disclosure laws had on the advertising and sale of franchises by franchisors?* To investigate the effects the full disclosure laws have had on advertising, three more specific questions must be explored: (1) What effects have the full disclosure laws had on the *amount of advertising* by franchisors to solicit franchisees? (2) What effects have the full disclosure laws had on the *nature of the advertisements* used by franchisors to solicit franchisees? and (3) What effects have the full disclosure laws had on the *kinds of franchisors who advertise* for franchisees?

Amount of Advertising. Full disclosure laws may discourage franchisors from offering franchises in a state and, therefore, may reduce the amount of advertising for franchisees. Table 1 shows the average number of franchisor advertisements for franchisees in each Sunday edition by year and quarter for each of the four newspapers. These figures show a substantial reduction in the level of franchisor advertising in states after their full disclosure laws went into effect. For

13. Same reference as footnote 8, p. 301.

TABLE 1
ADVERTISEMENTS BY FRANCHISORS FOR FRANCHISEES IN THE
SUNDAY EDITIONS OF FOUR MAJOR NEWSPAPERS

Year and Quarter	<i>Los Angeles Times</i>			<i>Milwaukee Journal</i>			<i>Detroit News</i>			<i>Chicago Tribune</i>			
	Ads ^a	Ads w Income ^b	(%) ^c	Ads	Ads w Income	(%)	Ads	Ads w Income	(%)	Ads	Ads w Income	(%)	
1970	1	46.7	3.5	(7.5)									
	2	41.7	1.3	(3.1)									
	3	35.4	2.3	(6.5)									
	4 ^d	26.5	1.8	(6.8)									
1971	1	20.9	1.5	(7.2)									
	2	13.6	.2	(1.5)									
	3	14.3	.2	(1.4)	15.4	2.5	(16.2)	5.2	2.3	(44.2)	17.8	3.6	(20.2)
	4	14.8	.2	(1.4)	12.5	2.1	(16.8)	4.8	.5	(10.4)	16.5	4.0	(24.2)
1972	1	12.5	.1	(0.8)	11.9	3.1	(26.1)	6.6	1.4	(21.2)	19.8	5.0	(25.3)
	2 ^e	11.8	.4	(3.4)	14.7	2.6	(17.7)	5.8	1.6	(27.6)	18.8	3.6	(19.1)
	3	13.8	.6	(4.3)	5.6	.8	(14.3)	8.2	1.5	(18.3)	20.4	3.8	(18.6)
	4	11.2	.1	(0.9)	4.9	.5	(10.2)	6.1	1.6	(26.2)	11.7	2.1	(17.9)
1973	1	10.4	.2	(1.9)	5.3	.7	(13.2)	7.3	1.6	(21.9)	17.7	1.9	(10.7)
	2	10.3	.4	(3.9)	6.2	.1	(1.6)	5.0	.4	(8.0)	18.4	2.1	(11.4)
	3	12.0	1.1	(9.2)	6.6	.1	(1.5)	3.9	.5	(12.8)	17.3	1.8	(10.4)
	4 ^f	9.0	.6	(6.7)	4.0	.0	(.0)	5.1	.8	(15.7)	14.0	1.8	(12.9)
1974	1									9.2	1.1	(12.0)	

^a Average number of advertisements by franchisors for franchisees in each Sunday edition.

^b Average number of franchisors' ads with income representations in each Sunday edition.

^c Percentage of franchisors' ads with income representations ($b \div a$) in each Sunday edition.

^d California's full disclosure law went into effect after 4th quarter 1970.

^e Wisconsin's full disclosure law went into effect after 2nd quarter 1972.

^f Illinois' full disclosure law went into effect after 4th quarter 1973. The observation period for Illinois was extended through 1st quarter 1974 to observe the immediate effects of the law.

example, in the year preceding the effective date of Wisconsin's full disclosure law, the *Milwaukee Journal* averaged approximately thirteen franchisor ads in each Sunday edition. However, the comparable figure in the next year was only five.

These reductions in franchisor advertising apparently cannot be attributed to extraneous factors (for example, the state of the economy), since a corresponding decrease was not evident in the *Detroit News* and *Chicago Tribune*, which served as control papers. Similar results were observed in the *Los Angeles Times* after the California law became effective, and seem to be taking place in the *Chicago Tribune* since the passage of Illinois' law. The state full disclosure laws seem to induce an immediate and perhaps permanent reduction in franchisor advertising activity.

Nature of the Advertisements. As previously mentioned, the full disclosure laws have rather stringent provisions regarding advertising practices. The Wisconsin Franchise Law, for example, contains a section entitled "Standards of Advertising," which states:

No advertising shall make reference to . . . (ii) Projections of operations or of income from the

operation of any franchise unless based on past certified and audited financial statements except during the time preceding the first yearly report of operations of the franchisor. . . .¹⁴

Advertising practice provisions like the above may discourage franchisors from using income representations in their advertisements. The term *income representations* refers to statements of actual dollar amounts of income and to extravagant claims such as "guaranteed success."

The average number and percentage of franchisors' advertisements with income representations are also shown in Table 1. The figures indicate that the percentage of franchisors using income representations in their advertisements dramatically decreased in states after the passage of their full disclosure laws. Especially notable is Wisconsin, where approximately one-fifth of franchisors' advertisements for franchisees in the *Milwaukee Journal* had income representations prior to the law, compared to virtually no advertisements with income representations a year and a half after the law. These results would appear to

14. Same reference as footnote 11.

be a consequence of the passage of full disclosure laws because there were comparatively small decreases in income representations for the two control papers.

In contrast to their advertising practices in other states, franchisors began to delete income representations from their advertisements in states with full disclosure laws. To show the nature of these deletions, the before-law and after-law versions of two franchisors' advertisements for franchisees are illustrated in Table 2. Notice that the "before-law" versions of both franchisors' advertisements contained income representations such as "Opportunity to earn \$17,000 to \$22,000 Plus Per Year," "Increased profit year after year," "You pick the income you want!" and "... once in a lifetime opportunity." The income representations have been removed from the "after-law" versions of these advertisements.

One surprising result shown in Table 1 is that the percentage of franchisors' advertisements in the *Los Angeles Times* that contain income representations suddenly increased to its prelaw level in the third year after California's full disclosure law became effective. Similar increases were not observed in the *Milwaukee Journal* or in either of the two control papers, the *Detroit News* and the *Chicago Tribune*.

Two possible explanations are tentatively proffered for this phenomenon. First, franchisors who stopped using income representations in their ads after the full disclosure law became operative may have been collecting the information required to substantiate their income representations. Hence, some franchisors may be again using income representations in their California advertisements now that they have acquired the substantiating information. If this is the case, franchisors advertising in Wisconsin can be expected to start including income representations in their advertisements in the near future.

Another possible explanation might be that the provisions of California's full disclosure law with respect to franchisor advertising are less severe and less ardently administered than the provisions of Wisconsin's full disclosure law. Wisconsin's full disclosure law states that

... no person may publish, distribute, or use in this state any advertisement offering to sell or to purchase a franchise unless 2 true copies of the advertisement have been filed in the office of the commissioner at least 5 days prior to the first publication, distribution, or use thereof.¹⁵

15. Same reference as footnote 11, p. 15.

California's law, by contrast, requires *only* nonexempt franchisors to file a true copy of the advertisement in the office of the commissioner at least three business days prior to the first publication. Hence, exempt franchisors *do not* file a copy of their advertisements with the commissioner. Also, in Wisconsin the Office of the Commissioner of Securities systematically reviews each franchisor's advertisements and suggests changes in the advertisements whenever an income representation is made that cannot be substantiated. It is possible that California's full disclosure law is not being as carefully administered as Wisconsin's, so franchisors are once again starting to include unsubstantiated income representations in their advertisements.

Kinds of Franchisors Who Advertise. As part of the full disclosure provisions in Wisconsin, franchisors (except certain large franchisors) must register a prospectus and all of their advertisements with the state commissioner of securities. Many small franchisors might not be able to afford the legal fees and filing fees associated with registering and, hence, might reduce their franchising activity (and their advertising) in states with full disclosure laws.

Two sources containing information on the size of franchisors were used in investigating whether smaller, less financially secure franchisors decrease their advertising relative to larger franchisors in states with full disclosure laws. These sources were: (1) the *Franchise Opportunity Handbook*, which reports the number of franchises per franchisor; and (2) *Standard & Poor's Register of Corporations*, which reports annual sales per franchisor.¹⁶ Although there are many small franchisors listed in the *Franchise Opportunity Handbook*, as a class they tend to be underrepresented. For example, in the fast-food restaurant category this publication lists 100 franchisors and only 22% of them have ten or fewer franchises. Other evidence indicates that over 60% of all restaurant franchisors have ten or fewer franchisees.¹⁷ The underrepresentation of small franchise systems can probably be accounted for by noting that relatively new (hence, small) franchisors will not be in the *Handbook*, and small franchisors in general are less likely to be aware of the publication than are large franchisors. Similarly, the normal pro-

16. Same reference as footnote 12; and *Register of Corporations, Directors and Executives* (New York: Standard and Poor's, 1974).

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

TABLE 2
FRANCHISOR ADVERTISEMENTS BEFORE AND AFTER WISCONSIN'S
FULL DISCLOSURE LAW: TWO ILLUSTRATIONS

Before-Law Version	After-Law Version
Illustration 1—Ready Access	
May 7, 1972— <i>Milwaukee Journal</i>	November 12, 1972— <i>Milwaukee Journal</i>
<p>You Can Own a Beautiful Ready Access Food Mart For a Very Modest Investment</p>	<p>You Can Own a Beautiful Ready Access Food Mart For a Very Modest Investment</p>
<p>Make an appointment now to visit the beautiful Ready Access Food Mart.</p>	<p>Make an appointment now to visit the beautiful Ready Access Food Mart.</p>
<p>See these modern, attractive, convenient type grocery stores in operation. Talk directly to the owners who took advantage of the opportunity to earn \$17,000 to \$22,000 Plus Per Year.</p>	<p>See these modern, attractive, convenient type grocery stores in operation. Talk directly to the owners who took advantage of the opportunity to earn.</p>
<p>Previous experience not necessary because we train you and guide you all the way.</p>	<p>Previous experience not necessary because we train you and guide you all the way.</p>
<p>Future security. Increased profit year after year. Continuing growth in the value of your franchise.</p>	
<p>Modest cash investment required for a brand new food mart, air conditioned, completely stocked and ready to go. Complete financing help available to those who qualify. Franchised stores available now in Oshkosh, Fond du Lac, Green Bay, and Milwaukee.</p>	<p>Modest cash investment required for a brand new food mart, air conditioned, completely stocked and ready to go. Complete financing help available to those who qualify. Franchised stores available now in Oshkosh, Fond du Lac, Green Bay, and Milwaukee.</p>
<p>Phone or write Bob Castle Ready Access Food Marts of Southeastern Wisconsin 7171 Summer St., Racine, Wisconsin Phone: 632-8736 or 633-2357 Ready Access</p>	<p>Phone or write Bob Castle Ready Access Food Marts of Southeastern Wisconsin 7171 Summer St., Racine, Wisconsin Phone: 632-8736 or 633-2357 Ready Access</p>
Illustration 2—Everneat	
March 26, 1972— <i>Milwaukee Journal</i>	July 30, 1972— <i>Milwaukee Journal</i>
<p>Need a Second Income? Existing Everneat Cleaning Stores</p>	<p>Everneat Cleaning Stores</p>
<p>Excellent way to supplement your family income or add to your pension. Your wife and daughter can operate the store while you continue your job. Invest from \$950 plus inventory and fixtures at cost. Larger volume stores also available. Liberal financing available.</p>	<p>Excellent possibility of supplementing your family income. Your wife and children can operate the store while you continue your job. Invest from \$950 plus inventory and fixtures at cost. Many existing locations throughout Milwaukee.</p>
<p>One of the following stores could be just right for you! These are only a few of the many locations available</p>	<p>Act today! Investigate this opportunity to own an operating store with known history of performance. Phone 331-6262 or write:</p>
<p>203 Teutonia 1445 Forest Home 138 Lincoln 144 Oakland 907 Capitol Drive</p>	<p>MR. BOB BOWMAN Everneat LAUNDRY & CLEANERS 170 Regent Drive, Milwaukee</p>
<p>These are established successful stores with proven profits. We open the books and show you the earnings. No gamble! No guesswork! You pick the income you want! We train you in 2 weeks. We do all the cleaning and pressing.</p>	
<p>Act today! Investigate this once in a lifetime chance to own your own business and increase your family income. Phone 331-6262 or write:</p>	
<p>MR. BOB BOWMAN Everneat Laundry and Cleaners, Inc. 170 Regent Drive Milwaukee, Wisc. 53212</p>	

Note: The franchisors' actual names and other identifying characteristics have been changed by the authors.

cedure for Standard and Poor's *Register of Corporations* is to refuse to accept small corporations with less than one million dollars in sales.

Table 3 shows the percentages of franchisors advertising in the Sunday editions of the four major newspapers who were listed in either or both of the two sources. A substantial increase in the percentage of franchisors listed occurred in California and Wisconsin after their full disclosure laws became effective. For example, only about 40% of the franchisors who advertised in the *Los Angeles Times* were listed in either the *Franchise Opportunity Handbook* or Standard & Poor's *Register of Corporations* in the year prior to the law's enactment in 1970. The comparative figure was over 75% in 1973. Similarly, only half of the franchisors advertising in Wisconsin were listed in the year prior to the law, compared to over 75% in 1973. These increases in the percentages of franchisors advertising who were listed appear to be the result of the passage of full disclosure laws, inasmuch as large increases were not evident for the control papers, the *Detroit News* and the *Chicago Tribune*. Since large franchisors are more likely to be listed in these two

sources than small franchisors, it seems that the full disclosure laws have discouraged smaller franchisors from offering franchises in California and Wisconsin.

As another indication of the size of the franchisors offering franchises in the four newspapers, the median number of franchises is reported for those franchisors advertising in the papers who are listed in the *Franchise Opportunity Handbook* (Table 3). To simplify the analysis, the mean of these medians is shown for each year. Again, the average size of the franchisor advertising in the *Los Angeles Times* and the *Milwaukee Journal* seems to have increased since their full disclosure laws were passed. In contrast, the average size of franchisors advertising in the *Detroit News* has stayed almost constant, while the average size of franchisors advertising in the *Chicago Tribune* has actually declined.

Sale of Franchises. Full disclosure laws should also affect the end results of franchisors' selling efforts, namely, the number of franchises sold. The sales of franchises in Wisconsin are reported by type of franchisor (registered, exempt, and nonregistered, nonexempt) in Table 4. The per-

TABLE 3
CHARACTERISTICS OF FRANCHISORS ADVERTISING IN THE SUNDAY EDITIONS OF
FOUR MAJOR NEWSPAPERS

Year and Quarter	Los Angeles Times			Milwaukee Journal			Detroit News			Chicago Tribune		
	Per- cent Listed ^a	Median No. Fran- chises ^b	Mean of the Me- dians	Per- cent Listed	Median No. Fran- chises	Mean of the Me- dians	Per- cent Listed	Median No. Fran- chises	Mean of the Me- dians	Per- cent Listed	Median No. Fran- chises	Mean of the Me- dians
1970	1	32	300									
	2	41	139									
	3	43	100			156						
	4 ^c	49	86									
1971	1	49	308									
	2	66	187									
	3	65	350	239	45	263		35	60		46	314
	4	71	109		57	200	232	57	493	277	47	314
1972	1	70	200		53	140		44	356		53	307
	2 ^d	72	175		49	61		53	86		53	243
	3	73	214	219	58	927	323	36	264	352	48	306
	4	77	285		68	175		53	700		53	263
1973	1	89	285		66	475		37	285		56	306
	2	84	213		72	475		41	200		64	200
	3	65	321	266	73	250	350	51	220	258	57	185
	4 ^e	75	243		97	200		62	327		53	200
1										66	240	240

^a The percentage of franchisors who advertised in the paper and who were listed in either the *Franchise Opportunity Handbook* or in Standard and Poor's *Register of Corporations*.

^b The median number of franchises for those franchisors listed in the *Franchise Opportunity Handbook* and who advertised in the paper.

^c California's full disclosure law went into effect after 4th quarter 1970.

^d Wisconsin's full disclosure law went into effect after 2nd quarter 1972.

^e Illinois' full disclosure law went into effect after 4th quarter 1973.

TABLE 4
SALES OF FRANCHISES IN WISCONSIN BY TYPE OF FRANCHISOR

FRANCHISES SOLD	TYPE OF FRANCHISOR											
	Registered Franchisors			Exempt Franchisors			Nonregistered, Nonexempt Franchisors			Total All Franchisors		
	1971	1972	1973	1971	1972	1973	1971	1972	1973	1971	1972	1973
Number of franchises sold in U.S.	769	1043	1197	1091	1280	1510	307	367	369	2165	2690	3076
Number of franchises sold in Wisconsin	60	72	75	24	29	32	9	8	2	93	109	109
Percent of U.S. franchises sold in Wisconsin	7.8	6.9	6.2	2.1	2.2	2.1	2.9	2.1	.5	4.3	4.1	3.5

Note: Sales figures reported are for the 102 franchisors who returned the questionnaire in the survey.

centage of U.S. franchises sold in Wisconsin by all franchisors has decreased steadily since Wisconsin's full disclosure law went into effect. The decrease in Wisconsin's share of the total number of franchises sold seems to have occurred with respect to only two of the three types of franchisors, namely, registered and nonregistered.

Of the total number of franchises sold in the U.S. by registered franchisors, Wisconsin's share has fallen from 7.8% in 1971 to 6.1% in 1973. This may have resulted from some potential franchisees deciding not to purchase a franchise from the registered franchisor after being shown a prospectus. Since it is illegal for nonregistered franchisors to sell franchises, their sales have become virtually nonexistent since the implementation of the full disclosure law. Finally, Wisconsin's share of the sales of franchises by large, exempt franchisors has not been affected by the full disclosure law. It seems that Wisconsin's full disclosure law has adversely affected the sales of franchises in Wisconsin by the registered and nonregistered, nonexempt franchisors, but it has had no apparent effect on the sales of exempt franchisors. Once again, since all of the exempt franchisors are large in size (more than 25 franchises in each of the five preceding years), the decline in the sales of franchises is confined primarily to small franchisors.

Conclusions and Recommendations

Many franchisors have been found to systematically mislead prospective franchisees concerning various aspects of their franchises, including the crucial issue of potential profitability. Several state legislatures have responded to these deceptive practices by passing full disclosure laws designed to protect prospective franchisees by requiring that franchisors give them accurate, un-

biased information. The results of the study reported in this article lead to several conclusions concerning the effects of full disclosure laws. Following the suggestion of Walker, Sauter, and Ford, a cost-benefit procedure seems most appropriate.¹⁸

The primary benefit of the full disclosure laws is the great reduction in the incidence of franchisors misleading prospective franchisees concerning the potential profitability of their franchises. This conclusion is based both on responses from franchisees and on an analysis of current advertising of franchisors. The resultant decrease in deceptive practices has undoubtedly benefited franchisees in their efforts to evaluate franchise investments and screen out undesirable franchise opportunities.

A second benefit of the law concerns its enforcement provisions. Franchisees can apply for restitution if their franchisors did not comply with the law's disclosure and registration procedures. For example, during the first year of the law's existence in Wisconsin, franchisees received approximately \$55,000 in cash and voided contract obligations as a result of enforcement actions by the state. These benefits of full disclosure laws are impressive. Yet, just as "there is no such thing as a free lunch," neither are these laws costless.

The costs of full disclosure laws are borne by the state, franchisors, and franchisees. The state incurs costs for both the administration and enforcement of full disclosure laws. Administrative budgets typically amount to approximately \$50,000 per year. Legal fees for enforcement vary

18. Orville C. Walker, Jr., Richard F. Sauter, and Neil M. Ford, "The Potential Secondary Effects of Consumer Legislation: A Conceptual Framework," *Journal of Consumer Affairs*, Vol. 8 (Fall 1974), pp. 144-156.

widely depending on the nature and number of cases that go to court. Another cost to the state is the resultant decline in new business formation and economic activity. Wisconsin's share of new franchises dropped from 4.3% of the national total in 1971 to 3.5% in 1973, the year after the law was passed.

Full disclosure laws impose substantial costs on franchisors in the form of filing fees, amendment fees, legal costs, accounting costs, printing expenses, and executive time. Registering in Wisconsin typically consumes two to three months' time and approximately \$3,000. Although these costs may be nominal for large corporations, they can be devastating to small franchisors, both existing and potential. The results of this study show a definite tendency for small franchisors to be squeezed out of franchising in states with full disclosure laws. As has been observed by the National Small Business Association and others, most laws regulating business are inherently disadvantageous to small companies because these companies cannot afford the executive time, paperwork, legal and accounting staff, and fees required to satisfy the provisions of the laws.¹⁹

Finally, there are costs incurred by franchisees. First, there are the direct costs, as franchisors pass on some, if not all, of their registration expenses in the form of higher franchise fees. More

importantly, franchisees incur *opportunity* costs when franchisors (both small and large) are discouraged from offering franchises in states with full disclosure laws.

The full disclosure laws are designed to benefit prospective franchisees by providing them with sufficient unbiased information to enable them to make sound investment decisions. *The overall benefits of the full disclosure laws seem to outweigh their costs.* However, the passage of a *national uniform* full disclosure law would (a) reduce state administrative costs, (b) reduce the potentially horrendous costs of franchisors having to register in all the states, and, thus, (c) increase opportunities for potential franchisees and franchisors.

Since franchisors would be one of the beneficiaries, the authors gathered data on whether they favored a national full disclosure law. Franchisors, by a 2 to 1 margin, supported the notion of a national full disclosure law. Given that the benefits seem to outweigh the costs, both efficiency and fairness suggest that a national full disclosure law in franchising is an idea whose time has come.

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19. Milton Stewart, President, National Small Business Association, quoted in "Small Business: The Maddening Struggle to Survive," *Business Week*, June 30, 1975, p. 101.