

LINK BETWEEN THE FRANCHISE SYSTEM AND US GOVERNMENT LOANS

Today it costs about \$1.5 million to become a franchisee at Burger King or Carl's Jr.; a McDonald's franchisee pays roughly one-third that amount to open a restaurant (since the company owns or holds the lease on the property). Gaining a franchise from a less famous chain — such as Augie's, Buddy's Bar-B-Q, Happy Joe's Pizza & Ice Cream Parlor, the Chicken Shack, Gumby Pizza, Hot Dog on a Stick, or Tippy's Taco House — can cost as little as \$50,000. Franchisees often choose a large chain in order to feel secure; others prefer to invest in a smaller, newer outfit, hoping that chains like Buck's Pizza or K-Bob's Steakhouses will become the next McDonald's.

Advocates of franchising have long billed it as the safest way of going into business for yourself. The International Franchise Association (IFA), a trade group backed by the large chains, has for years released studies "proving" that franchisees fare better than independent businessmen. In 1998 an IFA survey claimed that 92 percent of all franchisees said they were "successful." The survey was based on a somewhat limited sample: franchisees who were still in business. Franchisees who'd gone bankrupt were never asked if they felt successful. Timothy Bates, a professor of economics at Wayne State University, believes that the IFA has vastly overstated the benefits of franchising. A study that Bates conducted for a federal loan agency found that within four to five years of opening, 38.1 percent of new franchised businesses had failed. The failure rate of new independent businesses during the same period was 6.2 percent lower. According to another study, three-quarters of the American companies that started selling franchises in 1983 had gone out of business by 1993. "In short," Bates argues, "the franchise route to self-employment is associated with higher business failure rates and lower profits than independent business ownership."

In recent years conflicts between franchisees and franchisers have become much more common. As the American market for fast food grows more saturated, restaurants belonging to the same chain are frequently being put closer to one another. Franchisees call the practice "encroachment" and angrily oppose it. Their sales go down when another outlet of the same chain opens nearby, drawing away customers. Most franchisers, on the other hand, earn the bulk of their profits from royalties based on total sales — and more restaurants usually means more sales. In 1978 Congress passed the first federal legislation to regulate franchising. At the time, a few chains were operated much like pyramid schemes. They misrepresented potential risks, accepted large fees up front, and bilked millions of dollars from small investors. The FTC now requires chains to provide lengthy disclosure statements that spell out their rules for prospective franchisees. The statements are often a hundred pages long, with a lot of small print.

Federal law demands full disclosure prior to a sale, but does not regulate how franchises are run thereafter. Once a contract is signed, franchisees are largely on their own. Although franchisees must obey corporate directives, they are not covered by federal laws that protect employees. Although they must provide the investment capital for their businesses, they are not covered by the laws that protect independent businessmen. And although they must purchase all their own supplies, they are not covered by consumer protection laws. It is perfectly legal under federal law for a fast food chain to take kickbacks (known as "rebates") from its suppliers, to open a new restaurant next door to an existing franchisee, and to evict a franchisee without giving cause or paying any compensation.

According to Susan Kezios, president of the American Franchise Association, the contracts offered by fast food chains often require a franchisee to waive his or her legal right to file complaints under state law; to buy only from approved suppliers, regardless of the price; to sell the restaurant only to a buyer approved by the chain; and to accept termination of the contract, for any cause, at the discretion of the chain. When a contract is terminated, the franchisee can lose his or her entire investment. Franchisees are sometimes afraid to criticise their chains in public, fearing reprisals such as the denial of additional restaurants, the refusal to renew a franchise contract at the end of its twenty-year term, or the immediate termination of an existing contract. Ralston-Purina once terminated the contracts of 642 Jack in the Box franchisees, giving them just thirty days to move out. A group of McDonald's franchisees, unhappy with the chain's encroachment on their territories, has formed an organisation called Consortium Members, Inc. The group issues statements through Richard Adams, a former McDonald's franchisee, because its members are reluctant to disclose their names.

The fast food chains are periodically sued by franchisees who are upset about encroachment, about inflated prices charged by suppliers, about bankruptcies and terminations that seemed unfair. During the 1990s, Subway was involved in more legal disputes with franchisees than any other chain — more than Burger King, KFC, McDonald's, Pizza Hut, Taco Bell, and Wendy's combined. Dean Sager, a former staff economist for the U.S. House of Representatives' Small Business Committee, has called Subway the "worst" franchise in America. "Subway is the biggest problem in franchising," Sager told *Fortune* magazine in 1998, "and emerges as one of the key examples of every [franchise] abuse you can think of."

Subway was founded in 1965 by Frederick DeLuca, who borrowed \$1,000 from a family friend to open a sandwich shop in Bridgeport, Connecticut. DeLuca was seventeen at the time. Today Subway has about fifteen thousand restaurants, second only to McDonald's, and opens about a thousand new ones every year. DeLuca is determined to build the world's largest fast food chain. Many of the complaints about Subway arise from its unusual system for recruiting new franchisees. The chain relies on "development agents" to sell new Subway franchises. The development agents are not paid a salary by Subway; they are technically independent contractors, salesmen whose income is largely dependent on the number of Subways that open in their territory. They receive half of the franchise fee paid by new recruits, plus one-third of the annual royalties, plus one-third of the "transfer fee" paid whenever a restaurant is resold. Agents who fail to meet their monthly sales quotas are sometimes forced to pay the company for their shortfall. They are under constant pressure to keep opening new Subways, regardless of how that affects the sales of Subways that are already operating nearby. According to a 1995 investigation by Canada's *Financial Post*, Subway's whole system seems "almost as geared to selling franchises as it is to selling sandwiches."

It costs about \$100,000 to open a Subway restaurant, the lowest investment required by any of the major fast food chains. The annual royalty Subway takes from its franchisees — 8 percent of total revenues — is among the highest. A top Subway executive has acknowledged that perhaps 90 percent of the chain's new franchisees sign their contracts without reading them and without looking at the FTC filings. Roughly 30 to 50 percent of Subway's new franchisees are immigrants, many of whom are not fluent in English. In order to earn a decent living, they must often work sixty to seventy hours a week and buy more than one Subway.

In November of 1999, Congressman Howard Coble, a conservative Republican from North Carolina, introduced legislation that would make franchisers obey the same fundamental business principles as other American companies. Coble's bill would for the first time obligate franchise chains to act in "good faith," a basic tenet of the nation's Uniform Commercial Code. The bill would also place limits on encroachment, require "good cause" before a contract can be terminated, permit franchisees to form their own associations, allow them to purchase from a variety of suppliers, and give them the right to sue franchisers in federal court. "We are not seeking to penalise anyone," Coble said, before introducing his plan for franchise reform. "We only seek to bring some order and sanity to a segment of our economy which is growing and may be growing out of control." Iowa adopted similar franchise rules in 1992, without driving Burger King or McDonald's out of the state.

Nevertheless, the IFA and the fast food chains strongly oppose Coble's bill. The IFA has hired Allen Coffey, Jr., the former general counsel of the House Judiciary Committee, and Andy Ireland, a former Republican congressman who was the ranking member of the House Small Business Committee, to help thwart greater federal regulation of franchising. While in Congress, Ireland had criticised franchisees who sought legal reforms, calling them "whiny butts" who came running to the government instead of taking responsibility for their own business mistakes.

After congressional hearings were held on Coble's bill in 1999, the IFA claimed in a press release that federal regulation of franchising would interfere with "free enterprise contract negotiations" and seriously harm one of the most vital and dynamic sectors of the American economy. "Small businesses and franchising succeed by relying on marketplace solutions," said Don DeBoIt, the president of the IFA. Despite its public opposition to any government interference with the workings of the free market, the IFA has long supported programs that enable fast food chains to expand using government-backed loans.

For more than three decades the fast food industry has used the Small Business Administration (SBA) to finance new restaurants — thereby turning a federal agency that was created to help independent, small businesses into one that eliminates them. A 1981 study by the General Accounting Office found that the SBA had guaranteed 18,000 franchise loans between 1967 and 1979, subsidising the launch of new Burger Kings and McDonald's, among others. Ten percent of these franchise loans ended in default. During the same period, only 4 percent of the independent businesses receiving SBA loans defaulted. In New York City, the SBA backed thirteen loans to Burger King franchisees; eleven of them defaulted. The chain was "experimenting," according to a congressional investigation, using government-backed loans to open restaurants in marginal locations. Burger King did not lose money when these restaurants closed. American taxpayers had covered the franchise fees, paid for the buildings, real estate, equipment, and supplies.

According to a recent study by the Heritage Foundation, the SBA is still providing free investment capital to some of the nation's largest corporations. In 1996, the SBA guaranteed almost \$1 billion in loans to new franchisees. More of those loans went to the fast food industry than to any other industry. Almost six hundred new fast food restaurants, representing fifty-two different national chains, were launched in 1996 thanks to government-backed loans. The chain that benefited the most from SBA loans was Subway. Of the 755 new Subways opened that year, 109 relied upon the U.S. government for financing.