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Franchisees’ Optimism Bias and the Inefficiency of the FTC Franchise Rule

Uri Benoliel* and Jenny Buchan**

A seminal assumption that underlies current franchise law is that franchisees are intrinsically rational. As such, franchisees are presumed to be able to rationally assess the risks involved in the franchise contract and avoid those risks. Based on this rationality assumption, current law is predominantly based on the FTC Franchise Rule, in which franchisors are obliged to disclose to franchisees information regarding future risks. Equipped with this information, franchisees, as rational actors, are assumed to be capable of protecting themselves against the franchise risks.

This Article questions the validity of the assumption that franchisees are rational actors. Based on a significant body of existing empirical research, which has thus far been overlooked in the legal debate over the FTC Franchise Rule, this Article presents the following arguments. First, although franchisees are often perceived as sophisticated business people, they systematically suffer from a common psychological bias: over-optimism about the future. Second, franchisees, being optimistically biased about the future, repeatedly avoid reading disclosure documents, which contain informative data about future risks. The conclusion therefore is that the efficiency of the Franchise Rule in protecting franchisees is dubious.

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* Faculty of Law, College of Law & Business. J.S.D. (UC Berkeley); LL.M (Columbia University).

** Business School, University of New South Wales. PhD (QUT); LLM (Melbourne University); LLB (Otago University). We are grateful to Oren Bar-Gil, Tamar Frankel, Arie Reichel, and James White for their invaluable comments.
A legal war is being waged between the advocates of franchisees and franchisors. On one side, franchisees' proponents, led mainly by the American Association of Franchisees and Dealers ("AAFD"), argue that sophisticated franchisors often behave opportunistically towards their less sophisticated franchisees. Specifically, franchisors are mainly blamed for opening new competing franchise units in too close proximity to their existing franchisees, or unjustly terminating the franchise contract only in order to resell the terminated unit to a new franchisee for higher fees. Franchisees' advocates are consequently trying to persuade policy makers in numerous states to enact laws that protect franchisees against such opportunistic behavior by their franchisors. For example, in California, a new bill, known as "Senate Bill 610," was recently enacted in order to protect franchisees against franchisor abuse. Similarly, a new bill in Pennsylvania called the "Responsible Franchise Practices Bill," was recently proposed in an effort to protect franchisee against franchisor opportunism. In Maine, a bill called the "Small Business Investment Protection Act," was introduced, which aims to defend franchisees against franchisor exploitation. Likewise, in Vermont, "House Bill 694" was proposed as an effort to protect franchisees against franchisor opportunism. In Massachusetts, "An Act Further Regulating Franchise Agree-

1. See infra Part II.
3. See infra Part II.A.
4. Id.
ments” was introduced with the goal of safeguarding franchisees against franchisor misconduct. In the same vein, in New Hampshire, a franchisee protection bill called “The New Hampshire Small Business Investment Protection Act” was recently introduced in an effort to reduce franchisor opportunism towards their franchisees. In other several states, franchisee protection laws are likely to be introduced in the near future.

On the other side of the battle, franchisors, supported by the intense lobby of the International Franchise Association (“IFA”), strongly resent these laws. Deeply ingrained in franchisor advocates’ opposition to such legislation is the belief that the current federal disclosure legal regime, known as “the Franchise Rule,” sufficiently protects franchisees against potential franchisor opportunism. According to the Franchise Rule enacted by the Federal Trade Commission (“FTC”), each franchisor is obliged to disclose to potential franchisees – before they sign the franchise contract – information indicating risk of future opportunism by the franchisor. Equipped with this information, prospective franchisees can allegedly assess the risks of franchisor opportunism, and therefore protect themselves, ex ante, against potential abuse by the franchisor.

Franchisor advocates’ opposition to franchisee protection laws has been influential in the development of franchise law at this stage of the legal battle. To date, several states have already refused to adopt the novel franchisee protection laws. For example, in California, Governor Jerry Brown announced that he has vetoed Senate Bill 610, SMITH, GAMBERRELL, & RUSSELL, LLP (Mar. 2012), http://www.sgrlaw.com/resources/newsletters/franchise_law_newsletter/1808/1810/.

13. See infra Part II.B.
14. Id.
15. See About the FTC, FTC, http://www.ftc.gov/about-ftc (last visited Dec. 29, 2014), for information about the FTC.
16. See infra Part II.B.
17. Id.
18. Id.
essentially blocking the bill.\textsuperscript{19} Similarly, Maine’s state senate voted against the Small Business Investment Protection Act.\textsuperscript{20}

This Article questions the validity of franchisor advocates’ central argument: that the Franchise Rule is sufficient in protecting franchisees against franchisor opportunism. Based on a significant body of existing empirical research, which has thus been far overlooked in the legal debate over franchisee protection laws, this Article argues the following. First, although franchisees are often perceived as sophisticated business people,\textsuperscript{21} they systematically suffer from a common psychological bias: over-optimism about the future.\textsuperscript{22} Second, franchisees, being optimistically biased about the future, repeatedly avoid reading disclosure documents, which contain informative data about future risks.\textsuperscript{23} The conclusion therefore is that the efficiency of the Franchise Rule in protecting franchisees is dubious.

This Article will proceed as follows: Part II will provide legal context by briefly reviewing the legal battle over franchisee protection laws while outlining the central argument on which franchisor advocates base their opposition to franchisee protection laws: namely, that the Franchise Rule sufficiently protects franchisee against franchisor opportunism. Part III will present the authors’ critique of the franchisor advocates’ argument. Part IV provides a brief conclusion.

II. THE WAR OVER FRANCHISEE PROTECTION LAWS – OVERVIEW

A. The Franchisees’ Side: The Risk of Franchisor Opportunism

According to franchisee advocates, franchisors inherently have superior economic power and superior bargaining power in the negotia-

\begin{itemize}
    \item \textsuperscript{19} Don Sniegowski, \textit{California’s Governor Brown Vetoes Franchisee Bill}, \textsc{Blue Maumau} (Sept. 30, 2014, 12:03 AM), http://www.bluemaumau.org/14147/california%E2%80%99s_governor_brown_vetoes_franchisee_bill.
    \item \textsuperscript{20} Don Sniegowski, \textit{Maine’s Senate Kills Franchise Protection Bill}, \textsc{Blue Maumau} (Apr. 4, 2014, 9:01 AM), http://www.bluemaumau.org/13791/maine_senate_kills_franchise_protection_bill [hereinafter \textit{Maine’s Senate}].
    \item \textsuperscript{21} See Original Great Am. Chocolate Chip Cookie Co. \textit{v.} River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992) (“The Sigels are not vulnerable consumers or helpless workers. They are business people who bought a franchise . . . .”); \textit{see also} Broussard \textit{v.} Mieneke Discount Muffler Shops, Inc., 155 F.3d 331, 348 (4th Cir. 1998) (“By all lights, Mieneke franchisees are independent, sophisticated, if sometimes small, businessmen who dealt with Meineke at arms’ length and pursued their own business interests.”); Doctor’s Associates, Inc. \textit{v.} Jabush, 89 F.3d 109, 113 (2d Cir. 1996) (“As purchasers of a Subway sandwich franchise, the Spearses ‘[were] not vulnerable consumers or helpless workers. They [were] business people who bought a franchise.’”).
    \item \textsuperscript{22} \textit{See infra} Part III.A.
    \item \textsuperscript{23} \textit{See infra} Part III.B.
\end{itemize}
tion of the terms and conditions of the franchise contract. Such superiority is sometimes exploited by franchisors behaving opportunistically towards their franchisees. Franchisors opportunistic behavior can take numerous forms, which are often permitted under the one-sided franchise contract: First, the franchisor might open a new unit in close geographic proximity to an existing franchisee to directly compete with this franchisee. Such an action, known as "territorial encroachment," might dramatically reduce the existing franchisee's profits and in some cases even cause her business failure. In addition, the franchisor may force its franchisees to buy from a specific supplier at an excessive price. In addition, the franchisor may receive rebates from suppliers at the expense of its franchisees. Moreover, franchisors might opportunistically force one-sided modifications of agreements on franchisees by threatening to terminate the franchise relationship at will. In addition, the franchisor might opportunistically terminate the franchise contract during its term only in order to appropriate the profits of a successful franchisee unit. Such abusive behavior, known as "churning," can take two

24. See, e.g., Peter C. Lagarias & Robert S. Boulter, The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections, 29 Franchise L.J. 139, 139 (2010) ("franchisors continue to maintain and exploit their systemic economic superiority vis-à-vis franchisees... most franchise agreements are drafted by a franchisor's lawyers to benefit the franchisor in every possible way and are usually presented to franchisees on a take-it-or-leave-it basis").

25. See Maine's Senate, supra note 20 (Franchise owners have complained "that their businesses are being stolen or abused by franchisors"); Matt Ellis, Dunkin' Donuts Franchise Owners Applauds Joint Committee's Efforts for Fair Franchising Legislation, Dunkin Donuts Independent Franchise Owners (May 7, 2012), http://ddifo.org/dunkin-donuts-franchise-owners-applauds-joint-committees-efforts-for-fair-franchising-legislation/ ("Franchising suffers when franchisors abuse the power granted them in their franchise agreements and wipe out the equity that’s been built and the personal money that’s been invested").


27. See id.


29. See id.


central forms: 1) the franchisor might terminate the contract of an efficient franchisee who fully complies with the franchise contract in order to sell the latter's profitable unit to a new franchisee for higher franchise fees;\textsuperscript{32} and, 2) the franchisor may terminate the contract of an efficient franchisee simply in order to manage the successful unit himself.\textsuperscript{33}

Given the risk of franchisor opportunism, franchisee advocates have been calling on policymakers to enact laws that protect franchisees.\textsuperscript{34} For example, in order to protect them against territorial encroachment, franchisee advocates have called on policy makers to enact laws that restrict the ability of a franchisor to open new units in unreasonable proximity to their existing franchisees.\textsuperscript{35} Similarly, franchisee advocates have been calling policymakers to protect franchisees against opportunistic hold-ups and churning by enacting laws that restrict the ability of franchisors to terminate a franchisee without showing "good cause."\textsuperscript{36}

B. The Franchisors' Side: Reliance on the FTC Franchise Disclosure Rule

Franchisors, supported by the relentless lobbying by the IFA, strongly oppose the adoption of franchisee protection laws.\textsuperscript{37} One central argument that underlies their opposition is that the FTC


\textsuperscript{33} Blair & Lafontaine, supra note 32, at 271; see also Byers, supra note 30, at 621; Lockery, supra note 30, at 834; David Hess, The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors, 80 Iowa L. Rev. 333, 334 (1995); Tracey A. Nicas- tro, Note, How The Cookie Crumbles: The Good Cause Requirement For Terminating A Franchise Agreement, 28 Val. U. L. Rev. 785, 801 (1994); Mark Pruitt, Disclosure and Good Cause Legislation: "Where's the Beef" in Franchise Regulation?, 90 Com. L.J. 563, 565 (1985); see, e.g., Maine's Senate, supra note 20 ("Franchise owners ... have complained that their businesses are being stolen or abused by franchisors.")

\textsuperscript{34} See supra Part I.


Franchise Rule sufficiently protects franchisee against franchisor opportunism.\textsuperscript{38}

The Franchise Rule is a pre-sale disclosure rule that requires each franchisor to provide potential franchisees with a franchisor disclosure document ("FDD") before they sign the franchise contract.\textsuperscript{39} The FDD contains information – in twenty-three distinct disclosure items – regarding franchisor current policies and past conduct.\textsuperscript{40} This information is intended to allow franchisees to evaluate the future risks of franchisor opportunism.\textsuperscript{41} For example, in order to allow franchisees to assess the risk of opportunistic territorial encroachment, the FDD must include the following details. First, the franchisor must disclose whether it grants exclusive territory to its franchisees.\textsuperscript{42} Second, if a franchisor does not offer its franchisees exclusive territory, the franchisor must include a prescribed statement underscoring that point, and a warning about the consequences of purchasing a franchise in a non-exclusive territory.\textsuperscript{43} Specifically, the franchisor must warn the franchisee that she "may face competition from other franchisees [in the future], from outlets [the franchiser] own[s], or from other channels of distribution or competitive brands [that the franchisor] control[s]."\textsuperscript{44} Third, if the franchisor grants exclusive territory, it must


\textsuperscript{40} See Bailey & Wieczorek, supra note 39, at 103-116, for an overview of the FDD items.


\textsuperscript{44} 16 C.F.R. § 436.5(l)(5)(i).
disclose the circumstances that permit the franchisor to modify the franchisee's territorial rights in the future.\textsuperscript{45}

Furthermore, in order to allow the potential franchisee to assess the future risk of opportunist hold-ups and churning by their franchisor, the FDD must contain the following details. First, the franchisor must summarize the conditions under which it may terminate the franchise contract. Specifically, if the franchisor has a right to terminate the contract at-will, it must disclose this right in a specified tabular format.\textsuperscript{46} Second, the FDD must disclose the yearly rate of franchisees that were terminated in the past by their franchisor.\textsuperscript{47} Third, the franchisor must disclose contact information of former franchisees that were terminated by the franchisor.\textsuperscript{48} This information is intended to allow prospective franchisees to investigate the causes for past termination of franchisees, and therefore assess the future risks of opportunist termination by the franchisor.\textsuperscript{49}

In order to assist franchisees to effectively assess the risks of franchisor opportunism, the Franchise Rule furthermore requires that the FDD meet several formal standards. First, the language of the FDD must be clear.\textsuperscript{50} The FDD must use plain English, namely a) "understandable by a person unfamiliar with the franchise business"; b) "incorporating short sentences; definite, concrete, [and] . . . active voice"; c) excluding "legal jargon, highly technical business terms, and multiple negatives."\textsuperscript{51} Second, the FDD must be concise.\textsuperscript{52} It should not include any information other than that required or permitted by the Franchise Rule.\textsuperscript{53} Third, the disclosed information must be assembled. In other words, the franchisor must disclose all re-

\begin{itemize}
  \item \textsuperscript{45} § 436.5(l)(5)(ii).
  \item \textsuperscript{46} § 436.5(q) & Item 17 Table.
  \item \textsuperscript{47} § 436.5(t) & Item 20, Table No. 3.
  \item \textsuperscript{48} § 436.5(t)(5).
  \item \textsuperscript{49} Mario Herman, \textit{Don't Be a Victim of Franchise Fraud, aka, Churning — Understanding Item 20 Part 2}, http://www.franchiseknowhow.com/legal_corner/churning2.htm (last visited May 15, 2015) ("[A] careful review of Item 20 [of the Franchise Rule] can disclose some red flags which might help to prevent you from falling victim to franchise . . . churning. Is there a high turnover rate? What are the reasons for the turnover rate?"); see \textit{Look before You Leap: A Guide to Buying a Franchise}, \textit{CAL. DEP'T OF CORPS.} 5 (Jan. 2007), available at http://www.dbo.ca.gov/Licensees/franchise_investment_law/pdf/Look_Before_You_Leap_ENG.pdf ("Questions to ask a former franchisee: If there was a termination or non-renewal, did the franchisor explain why . . .?").
  \item \textsuperscript{50} 16 C.F.R. § 436.6(b).
  \item \textsuperscript{51} § 436.1(o).
  \item \textsuperscript{52} § 436.6(b).
  \item \textsuperscript{53} § 436.6(d). "For example, franchisors may not include testimonials or promotional literature in a disclosure document." \textit{Franchise Rule 16 C.F.R. Part 436 Compliance Guide}, FTC 122 (May 2008), available at http://www.business.ftc.gov/sites/default/files/pdf/bus70-franchise-rule-compliance-guide.pdf [hereinafter \textit{Compliance Guide}].
\end{itemize}
quired information in a single document, and the disclosure cannot be
done in multiple discrete parts.⁵⁴ Fourth, the FDD must be *storabe.*⁵⁵
Specifically, “the disclosure[ ] must be in a form that permits each
prospective franchisee to store, download, print, or otherwise main-
tain the document for future reference.”⁵⁶ Fifth, the FDD must be
*complete.* It should specifically address each of the twenty-three disclo-
sure items set forth in the Franchise Rule.⁵⁷ If a particular disclo-
sure item is not applicable, then a negative response by the franchisor
is required that includes a reference to the type of information the
non-applicable item required to be disclosed.⁵⁸ Finally, the FDD must
be provided to the franchisee in a *timely* manner. Specifically, the
franchisee “must receive the disclosure document at least fourteen
calendar days before . . . sign[ing] a binding franchise agreement with,
or make any payment to, the franchisor.”⁵⁹

### III. The Theoretical Critique

A seminal theoretical assumption that underlies the argument that
the Franchise Rule efficiently protects franchisees against franchisor
opportunism is that franchisees are intrinsically rational and are cogni-
tively capable of rationally assessing the future risks of franchisor op-
portunism.⁶⁰ As the FTC explains, the current federal disclosure
regime is based on the theory that an informed franchisee “can deter-
mine whether a franchise deal is in his or her best interest.”⁶¹ Likewise,
the Bureau of Consumer Protection at the FTC explains that the
current disclosure regime is “a cost-effective way to provide material
information to prospective franchisees so they can assess the costs . . .

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⁵⁴. *Compliance Guide,* supra note 53, at 121. For example, a franchisor may not list lawsuits
in Item 3 and then provide a link to external documents that explain the suits in great detail.
⁵⁵. 16 C.F.R. § 436.6(b).
⁵⁶. *Id.* For example, when disclosure documents are furnished as an email attachment or
made accessible online, they must be in a format that a prospective franchisee can download
onto a computer, a CD-ROM, or the like. *Compliance Guide,* supra note 53, at 121.
⁵⁷. 16 C.F.R. § 436.6(c).
⁵⁸. *Id.* For example, if no financing is provided by the franchisor, it should disclose in item 10:
“We do not offer any direct or indirect financing.” *Compliance Guide,* supra note 53, at 121-22.
⁵⁹. 16 C.F.R. § 436.3(e)(2). Disclosure Requirements and Prohibitions, Concerning Franchis-
ing and Business Opportunities, 72 Fed. Reg. 15,444, 15,491 (Mar. 30, 2007) (to be codified at 16
16 C.F.R. § 436) [hereinafter Proposed Franchise Rule]; Bureau of Consumer Protection, *Staff
Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR
staff-report-bureau-consumer-protection-federal-trade-commission-and-proposed-revised-trade/
0408franchiserulerpt.pdf.
and potential financial risks involved in entering into a franchise relationship."\(^{62}\) Given the assumption that franchisees can rationally assess the franchise risks, the FTC's long-held conclusion is that "informed [franchisee] choice is the best regulator of the market."\(^{63}\)

We argue that this conclusion and its underlying rationality assumption are questionable. As will be explained in more detail below, franchisees inherently suffer from a cognitive constraint, known as optimism bias. In addition, franchisees, being overly optimistic about the future, systematically avoid reading franchisee disclosure documents that contain data about future risks.

A. Franchisees Are Optimistically Biased

Empirical studies show that people at various ages, and in various aspects of life, systematically suffer from an inherent bias: over-optimism.\(^{64}\) For example, heavy smokers are optimistically biased about their chances of reaching age seventy-five.\(^{65}\) Regular smokers are optimistically biased about their risk of lung cancer, heart disease, and emphysema.\(^{66}\) Individuals are optimistically biased regarding their likelihood of contracting HIV.\(^{67}\) Individuals are optimistically biased about their chances of having health problems, such as heart attacks or arthritis.\(^{68}\) Women aged fifty to seventy are optimistically biased about their risk of getting breast cancer.\(^{69}\) Men aged forty-five to sixty

\(^{62}\) Bureau of Consumer Protection, supra note 60, at 6 (emphasis added).

\(^{63}\) Id. at 11.

\(^{64}\) "The optimism bias is defined as the difference between a person's expectation and the outcome that follows. If expectations are better than reality, the bias is optimistic . . . ." See Tali Sharot, The Optimism Bias, 21 CURRENT BIOLOGY R941, R941 (2011).


\(^{66}\) Tracy Williams & Valerie A. Clarke, Optimistic Bias in Beliefs About Smoking, 49 AUSTL. J. PSYCHOLOGY 106, 110 (1997); see also N. D. Weinstein et al., Smokers' Unrealistic Optimism About Their Risk, 14 TOBACCO CONTROL 55, 58 (2005).


are optimistically biased about their risk of getting prostate cancer.\textsuperscript{70} Cancer patients who are enrolled in clinical cancer trials are optimistically biased about the possibility of their cancer being controlled by drugs administered in the trials.\textsuperscript{71} Drivers aged sixty-five and above are optimistically biased about their driving risks.\textsuperscript{72} College students are optimistically biased about their risk of being involved in a traffic accident.\textsuperscript{73} Motorcyclists are optimistically biased about their risk of having a serious road accident.\textsuperscript{74} College students are optimistically biased about positive life events, such as liking their post-graduation job or owning their own home.\textsuperscript{75} College students are also optimistically biased about negative life events, such as having a drinking problem or being fired from a job.\textsuperscript{76} Individuals are optimistically biased about their risk of committing suicide or becoming addicted to drugs.\textsuperscript{77} Individuals who had recently applied for a marriage license are optimistically biased about the longevity of their marriage.\textsuperscript{78} Students who experienced an earthquake are optimistically biased, a couple of months after the earthquake, about their risk of being hurt in a natural disaster.\textsuperscript{79} Novice bungee jumpers are optimistically biased about their risk of injury.\textsuperscript{80}

Equally, empirical studies consistently show that business people, although being often perceived as less vulnerable than non-business

\begin{itemize}
\item \textsuperscript{70} Id. at 371-74.
\item \textsuperscript{71} Lynn A. Jansen et al., \textit{Unrealistic Optimism in Early-Phase Oncology Trials}, 33 IRB: ETHICS & HUMAN RESEARCH 1, 4 (2011).
\item \textsuperscript{72} See Dominique Gosselin et al., \textit{Comparative Optimism Among Drivers: An Intergenerational Portrait}, 42 ACCIDENT ANALYSIS & PREVENTION 734, 738 (2010); see also Ola Svenson et al., \textit{Perceived Driving Safety and Seatbelt Usage}, 17 ACCIDENT ANALYSIS & PREVENTION 119, 126 (1985).
\item \textsuperscript{73} David M. Dejoy, \textit{The Optimism Bias and Traffic Accident Risk Perception}, 21 ACCIDENT ANALYSIS & PREVENTION 333, 338 (1989).
\item \textsuperscript{74} D. R. Rutter et al., \textit{Perceptions of Risk in Motorcyclists: Unrealistic Optimism, Relative Realism and Predictions of Behaviour}, 89 BRITISH J. PSYCHOLOGY 681, 691-692 (1998).
\item \textsuperscript{75} Neil D. Weinstein, \textit{Unrealistic Optimism about Future Life Events}, 39 J. PERS. SOC. PSYCHOLOGY 806, 810-811 & 813 (1980).
\item \textsuperscript{76} Id.
\item \textsuperscript{79} Jerry M. Burger & Michele L. Palmer, \textit{Changes in and Generalization of Unrealistic Optimism Following Experiences with Stressful Events: Reactions to the 1989 California Earthquake}, 18 PERS. SOC. PSYCHOLOGY BULL. 39, 42 (1992).
\item \textsuperscript{80} Wendy Middleton et al., \textit{Give 'Em Enough Rope: Perception of Health and Safety Risks in Bungee Jumpers}, 15 J. SOC. CLINICAL PSYCHOLOGY 68, 76 (1996).
\end{itemize}
people. For example, Cooper, Woo and Dunkelberg administered a survey to 2,994 entrepreneurs in various industries, who had recently become owners of businesses. The entrepreneurs were asked what the odds of their business succeeding were. They were also asked what the odds of any business like theirs to succeed were. The results show that the entrepreneurs in the sample were optimistically biased. To begin with, most entrepreneurs assessed “their own odds for success as far higher than would seem justified by the historic experience of new [entrepreneurs].” While the historic experience revealed “less than 50% of businesses survive for more than five years,” entrepreneurs believed, on average, that their chances of success were 81%. In addition, “entrepreneurs perceive[d] their prospects for success as substantially better than those for similar business[ ].” While entrepreneurs believed, on average, that their chances of succeeding were, as mentioned above, 81%, they believed that the chances of any business like theirs to succeeding were, on average, only 59%.

Similarly, Pinfold administered a survey to 548 entrepreneurs “who had started a business in the previous three months or intended to do so in the next six months.” On average, entrepreneurs estimated that the probability of their business surviving after five years was 75.7%, while the true rate was approximately 42.5% at that time. In the same vein, in a longitudinal study conducted by Arabsheibani, Meza, Maloney and Pearson, self-employed individuals were asked to

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81. For example, in the legal context, business people are often perceived as less vulnerable and more sophisticated than members of the general population, such as consumers. See, e.g., Doctor's Assocs., Inc. v. Jabush, 89 F.3d 109, 113 (2d Cir. 1996); Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992); Susan Saab Fortney, Seeking Shelter in The Minefield of Unintended Consequences - The Traps of Limited Liability Law Firms, 54 WASH. & LEE L. REV. 717, 752 n.158 (1997); Harry G. Prince, Unconscionability in California: A Need for Restraint and Consistency, 46 HASTINGS L.J. 459, 460 (1995).


83. Id. at 102.
84. Id. at 103.
85. Id.
86. Id. at 106.
87. Cooper et al., supra note 82, at 99.
88. Id. at 103.
89. Id. at 106.
90. Id. at 103.
92. Id. at 280 & 281, Table 1.
forecast their future financial situation.\textsuperscript{93} The results of the study show that 4.6 times as many individuals forecast an improvement in their financial situation, but experienced deterioration, as forecasted deterioration but experienced an improvement.\textsuperscript{94}

Within the field of franchising, empirical studies, which have thus far been overlooked in the legal debate over the effectiveness of the Franchise Rule, show that franchisees are not different from any other people. These studies suggest that franchisees, although often perceived as sophisticated business people,\textsuperscript{95} are systematically too optimistic. For example, an empirical study conducted by Kalnins suggests that franchisees are unrealistically optimistic regarding their business capabilities.\textsuperscript{96} The study analyzed 142 franchise contracts with contractual clauses, known as ‘development commitments,’ which specify a “number of units to be developed by a . . . franchisee in its territory within a certain time period.”\textsuperscript{97} The study reveals that 61\% of master franchisees

did not survive to the end of their development commitment period. Further, surviving franchisees typically came nowhere near to building the number of units specified by the development commitments. Only 6 of the 55 [master franchisees] still ongoing at the end of their development periods fulfilled or exceeded the commitment size.\textsuperscript{98}

In the same vein, an empirical study conducted by Winter, Szulanski, Ringov and Jensen suggests that franchisees are optimistically biased about their business capabilities to uncover and implement novel business alternatives, which are superior to the ones provided by their experienced and knowledgeable franchisor.\textsuperscript{99} The study found that many franchisees deviate from the franchisor’s original business

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\textsuperscript{94} Id. at 37.

\textsuperscript{95} See Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992) ("The Sigels are not vulnerable consumers or helpless workers. They are business people who bought a franchise . . . "); see also Broussard v. Mieneke Discount Muffler Shops, Inc., 155 F.3d 331, 348 (4th Cir. 1998) ("By all lights, Mieneke franchisees are independent, sophisticated, if sometimes small, businessmen who dealt with Mienes at arms’ length and pursued their own business interests."); Doctor’s Assocs., Inc. v. Jabush, 89 F.3d 109, 113 (2d Cir. 1996) (‘As purchasers of a Subway sandwich franchise, the Spearses ‘were’ not vulnerable consumers or helpless workers. They ‘were’ business people who bought a franchise.’").

\textsuperscript{96} Arturs Kalnins, Overestimation and Venture Survival: An Empirical Analysis of Development Commitments in International Master Franchising Ventures, 14 J. Econ. MGMT. STRAT. 933, 951 (2005).

\textsuperscript{97} Id. at 933.

\textsuperscript{98} Id. at 951.

model by providing their customers new products that are not part of the original model.\textsuperscript{100} In addition, the study empirically shows that franchisee deviation from the franchisor business model increases their risk of franchisee failure.\textsuperscript{101}

Another empirical study conducted by Grünhagen and Dorsch suggests that franchisees have "unrealistically [optimistic] expectations of the franchisors" at the time they make a decision to start a franchise.\textsuperscript{102} Franchisees were asked, among other things, to rate "the value that [they] expected [to receive] from the franchisor at the time that the franchise was started."\textsuperscript{103} These franchisees were also asked to rate the value they currently are experiencing from the franchisor.\textsuperscript{104} The results, obtained from 206 franchisees from 14 franchise chains,\textsuperscript{105} reveal that franchisees, both single-unit and multi-unit, reported "significantly stronger, positive perceptions of expected franchisor value when asked about the time they started their franchise relative to the . . . current value they perceived to be receiving from their franchisors."\textsuperscript{106} Likewise, an empirical study by Blut, Backhaus, Heussler, Woisetschläger and Ahlert strongly implies that franchisees are optimistically biased about their potential profits, and the level of training and support provided by the franchisor.\textsuperscript{107} Collecting data from 2,668 franchisees from 54 different franchise chains,\textsuperscript{108} the study shows that at the very beginning of the franchise relationship, franchisees have relatively high levels of loyalty towards their franchisors,\textsuperscript{109} measured by their willingness to renew the franchise agreement and to still purchase their franchise, if they had to do over again.\textsuperscript{110} However, one year into the franchise relationship,\textsuperscript{111} there is a significant decline in the franchisee's loyalty towards the franchisor.\textsuperscript{112} One explanation for this decline is that at the begin-

\textsuperscript{100} Id. at 676.
\textsuperscript{101} Id. at 681.
\textsuperscript{103} Id. at 373.
\textsuperscript{104} Id.
\textsuperscript{105} Id. at 371-72.
\textsuperscript{106} Id. at 376.
\textsuperscript{108} Id. at 311.
\textsuperscript{109} Franchisees scored their loyalty intentions as 5.24 out of 7. See id. at 318, Table 4.
\textsuperscript{110} See id. at 317, Table 2.
\textsuperscript{111} Id. at 312.
\textsuperscript{112} Franchisees scored their loyalty intentions as 4.08 out of 7, compared to 5.24 out of 7 at the honeymoon phase. See Markus Blut et al., supra note 107, at 318, Table 4.
ning of the franchise relationship, franchisees tend to be euphoric and over-optimistic about entering a new phase in their working lives. However, following this honeymoon stage, franchisees confront the harsh reality and realize that the “high level[] of expectations towards profit, training, and support [were unrealistically optimistic].”

Qualitative studies furthermore show that franchisees suffer from an optimism bias. In an empirical qualitative study, conducted by Frazer, Weaven, Giddings and Grace, “[a] series of 11 multiple case studies, involving 30 protocol discussions with franchisors and franchisees, [were] undertaken.” Out of 22 total franchisees, a strong majority of franchisees self-identified that they had initially held unrealistically optimistic expectations at the pre-entry stages of entering the franchise system. As one franchisee explains: “I really believed that I would get a good return on my investment and I would have some flexibility [. . .] but it just did not happen. . . . I could not understand how I got it so wrong.” Unrealistic optimism on the part of franchisees was also identified by franchisors, interviewed in the study. For example, one franchisor stated that: “A lot of franchisees have not reviewed their business operations rationally, and so there is a gap between what they are expecting and what they actually receive.” Similarly, another qualitative study conducted by Schell and McGillis shows that franchisees are optimistically biased about their sales volume. In this study, out of 37 franchisees, the majority felt that the sales volume of their franchise during its first year of operation was somewhat lower or significantly lower than expected.

B. Biased Franchisees Ignore Disclosure Documents

On a theoretical level, optimism bias has potential negative implications for the willingness of individuals to seek information about their potential risks: “[p]eople may simply avoid information that might
contradict their optimistic beliefs."123 "If individuals perceive that particular negative events are less likely to happen to them then it is possible that they will pay less attention to risk-related information."124 Individuals who are unrealistically optimistic about their own abilities may not pay much attention to risk information, which they may feel is mainly directed at other less careful or less skillful individuals than themselves.125

Indeed, empirical studies systematically show that people who are optimistically biased about their risks are less likely to seek information about those risks. For example, in an experimental study conducted by Fowler and Geers, subjects who were undergraduate students126 were asked to provide their email address if interested in attending informative seminars on health problems.127 The study revealed that subjects who were optimistic about their health conditions "were less likely than other subjects to seek . . . health information" by attending to the informative seminars.128 In the same vein, in an empirical study conducted by Radcliffe and Klein, "a sample consisting of 146 subjects between the ages of 40 and 60,"129 were given a choice to read about one heart-attack risk factor out of six, including "alcohol consumption, fat consumption, nutrition, smoking, exercise and stress."130 The study shows that subjects who were unrealistically optimistic about their heart attack risk chose to read about a risk factor towards which they believed they possessed a favorable standing, and they chose not to read about risk factors towards which they possessed less favorable standing.131 Likewise, according to an empirical telephone survey, conducted by Lu, Dzwo, Hou and Andrews,132 subjects who were optimistically biased about the risks of eating food

127. Id. at 462.
128. Id. at 465.
130. Id.
131. Id. at 844.
cooked by arsenic-contaminated oil had less intention of seeking information regarding those risks. Similarly, in an experimental study conducted by Wiebe and Black, subjects "were chosen from never-married, heterosexual students taking an introductory psychology course." These subjects received an informative pamphlet, which contained "[data] about contraception as well as about the specific advantages and disadvantages of several different contraceptives." Prior to reading the pamphlet, the optimistically-biased subjects, namely participants whose behavioral risk was relatively high and whose perceived risk were relatively low, reported lower interest in the pamphlet than did the more realistic subjects.

In the same vein, based on a survey with 699 members of an online consumer panel, a study by Park, Ju and Kim reveals that as consumers are more optimistically biased about the future risk of depression, they are less likely to seek information about this health problem. More straightforwardly related to the debate over the effectiveness of the FTC franchise disclosure rule on optimistically biased franchisees, a recent empirical study by Anh, Park and Haley examined the relationship between consumers' optimism bias and their inclination to read mandated legal disclosures. By analyzing survey data of 404 consumers, the study reveals that optimistically biased consumers are less likely to pay attention to the mandated legal disclosure on drugs' health risks, which is required by the Food and Drug Administration ("FDA"). The study furthermore shows that optimistically biased consumers are less likely to seek further information about the drug's health risks through alternative sources.

Similarly, in the field of franchising, empirical and anecdotal evidence strongly implies that franchisees, being unrealistically optimistic about future risks, systematically avoid reading the franchisors disclo-

133. Id. at 1442 & 1446.
135. Id. at 1729.
136. Id. at 1733.
137. Id. at 1731.
138. Id. at 1744.
141. Id. at 182.
142. Id. at 185.
143. Id.
sure documents, which are aimed to protect franchisees against those risks. For example, according to an empirical study conducted by Kimberly Morrison, which is based on data collected by a mailed questionnaire from 307 U.S. franchisees in various industries, most franchisees ignore the franchise disclosure documents before investing in the franchise.144

This important empirical finding, which casts significant doubt on the effectiveness of the FTC franchise disclosure rule, is supported by countless statements by franchise legal experts. For example, Keith Kanouse, a U.S. franchise attorney boasting twenty-two years of experience in franchise matters, claims that most prospective franchisees simply do not read franchise disclosure documents.145 Similarly, according to the Franchise Business Law Group, which represents “large, midsize, and small franchisors,”146 “most franchisees who receive [the] franchise disclosure document will not read the entire thing.”147 In the same vein, Michael Daigle, who spent more than twenty years as chief legal counsel for franchisors such as Blockbuster, Quiznos, Boston Market and Einstein Bagels and also served as Co-Chair of the International Commercial Transactions, Franchising and Distribution Committee of the American Bar Association Section of International Law,148 states that “[t]oo often, franchisees don’t read . . . disclosure documents.”149 Also, according to Mitchell Kassoff, who has been representing both franchisors and franchisees in franchising matters in all fifty states since 1979,150 many prospective franchisees do not read


franchise disclosure documents. In addition, according to David Kaufmann, who wrote the New York’s Franchise Disclosure Law and served as Special Deputy Attorney General in the Franchise Section of the New York Attorney General’s office, “many prospective franchisees don’t read the franchise disclosure document, cover to cover.”

Franchise industry experts too, repeatedly argue that franchisees systematically ignore franchise disclosure documents. For example, according to Arnie Williams, who spent 27 years in the franchise business at franchisor corporate level, states that “being in the business made it abundantly clear to me that most franchisees do not read their [franchise disclosure documents].” Likewise, according to Ginny Wilmerding, a business strategy consultant and a former research associate at the Harvard Business School, too many franchisees do not read franchise disclosure documents carefully. Similarly, Tom Portesy, President and Chief Executive Officer of MFV Expositions, a company that produces the leading franchise events worldwide, states that “many franchise prospects do not read the franchise disclosure document.” Likewise, according to Eddy Goldberg, Managing Editor at Franchise Update Media, a leading integrated content provider in franchising, “many franchisors bemoan the fact that candidates don’t read the [franchise disclosure document].” Finally, a statement by FranNet, a franchisor and franchisee consultant company established in 1987, supports the assertion that franchisees, being


155. Id.

156. GINNY WILMERDING, SMART WOMEN AND SMALL BUSINESS: HOW TO MAKE THE LEAP FROM CORPORATE CAREERS 89 (2006).


unrealistically optimistic, systematically ignore franchise disclosure documents:

It's baffling to think that a franchisee would invest thousands of dollars in a business venture without knowing what he or she was getting into – especially when the law requires franchisors to disclose detailed information about operations, costs, earning potential and legal requirements.

But it happens. All the time. People get so excited about their business venture that they don't read the Franchise Disclosure Document, or just read the Item 7 expenditures and Item 19 earnings information and skip over the rest. Then they're caught by surprise later when it's too late.159

In addition to business experts' statements, anecdotal court cases repeatedly show that franchisees, in diverse industries, ignore franchise disclosure documents. For example, in Ayu's Global Tire v. Big O Tires,160 when the franchisee investigated buying a tires store franchise, the franchisor sent him several copies of its franchise disclosure document.161 However, the franchisee admitted in his deposition that he did not read the franchise disclosure document carefully.162 Similarly, in Bakrac v. Villager Franchise Sys.,163 a hotel franchisor mailed its franchisee a copy of its franchise disclosure document.164 According to the court, "[the franchisee] did not read any part of the [franchise disclosure document] other than the cover page."165 Similarly, in Massey v. Moe's Southwest Grill, LLC166 the fast-food franchisee admitted that he did not read the franchise disclosure document before buying his franchise.167 Likewise, in TES Franchising v. Dombach,168 a business coaching franchisee self-confessed that he did not read the franchise disclosure document.169

161. Id. at *20.
162. Id. at *21.
163. 164 Fed. App'x 820 (11th Cir. 2006).
164. Id. at 822.
165. Id. at 822.
167. Id. at *24; cf. Mary Beth Gettins, Duty to Disclose, but no Duty to Read!, GETTINS LAW (Oct. 11, 2012, 6:10 PM), http://gettinslaw.com/blog/2012/10/11/duty-to-disclose-but-no-duty-to-read/.
169. Id. at *34.
IV. CONCLUSION

A seminal assumption that underlies current franchise law is that franchisees are intrinsically rational. As such, franchisees are presumed to be able to rationally assess the risks involved in the franchise contract and avoid those risks. Based on this rationality assumption, current law is predominantly based on the FTC Franchise Rule, in which franchisors are obliged to disclose to franchisees information regarding future risks. Equipped with this information, franchisees, as rational actors, are assumed to be capable of protecting themselves against franchisor opportunism risks.

This Article questions the validity of the assumption that franchisees are rational actors. Franchisees, although being business people that make large investments in the franchise, are not different from other people: they inherently suffer from a cognitive constraint, known as optimism bias. Being overly optimistic about the future, franchisees systematically avoid reading franchisee disclosure documents, which contain information about future risks. Since franchisees, being overly optimistic, persistently ignore disclosure documents, the efficiency of the FTC Franchise Rule becomes questionable. Consequently, the door should be reopened to considering the adoption of laws that substantially protect franchisees against franchisor potential opportunism.