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Franchisees in a Fringe Banking World: Striking the Balance Between Entrepreneurial Autonomy and Consumer Protection

Robert W. Emerson

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FRANCHISEES IN A FRINGE BANKING WORLD:  
STRIKING THE BALANCE BETWEEN ENTREPRENEURIAL 
AUTONOMY AND CONSUMER PROTECTION  

Robert W. Emerson* 

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   A. The Materiality Requirement ................................. 42
I. INTRODUCTION

The cycle of poor credit history is a powerful one. An individual or business with a low credit rating, perhaps from the late payment of past bills, will have difficulty gaining access to traditional forms of lending. According to some sources, many banks within the United States may even collect data about the financial histories of individuals with respect to their bank accounts and use that information to prohibit individuals with a poor record from opening or maintaining a checking account. Yet, it is the status of maintaining a traditional bank account that provides creditors with the assurance that an individual or business is credit worthy. Without access to credit, those with a poor or non-existent credit history will not have the opportunity to improve their ratings. Thus, the cycle continues: those with bad credit are unable to gain access to loans or to make improvements to their businesses. They are the “asset rich” business owners who are most likely to benefit from low interest rates via a commercial mortgage or a loan program backed by the SBA. Twice as many business owners are either “marginal (B grade) business owners” (47%) or “non-lendable (C grade) business owners” (15%), who all lack the assets backing their business and needed for the standard lending arrangements. The “B Borrowers” who are “marginal” have adequate credit and cash flow, but must turn to Factoring, Merchant Cash Advance Loans, Unsecured Loans or Private Money Loans; to get financing, they must pay a high premium because of their lack of collateral. As for the non-lendable group, their bad credit and poor cash flow, along with having no collateral, means even the fringe lending would be extremely difficult if not impossible to obtain. Therefore, a national lending crisis faces more than 30 million small businesses; this is particularly problematic for the smaller “small” businesses, which have under $1 million in income. The C borrowers’ only option would be microlenders, with loans capped at $35,000 to $50,000. See Dawn Rivers, This Month, a New Financing Crisis for Small Businesses, SMALL BUSINESS TRENDS (June 3, 2011), http://smallbiztrends.com/2011/06/new-financing-crisis-small-businesses.html; Rebecca Mowbray, A New Crop of Microlenders Can Help Businesses When Larger Banks Can’t, THE
are stuck in the fringe economy: a banking world where consumers and small businesses alike suffer from questionable practices and, at least for the consumers, inadequate regulation.

This Article considers fringe banking issues—the gaps or problems in service for both individuals and businesses when the usual banking channels are impractical or even unavailable. Some people may only have recourse to the robust, but often very expensive and less protected, financial products sold for what is, or is supposed to be, a very short-term basis. The Article first examines the fringe banking world, but ultimately considers whether and how consumer protections are needed for franchisees. Small businesses, including franchisees, are often the forgotten players in the fringe economy. If a franchise actually engages in selling fringe banking products, it almost certainly got to that position by not engaging in the financial practices it now trumpets and sells to others. If a franchisee buys fringe banking products, whether and how this small businessperson deserves the regulatory protections of a person not engaged in business is a matter not just for statutory or administrative law but also requires consideration of the franchise relationship and its likely impact on franchisee finances.

II. FILLING THE FINANCIAL SERVICES GAP: THE RISE AND REGULATION OF FRINGE BANKING

A. The Dramatic Growth of Fringe Services

In the past two decades, fringe banking services have grown from near nonexistence into a $100 billion business, with more check-cashing and payday lending locations in the United States than McDonald’s, Burger King, Target, Sears, JCPenney, and Wal-Mart locations combined. Indeed, there are many nontraditional fringe
lending locations. For example, the Federal Deposit Insurance Corporation (“FDIC”) reports that about eighteen percent of all U.S. households have relied on pawn shops, payday lenders, or check-cashing outlets at least once throughout the past five years. While many of these customers do in fact possess bank accounts, they responded to an FDIC survey that they plan to continue using these fringe services due to their convenience and the ease of acquiring loans. In addition, one report states that the typical user for payday loans is actually the head of a family unit with checking accounts and steady employment, but with blemished credit.

Financial institutions subject to federal regulation, such as banks and credit unions, have been the traditional resource for consumers and businesses seeking to procure loans and to cash checks. However, with nearly seventeen million Americans, or 7.7% of all households, without any sort of checking or savings account, there has been an increasing...
need to provide financial services through alternative means. It appears that even those with bank accounts may have financial needs that standard banks cannot or will not meet, such as advanced payments to cover emergency expenses or small loans that are too hard to acquire. For individuals with poor credit records, access to credit may be as limited as for those that are without bank accounts entirely.

Fringe banking organizations, a term used to characterize any financial service provider offering products outside of the standard banking industry, have become the main financial resource for the “unbanked” and individuals lacking suitable credit. Fringe banking outlets include check-cashing businesses, payday lenders, and pawn shops.

Indeed, for many small businesses, such as franchisees, pawn shops have become a prominent source of funds, albeit usually just a short-
term solution to “help a struggling business stay afloat a little while longer, which may be all the business needs to recover.” Also, various lenders provide credit in the form of auto title loans, comparable property loans, and refund anticipation loans.


Alternatively, the argument is that a small, struggling business, being forced to resort to fringe banking and the high interest rates implicit in fringe banking may only perpetuate or contribute to additional economic troubles, if not collapse. Id.

18. While auto title loans are analogous to check-cashing and payday loans, the collateral that the creditor holds is an individual’s automobile title. Michael S. Barr, Banking the Poor, 21 YALE J. ON REG. 121, 164 (2004). These loans are typically within the range of $250 to $1,000 and have a one-month term of repayment. Id. at 164. If the borrower does not repay the loan and the interest accrued, the lender repossesses the automobile and may retain the proceeds from the sale of the automobile, even when the value exceeds the amount of the loan. Id. at 164-65. Title lending is arguably an especially egregious service, as the borrower gives her vehicle as collateral for a cash loan. Id. at 166. If the borrower is unable to repay the loan, her mode of transportation is lost, which may be her sole method of getting to work or getting her children to school. Id.

One report indicated that 9.18% of new-title vehicles were repossessed in Tennessee in 2008 for failure to repay a loan amount. Jim Hawkins, Credit on Wheels: The Law and Business of Auto-Title Lending, 69 WASH. & LEE L. REV. 535, 565 (2012). As such, borrowers take on a huge risk in choosing to get a loan, even if the numbers have sometimes been overstated. Id. at 560-61, 565 (concluding that confusing reports from Tennessee led to the erroneous conclusion in a 2007 law review article, Jean Ann Fox, Fringe Bankers: Economic Predators or a New Financing Services Model?, 30 W. NEW ENG. L. REV. 135, 140 (2007), that 35% to 50% of auto-title loans resulted in repossessions while the actual rate of repossession was three to seven times smaller and reporting figures from six states—Idaho, Illinois, Montana, Oregon, Tennessee, and Virginia—indicating that “repossession rates for those states are much lower than previous research has indicated”).

19. Some lenders provide a service similar to auto title loans, involving collateral other than motor vehicles; they instead use household appliances as the collateral. Barr, supra note 18, at 164.

20. Refund anticipation loans (RALs) may be less prominent than other fringe lending services such as auto title or payday or check-cashing loans, in part because these tend to be seasonal, typically existing in the early part of the year when persons are completing their tax forms and awaiting a refund. These loans, though, have been very popular. Kathryn Smetana, Refund Anticipation Loans: Less Money for Consumers Entitled to Refunds, More Profit for H&R Block, 14 LOY. CONSUMER L. REV. 371, 371 (2002) (noting that an estimated eleven million taxpayers utilize these loans and spend more than $800 million each year to obtain them). They provide borrowers with a guarantee of receipt of their tax refund checks more quickly than the standard receipt by the IRS. Id. at 371 (refund checks are delivered typically in two days as opposed to ten to fourteen days if obtained through the standard IRS delivery). The average annual interest rates for these loans range from 67% to an astronomical 774%, depending on the total amount of the refund check. Id. For an average $2,500 loan, the resulting APR would likely range from 85% to 170%. Fox, supra note 18, at 137. Still, the poor and the unbanked may have more of a market for these services precisely because they may be less likely to file online returns and to specify a bank for deposit of the refund, both of which would likely speed the refund process.
B. Initial Regulation: Some State Law Examples for Auto Titles and Payday Loans

1. Auto Title Loans

Fringe providers target those that are more likely to use their services than traditional banks. That alone, however, is unremarkable. Therefore, the question remains whether the state and federal governments should implement regulation to protect individuals from such practices. Before considering that issue later in the Article, it is important to first recognize that this industry already has had regulation, particularly at the state level, which is sometimes well planned, but usually sporadic.

As a general matter, auto-title loans are a source of credit for millions of Americans. In an auto-title loan transaction, a borrower receives a one-month loan at a higher interest rate and gives the lender a security interest in a vehicle. As of 2007, the issuance of auto title loans was legal in about half of the states within the United States. Some of these states have deregulated rates for licensed lenders, whereas others have legislation permitting triple-digit annual interest rates for title loans. In some states, title lenders use loopholes or operate under other lending laws to avoid punishment for illegal behavior. Auto-title loans have been an issue for policymakers concerned with individuals using what, in many cases, is their primary asset and only means of transportation as collateral for a loan.

2. Refund Anticipation Loans

Refund anticipation loans (RALs) have also been problematic. RALs, however, need not be a large concern because several federal agencies, including the Internal Revenue Service (IRS) and the FDIC, took actions in 2010 and 2011 that effectively have left only one bank, working with just two national tax preparation services, to provide this form of loan. As such, there may no longer be any banks available to

21. See infra notes 84-101 and accompanying text.
23. Id. at 538.
24. Fox, supra note 18.
25. Id. at 145.
26. Id.
27. Hawkins, supra note 18, at 538.
28. In August 2010, the IRS stopped providing tax preparers and banks with the Debt
offer refund anticipation loans during the 2012 tax season.\textsuperscript{29}

3. Payday Loans

Most states permit high-cost payday lending practices. Eighteen states have prohibited or set very strict caps on interest rates for payday lending institutions, while thirty-two states have allowed such practices with varying regulation.\textsuperscript{30} Indeed, many states allow payday lenders to charge triple digit interest rates or have no rate cap at all.\textsuperscript{31} According to the Consumer Federation of America, Missouri tops the list with an amazing Annual Percentage Rate (“APR”) of 1,950% on a loan in the amount of $100 with a two-week maturity.\textsuperscript{32} While this is the only four digit interest rate, several states have no caps at all, including Delaware, Indicator, a service helping lenders check the credit of taxpayers. See Press Release, Consumer Fed’n of Am., Nat’l Consumer Law Ctr, End in Sight for Quickie Tax Loans: Latest NCLC/CFA Report Documents Twilight of the Refund Anticipation Loan (Feb. 28, 2011), available at http://www.consumerfed.org/pdfs/2011-RAL-press-release.pdf. Later in 2010, the Office of Thrift Supervision and the Office of the Comptroller of the Currency both issued directives prohibiting MetaBank, the likely loan partner for Jackson Hewitt (the second largest tax preparation firm), and HSBC, the lending bank partner of H&R Block (the largest tax preparation firm), from offering refund anticipation loans. (In 2010, H&R Block ended its contract for tax refund anticipation loans. Kristina Peterson, Now Private Company, Jackson Hewitt Plans to Still Offer Tax Loans, DOW JONES NEWSWIRES (Aug. 9, 2011), available at http://www.advfn.com/nasdaq/StockNews.asp?stocknews=RBCAA&article=48768284). In February 2011, the FDIC notified the three remaining state-chartered banks making these loans that offering such loans without the Debt Indicator from the IRS is an unsafe and unsound practice. Nat’l Consumer Law Ctr. As a result, two of the three banks announced that they would no longer offer loans after the 2011 tax season, while the third bank appealed the decision in the courts. Id.

\textsuperscript{29} Nat’l Consumer Law Ctr., supra note 28. Jackson Hewitt and Liberty Tax are now the only two national tax preparation companies that may offer the loans provided by Kentucky-based Republic Bank & Trust, a unit of holding company Republic Bancorp Inc. (RBCAA). Id.; Peterson, supra note 28. Refund anticipation checks (RACs) will still be available, at a cost to customers who temporarily open a bank account simply for the purpose of receiving a tax refund payment, but these services are relatively cheap (a fee of approximately $30), offered by traditional banks, and presumably could even lead to more of the unbanked deciding instead to save some money short-term (avoiding the RAC fee) and perhaps also long-term by opening a regular bank account. Nat. Consumer Law Ctr., supra note 28.

\textsuperscript{30} See PayDay Loan Consumer Information: Legal status of Payday Loans by State, CONSUMER FED’N OF AM., http://www.paydayloaninfo.org/state-information (last visited Dec. 14, 2012). These numbers have held remarkably steady for the past decade, with just one more state prohibiting payday lending in the past 11 years or more. See Gregory Elliehausen & Edward C. Lawrence, Payday advance credit in America: An analysis of consumer demand 5 (McDonough School of Business, Georgetown University, Monograph No. 35, 2001), available at http://faculty.msb.edu/prog/CRC/pdf/mono35.pdf (noting that 17 states effectively prohibit payday lending through strict interest rate ceilings).

\textsuperscript{31} PayDay Loan Consumer Information: Legal status of Payday Loans by State, supra note 30.

\textsuperscript{32} Id.
Idaho, Nevada, South Dakota, Utah, and Wisconsin.\textsuperscript{33} In contrast, the states that bar extremely high-cost payday lending do so through various methods.\textsuperscript{34} For example, states have applied their small loan rate caps to those operating payday outlets, resulting in a prohibition of such lending altogether.\textsuperscript{35} Also, states with less regulation related to interest rates may provide statutory limitations through other methods, such as by limiting the total loan amount or the number of allowable rollover transactions. For example, Florida permits an APR of 419\% for a fourteen-day $100 loan; however, the maximum loan amount is $500 with no rollovers permitted.\textsuperscript{36} A limit on the number of rollovers may be an especially valuable tool for protecting consumers, as the rollover transactions often constitute the process that allegedly entangles borrowers in a trap of indebtedness.\textsuperscript{37}

Several states, including Arkansas, New Jersey, and New York, have limited loans through the application of their usury laws, which dictate the interest rate that can be charged for lending money.\textsuperscript{38} Thirty-seven states and the District of Columbia have a payday loan act or a small loan statute specifically addressing payday loans.\textsuperscript{39} These enactments are much more specific than the respective states’ general usury laws; they apply to payday loan lenders directly.\textsuperscript{40} Still, many fringe banking outlets have attempted to evade usury laws by claiming that they are not extending credit or offering loans.\textsuperscript{41} For example, 	extit{Betts v. McKenzie Check Advance of Florida, LLC}, explains how fringe lenders characterize “deferred presentment” as a service for a fee instead of a loan charging interest.\textsuperscript{42} Fringe lenders describe the transaction as the lender simply holding the check, giving the customer cash, and

\begin{itemize}
  \item \textsuperscript{33} Id.
  \item \textsuperscript{34} Id.
  \item \textsuperscript{35} Id.
  \item \textsuperscript{37} Hawkins, supra note 5, at 1398.
  \item \textsuperscript{38} PayDay Loan Consumer Information: Legal status of Payday Loans by State, supra note 30.
  \item \textsuperscript{40} Id.
  \item \textsuperscript{41} Drysdale & Keest, supra note 11, at 596.
  \item \textsuperscript{42} Betts v. McKenzie Check Advance of Fla., LLC, 879 So.2d 667, 668 (Fla. Dist. Ct. App. 2004).
\end{itemize}
promising to refrain from cashing the check for a period of time.\textsuperscript{43} In exchange for its promise to not cash the check, the fringe lender extracts a fee from the customer as consideration.\textsuperscript{44} Fringe banking outlets classify the transaction as a whole service and the fee extracted as consideration for the service, rather than a charge of interest.\textsuperscript{45}

Moreover, the ability of fringe banking outlets to evade, if not usury laws,\textsuperscript{46} more general supervision, was enhanced by deregulation of the consumer credit marketplace during the 1980s and 1990s.\textsuperscript{47} Furthermore, since most of the advertisements for these fringe lenders focus on the quick and easy cash aspect, they generally do not contain any “trigger terms”\textsuperscript{48} that would require them to state the APR under the Truth in Lending Act (“TILA”).\textsuperscript{49}

It is likely that states will continue to enact additional, payday loan legislation. As of December 7, 2011, bills were pending in twenty-eight state legislatures.\textsuperscript{50} In 2011, eight states enacted legislation: Arkansas, Illinois, Mississippi, New Mexico, North Dakota, Tennessee, Texas and

\textsuperscript{43} See id. at 669.

\textsuperscript{44} Id.

\textsuperscript{45} Id. Payday loans have also been called “cash advance loans,” “check advance loans,” “deferred deposit checks,” “delayed deposit checks,” and “postdated check loans.” See 12 C.F.R. § 226(2)(a)(14) (2000); see also Austin v. Ala. Check Cashers Ass’n., 936 So. 2d 1014, 1017 (Ala. 2005) (referring to payday loans as “deferred presentment transactions”).

\textsuperscript{46} A number of courts have rejected a fringe banking firm’s attempt to avoid usury restrictions. See, e.g., Hamilton v. York, 987 F. Supp. 953, 956 (E.D. Ky. 1997); Austin v. Ala. Check Cashers Ass’n., 936 So. 2d 1014, 1026-27 (Ala. 2005); Betts, 928 So. 2d 1204; White v. Check Holders Inc., 996 S.W.2d 496, 500 (Ky. 1999). However, commentators have concluded that most state usury laws do not restrict, for example, payday lenders. See Frank Burt, Farrokh Jhabvala, Jason Kairalla & Ari Gerstin, Refund Anticipation, Payday, and Auto Title Loans: A Survey of Select Fringe Lending Products, JORDENBURTLLP, 14-17 (2006), available at http://www.jordenburt.com/attachments/489.pdf.

\textsuperscript{47} Drysdale & Keest, supra note 11, at 596 n.28 (discussing the general rationale for deregulation to include proper disclosure and letting the market dictate price).

\textsuperscript{48} When used in advertisements, certain terms, such as the rate of interest or finance charges and member fees, act as triggers, which require further disclosure from the lender to the consumer. See David A. Basil & Christian G. Koelbl, Credit Advertising and Related Matters, in AM. BAR ASS’N, TRUTH IN LENDING (2003 Supp.). For instance if a lender advertises a 1% monthly finance charge, that “triggers” further disclosure. Under the Truth in Lending Act, that lender must then disclose the APR, any minimum, fixed, transaction or activity charge, and any membership fee. Id.


Wisconsin.51 While legislators will continue to take various approaches as to the best way to regulate this particular fringe service, some commentators believe that states need to do much more to protect consumers from the presumably outrageous practices of some fringe lenders.52 In contrast, some commentators believe that payday lending is a necessary evil and not allowing consumers access to such loans could lead consumers to face significant problems beyond merely paying a high interest rate, such as foreclosure, eviction, and bankruptcy.53

C. Federal Regulation: The Dodd-Frank Act and the Consumer Financial Protection Bureau

Even greater than the continued state legislative efforts against payday lending and the effective end to most refund anticipation loans is the federal government’s actions to protect consumers and regulate financial services. In 2010, the U.S. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which was the largest financial overhaul since the Great Depression.54 The stated purpose of the Act is to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”55 The Act spans 2,300 pages and creates regulation for a large number of consumer and commercial financial products.56

Especially important for the regulation of fringe products is the creation of the Consumer Financial Protection Bureau (CFPB) under Title X of the Act.57 The Bureau began operation on July 21, 2011 and has the authority to regulate nearly all consumer financial products, affecting over $14 trillion in consumer debt and services.58 The CFPB’s mission is to “make markets for consumer financial products and

52. Fox, supra note 18, at 146–49.
57. Id. at 119.
58. Id.
services work for Americans, whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products.” The Bureau plans to “promote fairness and transparency” for financial products and services and “set and enforce clear, consistent rules that allow banks and other consumer financial services providers to compete on a level playing field and that let consumers see clearly the costs and features of products and services.”

Prior to the creation of the Bureau and the passage of the Dodd-Frank Act, the Federal Trade Commission (FTC) had the authority to prohibit actions by financial service providers that were deemed unfair or deceptive under the Federal Trade Commission Act. However, the language of the Dodd-Frank Act now provides that the federal government can prevent these providers from engaging in “abusive acts or practices.” Some argue that this term is too broad of a standard with little to no guidance as to its scope and exact definition. Others state that there is a history of the use of the term in recent federal provisions that provide guidance as to what constitutes an abusive practice. Commentators contend that a practice which will fall within the category of abuse is the extension of high-risk credit without assessing each borrower’s ability to repay the loan. If this opinion proves accurate, it is the fringe lenders, themselves, who will be especially at risk of regulation and discipline by the Bureau unless their practices change.

D. The Opposite Perspective: The Necessity of Fringe Products

Despite the negative reputation of fringe banking services, the providers of such services offer something of value that many individuals would not otherwise be able to access. Payday lenders allow individuals to borrow small sums of money with quick repayment terms, a service that typically is unavailable via traditional banks, even for those with strong credit ratings. For families that are financially

61. Id.
63. Id. (quoting Dodd-Frank Act § 1031(a)).
64. Id.
65. Id.
66. Id.
strapped, a small loan may be the money needed to survive—as an
economic unit—for a short period of time. For example, a small loan
can increase a consumer’s general welfare “if the money is used to
purchase a durable good, like a car or washing machine, that provides
the consumer with a present-value savings compared to the alternative,
such as periodic payments for mass transit or taxis or using a
laundromat.” In addition, for many people that use these services, it is
their only source of legal credit. Although loans from these providers
are expensive, the payment of fees may be preferable to repossession or
late fees incurred from failure to pay a bill.

The ease of obtaining funds from fringe bankers is the dominant
attribute pushing sales. For example, an advertisement for National
Cash Advance proclaims, “[w]hatever the situation, getting a cash
advance of $100 or more . . . is quick, easy, and hassle free. Simply
write us a personal check. We’ll advance you the cash today and hold
your check until payday.” While such an advertisement surely
overstates the simplicity of the transaction, individuals in need of a loan
would likely find the process to be quicker and easier than with a bank.
Indeed, that is certainly the reason why many small businesses also
obtain fringe loans.

III. FRINGE BANKING DEMOGRAPHICS AND UNCONSCIONABILITY

A. The Demographics of Fringe Consumers

For a variety of reasons, individuals in low-income households tend
to be the most common customers of fringe services. According to the
United States General Accounting Office, approximately fifty-one
percent of adults earning less than $15,000 per year and thirty-six percent of adults making between $15,000 and $30,000 per year do not have a basic bank account.\textsuperscript{74} According to the FDIC, this practice results from insufficient financial education, high fees associated with banking, and inaccessibility to “mainstream” loans.\textsuperscript{75} In addition, many individuals feel as though they simply do not have enough money to make a bank account worthwhile.\textsuperscript{76}

As advertised online, providers attempt to express their motivation as genuine concern for those that are in a “cash dilemma.”\textsuperscript{77} The advertisement lists making a critical math mistake while balancing the checking account or having a “big” commission check delayed a week as examples that may cause a borrower to be in a cash bind.\textsuperscript{78} However, use of fringe services is most prevalent among the unbanked and low-income individuals.\textsuperscript{79} Therefore, it is most likely a rare borrower that uses fringe loans to rectify bank account mistakes or to cover delays in receiving a large payment.

For business owners and entrepreneurs, acquiring funds through bank loans can prove equally as difficult as for individuals with poor credit history, as many traditional lenders will be hesitant to extend credit to a business without a strong business credit record.\textsuperscript{80} This is

\begin{itemize}
  \item \textsuperscript{74} Perez, supra note 1, at 1594.
  \item \textsuperscript{76} Ellis, supra note 7.
  \item \textsuperscript{78} Id.
  \item \textsuperscript{79} This point does not mean that unbanked and low-income individuals do not effectively manage their money. There is actually empirical literature to the contrary. See Ronald J. Mann, After the Great Recession: Regulating Financial Services for Low-And Middle-Income Communities, 69 WASH. & LEE L. REV. 729, 740-41 (2012). According to some commentators, “households that use alternative financial services are in fact pretty good managers of their money . . . [and low-income] households do an admirable job of balancing use and payments among the various credit accounts they hold.” Id. Accordingly, the prevalence of fringe banking services does not indicate a prevalence of poor money management by the unbanked or low-income.
  \item \textsuperscript{80} Tracy L. Penwell, The Credit Process: A Guide for Small Business Owners, FEDERAL RESERVE BANK OF NEW YORK, http://www.newyorkfed.org/education/addpub/credit.html (last visited Dec. 14, 2012). See infra notes 176–178 and accompanying text (discussing the Small Business Administration data indicating that franchisees have not been relatively successful compared to other businesses and that loans to franchisees in fact have high default rates); ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 35 (2005) (noting that the data reveal that “business failure is a fact of life . . . just as true for franchisors and franchisees as it is for other players in the economy;” concluding, “franchising is no safer on average than independent business ownership, and in some cases is actually more risky”).
\end{itemize}
especially true depending on a business’s stage of development.\textsuperscript{81} Without access to the financial resources for continuing operations and making improvements, businesses suffer a higher risk of death: with inadequate finances, these businesses often fold.\textsuperscript{82}

\textbf{B. Unconscionability: Skepticism about Fringe Lenders’ Practices}

Fringe banking practices have come under heavy scrutiny. Most of the criticism center around notions of fairness: that fringe service providers are acting unconscionably in terms of the individuals they target and the interest rates charged.\textsuperscript{83}

1. Targeted Locations

Reports indicate that the one factor most strongly associated with the ratio of fringe provider locations to the total number of financial service providers is poverty: the greater a county’s poverty rate, the higher the market share of fringe providers.\textsuperscript{84} The prevalence of fringe providers in low-income locations appears to indicate that the providers are well aware of their target market and intentionally choose to operate in such areas. Additionally, individuals without bank accounts are prone to the use of fringe products and are largely undereducated, with approximately sixty-nine percent of unbanked individuals having only a high school education or less.\textsuperscript{85}

2. Outrageous Interest Rates Charged to the Poorest Consumers

Not only do fringe bankers often market their products to low-

\textsuperscript{81} Penwell, \textit{supra} note 80. Penwell discusses four different stages of development in an individual’s business and suggests that only those in the third or fourth step in development are in a position to approach a traditional lender for a loan. \textit{Id.; see also} Durkin, \textit{supra} note 73, at 2 (noting that the newness, small size, or inexperience of a franchised business make it very difficult to get any financing).

\textsuperscript{82} \textit{Id.} In its latest survey (August 2012), the National Federation of Independent Business (NFIB) reported that one in five small business owners seeking to meet credit needs were unsuccessful in having all their needs met. \textit{Small Business Economic Trends, NAT’L FED’N OF INDEP. BUS.}, http://www.nfib.com/research-foundation/surveys/small-business-economic-trends (last visited Sept. 21, 2012) (finding that 31\% of those surveyed reported that all of their credit needs were met, with seven percent reporting that not all of their credit needs were satisfied—the remainder were not interested in borrowing or did not answer the question). The survey is limited to the perspective of members of the organization, and the survey provides no indication as to the methods by which credit was obtained by business owners. \textit{Id.}

\textsuperscript{83} Hawkins & Mann, \textit{supra} note 15, at 857.

\textsuperscript{84} Mahon, \textit{supra} note 4.

\textsuperscript{85} Perez, \textit{supra} note 1, at 1594.
income individuals, but, to make matters even worse, those persons with the least income pay the most for their financial services. To exacerbate the issue, a flood of legislation during the 1990s and early 2000s left many payday lenders exempt from state usury laws. In an attempt to curb what some see as a predatory practice, or a structural problem, national regulation in the form of consumer protection has been proposed. As of recent, states have been more aggressive in trying to curb fringe lending by attempting to cap the extremely high interest rates of fringe lenders to ensure that those lenders cannot make a profit on short-term loans.

Despite these efforts, and given the recently difficult economic times, fringe lending is flourishing. An individual receiving a net annual income of $12,000 can expect to pay $250 a year for these services to cash his paycheck. The interest rates paid by these same individuals for small loans further illustrate the financial burden these services place on those that are barely making ends meet. An individual who receives a payday loan will likely pay 470% APR, an astronomical figure when considering the much lower interest rates that traditional banks charge to their account holders. Over time, an over

86. See supra notes 84-85 and accompanying text.
87. However, given the high risk of such loans, it seems rational that they would have to pay higher rates.
88. Hynes, supra note 53, at 625.
91. Hynes, supra note 53, at 625.
92. Id. at 608. Small businesses are a large percentage of the fringe banking customer base, and an even higher percentage of the total dollars lent. See, e.g., Todd J. Zywicki, Consumer Use and Government Regulation of Title Pledge Lending, 22 LOY. CONSUMER L. REV. 425, 449 (2010) (noting that small businesses constitute up to about 30% of the title loan customers and an even higher percentage of the total dollars lent).
93. Perez, supra note 1, at 1597.
94. Id. at 1598.
95. Id.
96. Dan Weil, 3 ways to get a small-business loan, BANKRATE.COM, http://www.bankrate.com/finance/personal-finance/3-ways-to-get-a-small-business-loan-1.aspx (last visited Dec. 14, 2012) (noting that interest rates for bank loans to small businesses—typically less than the 8% to 15% rate for online loans—are typically at the lowest rate offered, with many banks having established reputations as trustworthy lenders).
indebted individual could be thrust into default by repeatedly borrowing, even if in small amounts. 97

To a certain extent, lenders must charge a steep interest rate to account for the relatively high risk of default when dealing with individuals that have a poor history of repayment. However, fringe lenders ordinarily do not use credit histories to consider customers’ abilities to repay. In effect, these lenders do not require proof of repayment ability and instead rely upon a postdated check or other collateral. 98 Indeed, their behavior may be considered predatory lending, with these creditors having made little or no effort to assess a borrower’s credit history while intentionally targeting geographic areas whose demographics indicate a population disproportionately filled with potential customers that have a poor or nonexistent credit record. 99

Given these circumstances, the lenders must be estopped to deny that all their customers should be charged a high interest rate as a matter of the creditor’s use of market differentiation (between high credit risk customers and lower risk customers). Undoubtedly, the differentiation in price charged to customers is not so much internal (i.e., varying within a particular fringe banking company, depending on the customer), so much as it is simply traced to an “external” distinction between those customers who obtain their financing from the fringe banking entity itself and those who can and do bank with a more traditional institution (e.g., a bank or credit union).

While lenders could be required to evaluate borrowers based on

97. White, supra note 69, at 1108.
98. Barr, supra note 18, at 166; Hawkins, supra note 5 at 1394, 1401 (stating, “Lenders report payday loans to Teletrack, a credit bureau for fringe credit transactions, and lenders check Teletrack before extending loans to ensure potential borrowers have not taken out other payday loans”; further noting that that fringe lenders “use means other than credit history to ensure repayment,” with those methods including collection via collateral or a future paycheck).

As fringe banking outlets loan only small amounts to customers, the average fringe banking outlet has little time or money to gather a consumer’s financial information and to conduct a background search on the customer’s financial condition; those expenses in time and money outweigh the potential costs savings from weeding out high risk customers. Search costs also likely prevent fringe bankers from splitting their customer pool into different risk categories and charging distinct interest rates for each risk pool. Indeed, fringe bankers might in part be hedging their risk among the entire customer pool by charging all customers exorbitant interest rates. Hawkins, supra note 5, at 1399-1400.

99. Howard Karger, Shortchanged: Life and Debt in the Fringe Economy 11 (2005) (“While risks exist—as in all industries—they are mitigated by loan collateral, excessive markup in prices, and the socialization of losses among a class of borrowers. Put another way, enough people will make good on their payday loans to compensate for the bad ones—not difficult, given the extremely high industry-wide profit margins. In short, industry claims about the high risks associated with serving marginal populations are exaggerated.”).
their ability to repay the loan, as would a traditional bank, this would be a challenge when dealing with the typical borrower. For example, most individuals that use fringe lending services do so due to poor credit, which creates an inability to borrow from traditional banks. As a result, fringe lenders cannot not use an individual’s credit rating as a tool to evaluate a borrower’s ability to repay a loan. Most ratings of borrowers would likely be poor and would exclude lenders from providing loans to the vast majority of these individuals. Additionally, evaluating a borrower on the basis of income may prove an ineffective tool for assessing the probability of repayment. Some lenders have recognized the issue with lending solely based on credit scores and these lenders have adjusted their practices to include other considerations, such as cash flow. While this practice may not help the typical fringe borrower, it surely would help potential franchisees with no previous franchise or brand experience.

3. Oversimplified Marketing Campaigns

Perhaps fringe bankers’ marketing campaigns, coupled with their arguably unconscionable interest rates and targeting of low-income individuals, furnish additional grounds for scrutiny. One advertisement stipulates that the use of a payday loan service allows borrowers to save money, save their credit, and save face. The evidence seems to indicate that individuals using fringe services will pay large fees and annual interest rates between 100% and 500%. The advertisement, therefore, would lead a borrower to believe that using a payday lending service will save her money when compared with having to incur fees.

100. One report indicated that the typical borrower had an annual income of up to $50,000. Stegman & Faris, supra note 9, at 15. Some commentators might find it unfair to allow a fairly illiquid or perhaps nearly insolvent individual with an annual salary of $50,000 to obtain a loan and not the individual making $30,000 per year even if that individual is in a better financial position overall. While salary may be one tool to analyze the likelihood of repayment, it surely falls short of a complete analysis. The individual making less annually may have fewer financial obligations and be in a better position to repay the loan than the individual who has a greater salary. A formula that encapsulates this idea and thus better assesses an individual’s likelihood of repayment, is: Effective Gross Income (EGI) plus Other Investments/Collateral minus Total Obligations equals Net Income (ability to repay).


associated with a late bill payment. \footnote{104} Similarly, the advertisement appeals to the borrower’s concern for his credit, as it states that obtaining a payday loan will prevent an individual from receiving “bad marks” to his credit record by paying a bill after its due date. \footnote{105} This reasoning is backwards, as many users of fringe products obtain a fringe loan due to a poor or nonexistent credit rating, not for the purpose of protecting the rating. \footnote{106} Finally, the advertisement appeals to borrowers’ emotions: suggesting that a payday loan can protect borrowers’ personal and business relationships by helping borrowers avoid asking relatives or friends for money. \footnote{107} While most would agree that asking for a loan from a family member or a friend can be embarrassing, \footnote{108} the advertisement seems to unnecessarily invoke fear in individuals strapped for cash. \footnote{109} By way of comparison, in Australia, “the credit squeeze has forced new franchisees to borrow from their parents, family and friends to get into business;” \footnote{110} if Aussies can do that, why should Americans shy away? \footnote{111} Indeed, in a difficult economic climate, some franchisors

104. Payday Loans Review, supra note 102.

105. Id.

106. Indeed, the payday loan may just make things worse. Consider a small business and its recurring transaction costs for a payday loan:

1. Typically it is advanced 10%–15% of the company’s average monthly revenue;
2. The loan is personally guaranteed by the owner;
3. Every thirty days the costs occur again; and
4. For a year-long arrangement, the business would incur $1,200 in fees on a $1,000 loan.


In sum, “Borrowing money from a payday lender—especially for business—is like walking into quicksand. The longer you’re in the hole, the deeper you sink into debt and despair.” Id. (emphasis added).


108. Of course, family members or friends may not be an available source of funds for the simple reason that these persons have no more access to funds or credit than does the franchisee. John P Caskey, Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor 68-77 (1994).

109. Zywicki, supra note 92, at 454–55 (discussing survey results as well as social and psychological issues involved in borrowing money, or not seeking to borrow money, from family or friends).


111. Perhaps Australians are inclined to turn to family and friends when they need funds because they actually understand the alternative in the form of loans that fringe lenders would offer. Australia’s Uniform Consumer Credit Code (UCCC), which was adopted in 1994, is intended to make Australia’s fringe banking rates transparent to borrowers. Infosys Technologies Ltd., supra note 7, at 16. Credit providers in Australia are required “to disclose all relevant terms and
are doing more to line up financing.112

IV. SMALL BUSINESSES AS FRINGE BANKING CUSTOMERS: THE FRANCHISEE EXPERIENCE

Car title loans are a product of the ubiquitous “bad credit, no credit, no problem” advertisements offered by lenders.113 In exchange for the small loan that a borrower could not get at a bank, the lender requires a high interest rate and the title of the borrower’s car as collateral; in comparison to the already steep interest rates that credit card companies may charge, car title loans can legally be over ten times higher—as much as 250% or more.114 Of course, whether these loans are for personal debt or for business matters, the amounts owed—and the total payments expected—can be exorbitant, as borrowers struggle simply to pay interest while making little headway in reducing the outstanding principal. For example, a car title borrower paid $400 a month for seven months ($2800) just to pay off the accumulated interest on her $3000 conditions including annual interest rates before entering into a contract and ensure that borrowers receive adequate copies of loan documentation. Id. There is also a requirement of disclosure of annual interest rates in advertisements. Despite the regulation, fringe banking has been a significantly growing part of the Australian financial sector. Id. at 4.

112. Sarah E. Needleman, Franchisers Focus on Loans: Amid Weak Small-Business Lending, Franchisers Help Franchisees Get Loans, WALL ST. J. (Aug. 3, 2011, 7:26 PM ET) http://online.wsj.com/article/SB1000142405311903366504576486173595460998.html (reporting, “Thirty-nine percent of franchisers said more than half of their franchisees and franchise prospects were unable to obtain needed financing, according to a March [2011] survey of 147 franchisers by International Franchise Association, a trade group;” in response, some franchisors are taking more active roles to find financing for their struggling franchisees, and many businesses have formed with the purpose of connecting franchisees and their franchisor in order to arrange financing). For example, the franchised restaurant chain Wingstop has had financing arrangements with Franchise America Finance and The Bancorp Bank—securing $15 million for franchise lending to new and existing franchisees. Steven R. Thompson, Wingstop Secures $15 million for Franchise Lending, DALLAS BUS. J. (Dec. 1, 2011, 12:33PM CST), http://www.bizjournals.com/dallas/news/2011/12/01/wingstop-secures-15-million-for.html. Furthermore, franchisor GNC has also promoted how it seeks to do as much as possible to provide direct financing to its franchisees. Frequently Asked Questions, GNC LIVE WELL, http://www.gncfranchising.com/dom_faq.asp#q9 (last visited Dec. 14, 2012).


114. In addition to these high interest rates, multiple mandatory fees are standard, thereby making it that much harder for cash-strapped borrowers to escape the piling debt. Car Title Loans a Problem, supra note 113 (noting that such fees include processing, document, late, origination, and and lien fees).
loan. After those grueling payments she was still at square one, with the full loan to pay back. Indeed, this outcome is the ordinary result of loan terms “crafted to keep borrowers in a cycle of debt and bring customers either to the verge of repossession or to actual repossession.”

The horror stories are not limited to a particular type of loan. Besides auto title loans, payday loans, with nearly $11 billion lent online in 2010, serve as an economic “lifeline.” Just as often though, these payday loans serve as a debt sentence. Ramon Zayas had bills piling up from the treatment for his prostate cancer, so Zayas and his wife decided to take out a $250 loan from 500 FASTCASH at a 476% annual percent interest rate. The money was used in order to pay the Zayas’ electricity bill, and Ramon Zayas believed he was paying off the loan. However, confusing fees and enormous rates transformed his payments to $125 a month (half of the original loan). While Zayas thought he would be paying, in effect, thirty percent interest while paying off the loan within a few months, he actually paid far more interest than principal. Despite the fact that eighteen states have proscribed payday lending, 500 FASTCASH and over two dozen other online payday lenders have been shielded from state laws because they are owned by American Indian tribes.

A. The Effects of Regulation on Consumers

When considering regulation of fringe services, we must contemplate the effect on individuals and businesses that rely on the credit obtained thereby. If regulations restrict access to these services, many people will be without a form of credit when they desperately need it to survive. Even those that support the regulation of abusive

115. Id.
116. Id.
117. Id.
119. Id.
120. Id.
121. Id.
122. Id. (“I borrowed $250 [and] thought I was going to pay $325,” Zayas said).
123. Id. (Zayas ended up paying $700 on a $250 loan, “but it would have been $1,100 had [he] not gone to the bank and put a stop to this”).
124. See supra note 30 and accompanying text.
125. Keteyian, supra note 118.
126. Hawkins, supra note 5, at 1363.
practices acknowledge that it is likely to harm the “economically disadvantaged disproportionately,” due to their already limited access to loans.127 The irony of such regulation is that it is purported to protect individuals and businesses from the potentially harmful practices of financial providers, yet the regulation itself may cause more harm than good to those who are most in need.128

Consider whether fringe lending actually produces financial distress.129 Many fringe banking products (rent-to-own, pawning of goods, and title lending) are structured so that borrowers can “escape” their debt by walking away and only losing the equity they put in as well as their collateral. Most loans are for small amounts and, in pawn shops especially, the negative consequence from losing the collateral is often emotional rather than financial, such as losing a family heirloom, yet losing access to such a loan could cause financial distress by not being able to use the money (e.g., the pawnbroker’s loan) to pay off other bills and debts.130 Though structured differently from other fringe banking products, payday loans still operate in a similar manner in that loan amounts are capped at a relatively low number: the amount of a biweekly pay check.131

Perhaps there could be alternative sources of credit. For consumers these sources might be: loans from family and friends directly, use of credit cards to finance bills and purchases, home equity refinancing (assuming the consumer owns a home), and offering a family member’s or friend’s guarantee on a traditional loan. Further methods of credit could be the buying of inventory or equipment with a purchase-money security interest,132 having corporate owners provide personal guarantees on loans, the offering of unencumbered assets as collateral, and, in the worst case scenario, filing a Chapter 11 bankruptcy and obtaining credit during reorganization.133 If consumers and businesses have already

127. Lee, supra note 56, at 121.
128. DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 14-15 (2011). The Dodd-Frank Act and creation of the Bureau will likely lead to an increase in litigation against financial service providers, as the Bureau has the authority to pursue a civil action for violation of the federal consumer financial laws. Smith, Westbrook, & Niels, supra note 54, at 5. In addition, these providers are likely to be subjected to more civil or administrative actions based on the consumer protection regulations that the CFPB promulgates. Id.
129. Hawkins, supra note 5, at 1386–98.
130. Id. at 1390.
131. Id. at 1394.
exhausted the above sources, they may have no alternative to fringe financing. Consumers and small business owners in a financial crunch ordinarily will have little or no knowledge or other resources to pursue alternate credit sources, nor will they have time to educate themselves about more sophisticated forms of credit.

Perhaps a reason alternative credit sources are not utilized by individuals is because they prefer the fringe banking products' more convenient environment than for mainstream institutions. At any rate, the formal alternatives, such as bank loans, are usually unavailable to pawn shop customers because they would not, with their credit ratings, qualify for a loan.

There is evidence that customers of fringe outlets feel as though these businesses meet their needs better than mainstream institutions. One focus group report indicated that check cashers were superior to banks with regard to their access to immediate cash, locations, service, respect of the customer, and trustworthiness. More interestingly, some focus group members indicated that the pricing policies of check cashers were more transparent than the policies of banks. These individuals valued the ability to use check cashers without any obligation to continue a relationship on the part of the borrower. Thus, the focus group illustrates that there are aspects of fringe lending services that are appealing, regardless of the high fees that may be charged. The consumer preference for these services must be considered when determining the appropriate levels of regulation for fringe banking.

If lenders provide cash for individuals in genuine emergency situations, and do not simply prey on debtors’ chronic mismanagement of funds, it is arguable that they should not be subject to more regulation. Assisting those in need in times of crisis or when an unexpected expense occurs is a worthy service, with the sole principal

134. Timothy Bates & Constance R. Dunham, Introduction to Focus Issue: Use of Financial Services by Low-Income Households, 17 ECON. DEV. Q. 3, 4 (Feb. 2003) (citing DAVID CAPLOVITZ, THE POOR PAY MORE 34 (1963)). In order to fight the convenience of fringe banks that are check cashers, grocery stores and “regular” banks increasingly have acted as alternatives—the stores providing check cashing free to their customers and the banks cashing checks free of charge if the check originated from that bank. See Ebonya Washington, The Impact of Banking and Fringe Banking Regulation on the Number of Unbanked Americans, 41 J. HUMAN RESOURCES 106 (2006).
135. CASKEY, supra note 108, at 70. Even if pawn shop “banking” is a market reality, there may be useful reforms of its operations.
136. Stegman & Faris, supra note 9, at 13.
137. Id.
138. Id.
139. Id.
objection being the price of the service. 140 This is especially so when these individuals in crisis have no other practical source to obtain cash. 141

Greater regulation may result in fewer fringe providers. If a consumer obtains funds outside of fringe banking, she might be driven to independent loan sharks with the stereotypical bat in hand enforcing interest rates that are likely unregulated. As for approaching family members and friends, hat in hand and begging for cash, clearly that can be detrimental to one’s self worth and personal relationships. 142 In addition, this alternative presumes that one has family members and friends available and that those individuals are in a financial position to be able to lend.

In the business context, business owners might be hesitant to provide further personal guarantees or offer their own possessions and homes as collateral for loans when they might already be loaded down with other debts. To take away the alternative financing available through fringe banking is to remove some businessperson autonomy and perhaps even induce criminality. 143 Indeed, the alternate sources of credit might trigger more damage to small business debtors or to consumers than fringe financing produces. 144

140. At that point, we may be in the position of the old joke about prostitution or any other so-called victimless crime that, once you accept even the lightest variation from an absolute, morals-based prohibition, then all you are doing is arguing over price.

141. For example, fringe banking outlets may be the sole, legitimate stopgap measure to financially distressed consumers. See supra Part II.A.


144. The unavailability of fringe providers could drive consumers to less desirable, and possibly even illegal, options. See e.g., Katherine Porter, The Damage of Debt, 69 WASH. & LEE. L. REV. 979, 1004 (2012) (discussing generally how excessive debt can harm one’s welfare). One such undesirable choice, resorting to pawn shops, imposes costs on the debtor “comparable to payday loans, but [with the borrower required] to part with personal property to use as collateral.” Zywicki & Arca, supra note 143, at 2. Also, “because of the small size ($76 on average) and high transaction cost of pawn shop loans, these are of limited usefulness in managing financial difficulties.” Id. at 2-3.
B. Consider the Franchisee

1. Fringe Banking Services Franchisees and Their Own Financing

Perhaps the best ways to determine a fringe lender’s true perspective on its loans is to see its response to the use of such loans by individuals or entities in which the lender has a vested interest. For example, many fringe banking outlets are owned and operated as a member of a franchise network.145 If the fringe lenders truly believed in their product as a credible source of financing and not a precarious, overpriced loan, presumably they would allow their franchisees to utilize such services to obtain some or all of the funds necessary to purchase the franchise right.

The example of Cash Plus, Inc. may prove instructive. Cash Plus provides check cashing, payday advance loans, and other financial services,146 and it posts extensive information on its website regarding its franchise opportunities.147 While its standard franchise agreement does not specifically prohibit the use of fringe financing to acquire franchise purchase funds, the contract does state that the “method of payment specified by Franchisor may include Automated Clearing House (ACH) direct electronic bank debit system, certified check, bank or other financial-institution check or any other method as Franchisor may designate.”148 It seems clear that the franchise agreement anticipates that payments from the franchisee will be made in the most formal way through a standard bank transaction. Interestingly, while its website states that its customers have been “underserved by banks,” the franchisor, as a business, acknowledges the necessity and credibility of standard bank payments.149 Such a clause for most or all fringe banking

149. Cash Plus Franchise Info Franchise Facts, CASH PLUS, http://www.cashplusinc.com/franchise_info_ffacts.html (last visited Dec. 14, 2012). A fringe banking franchisor targets a different audience in franchise agreements than in its product advertisements. Perhaps the franchisor expects a higher level of financial stability and sophistication in its franchisees than in its product customers. So, while that difference in approach between franchisee “customers” and actual fringe banking customers may sound ironic or even hypocritical, the more exact payment terms in the franchise agreement may merely reflect the
service franchisors is highly likely, as contract provisions strongly and almost universally in favor of a franchisor have long been the norm in American franchising.150

2. Franchisees’ Use of Fringe Banking

While much of the discussion surrounding fringe banking practices focuses on individual consumers’ use of such products, the business community is not immune from the uses of and issues associated with fringe banking. For example, business owners may need fringe lending services to cover unforeseen expenses or to fill the gap if receipt of a payment is delayed. With the typical start-up business requiring, on average, about $25,000, a loan providing a few thousand dollars may serve a vital role in allowing the entrepreneur to get off the ground. That may especially be the case for franchising, where different sources often can be cobbled together to help the debtor-franchisee commence operations, even if any particular source of funds is problematic. Such sources could be the franchisor itself, a traditional bank, a credit union, a landlord, and third-party suppliers.152 Another potential financing avenue for franchisees is to seek a franchise-funding specialist. Doing so typically involves companies that have a relationship with particular lenders specializing in franchise financing.153 Alternatively, if the franchisor allegedly misled, or at least negligently informed, the franchisee about her estimated start-up costs, then the franchisee could


151. SCOTT A. SHANE, THE ILLUSIONS OF ENTREPRENEURSHIP: THE COSTLY MYTHS THAT ENTREPRENEURS, INVESTORS, AND POLICY MAKERS LIVE BY 79–80, 95 (2008) (noting three studies from the late 1990s arriving at figures of $15,000, of $20,000 or of $22,700; estimating the start-up total to be “$24,920 in today’s dollars”).

152. See W. MICHAEL GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE §§4:4–4:16 (2012) (describing the franchisee-landlord relationship, third-party suppliers and financing, and guarantees, pledges, and inventory as well as other forms of financing).

153. Jeff Eglin, 3 Sources of Franchise Financing: Know How to Make Sense of the Current Economy and Its Impact on Fringe Banking, ENTREPRENEUR (Nov. 3, 2008), http://www.entrepreneur.com/article/198310. Typically these companies will obtain your financials, advise you as to your lending options, and help you throughout the lending process without charging a fee unless you actually receive the loan. Id.
successfully sue the franchisor for that wrongful disclosure. In fact, when securing Small Business Administration (“SBA”) loans, several franchisees have been hurt by their franchisors’ overly optimistic financial projections.

Statistics indicate that access to high-cost credit such as auto title loans is an important aspect of the success of small business. Indeed, most small businesses use consumer lending to help finance their business, as these often are more expensive, but faster and more convenient sources of credit. Consumer lending can cover everything from seed capital for starting a business to the management of monthly cash flows, in addition to providing working capital. As one economist specializing in the regulation of consumer financial services has noted, “[m]any of these businesses [that obtain “consumer” financing] do not have access to a commercial line of credit, often because they are too small or too new.” Even those businesses that can get the more traditional business financing use consumer loan products to supplement their commercial credit. In fact, small businesses make up twenty-five to thirty percent of the customer base for title loans, and an even higher percentage of the total dollars loaned.

C. Lost Opportunities for Franchisees

Many prospective franchisees, looking to purchase the rights to operate under an established franchise system, can find startup costs under $10,000. For franchises such as Jazzercise, Inc., and Stratus

155. Don Sniegowski, Advice on SBA Liar Loans, BLUEMAU MAU.ORG (Sept. 26, 2011), http://www.bluemaumau.org/10713/part_3_lenders_give_advice_sba_liar_loans (advising franchisees to verify franchise numbers and to engage in due diligence before taking out franchise loans).
156. Durkin, supra note 73, at 2.
157. Id. at 19.
158. Zywicki, supra note 92, at 449. Professor Zywicki explains why small businesses, such as landscapers, plumbers, and handymen, may go through a series of high-in-transactional-costs, short-term loans pledging a motor vehicle title. Id. at 448–49.
159. Durkin, supra note 73, at 2.
160. Id.
161. Id.
162. Zywicki, supra note 92, at 449.
Building Solutions, two low-cost franchises (with startup costs as low as $3,000 to $3,500) ranked within the top thirteen franchises according to Entrepreneur Media, there is the potential to use fringe loans for filling any gaps in capital. A fringe loan, perhaps from an auto title loan or a payday advance, could provide a franchisee with the potential to operate her own business when she would otherwise not have the funds. The financing of even a small amount could be a real key to success for someone seeking to join an accomplished, often lucrative business network (franchise system)—someone (the franchise applicant) not normally thought of when considering the fringe banking industry and its traditional customers. Recent data tend to show that while small business lending has increased, small business owners are still having problems obtaining nominal loans ($150,000 or below) to get their businesses started. This is precisely the issue that potential franchisees face because these are the types of loans they need to procure to start-up their businesses.

These figures, however, do not say that franchisors play no part in helping franchisees obtain financing for their start-up costs. Some franchisors hire executives specifically dedicated to assisting franchisees obtain loans and also pay for services that match franchisees with lenders. Given the recent recession and inability to get credit, some franchisors have been more aggressive than ever in helping franchisees.

costs, the initial franchise fee that the franchisee must pay the franchisor (a part of the start-up costs) is a median charge of $20,000. BLAIR & LAFONTAINE, supra note 80, at 59.


165. Perhaps this has led to more franchisors directly extending financing to their franchisees. See infra note 169 and accompanying text.

166. See supra notes 156–162 and accompanying text (on small business financing, such as through auto title loans). As small businesses increasingly have turned to cash advances when banks have turned them down, a proposal has been the Small Business Lending Enhancement Act of 2011 (S. 509), currently in committee. This bill would amend the Federal Credit Union Act, 12 U.S.C. §§ 1751-1795k (2011) and thereby permit many credit unions to expand considerably the credit they make available via member business loans. It would certainly assist in having some small businesses, including franchisees, avoid fringe lending and obtain more traditional, safe, sound, and lower-cost loans. See The Small Business Lending Enhancement Act of 2011, S. 509, 112th Cong. (2011).

167. Emily Maltby, Small-Business Lending Jumps, But Credit Struggles Linger, WALL ST. J. (Oct. 5, 2011 1:24 p.m. ET) http://online.wsj.com/article/SB1000142405297020338804576612950561189010.html?mod=WSJ_SmallBusiness_sections_FinancingAndInvesting (discussing the incentive banks have to approve higher loans due to the amount of work needed to process loans and limited number they can approve).

168. See Needleman, supra note 112 (discussing the various methods that franchisors use to help franchisees secure loans).
obtain financing, including direct financing from the franchisor.\footnote{169} Due to faith in the franchise model, lenders in fact often require less due diligence when assessing a franchisee’s ability to repay.\footnote{170} However, the presumption that franchises are a safe bet has been recently dispelled, in strong fashion, by the high default rates on SBA-backed loans for franchisees.\footnote{171} Consequently, lenders are scrutinizing franchise loans more carefully now than they have in the past.\footnote{172} Indeed, some franchising experts comment that franchisors need to be extremely careful about lending so that new business operators-owners can buy into their system: these experts blame some franchisors’ business difficulties on the franchisors’ putting efforts into expansion through financing of franchisees rather than concentrating on the success of the existing operations.\footnote{173}

Use of fringe products by business owners and franchisees is amplified by the difficulty in obtaining credit through standard means.\footnote{174} For instance, recent data show that small business lending has been on a

\footnotesize{169. Kermit Pattison, \textit{Tight Credit Is Turning Franchisors Into Lenders}, \textit{N.Y. TIMES} (June 9, 2010), \url{http://www.nytimes.com/2010/06/10/business/smallbusiness/10sbiz.html?ref=franchising} (also mentioning other ways that franchisors are helping franchisees, including reducing royalties, fees, or other general requirements).


171. \textit{Infra note} 188 and accompanying text.

172. Don Sniegowski, \textit{SBA Franchise Lenders Hit}, \textit{BLUEMAUMAU.ORG} (Sept. 30, 2011, 1:29 AM), \url{http://www.bluemaumau.org/10727/national_franchise_lenders_hit_hard_change_model} (discussing how SBA lenders were harmed by franchisee loans and the steps they are taking to correct past mistakes).


174. That may especially be the case in light of the poor economy for the past few years. Even in a good economy, there are a number of reasons why a particular business might find credit hard to obtain: (1) banks’ unwillingness to carry an additional high risk borrower on their lending portfolios; (2) for a start-up business, difficulties in obtaining a thorough credit history; and (3) for a going concern, a borrowing business might already have collateralized its assets to secure previous debts, or it has inventory already encumbered by other purchase money debts, or the owners might have already personally guaranteed too many previous debts (a new lender would have no first or even second priority position). In sum, the inability to get credit stems from there being too little information to evaluate a new business and too little, if any, possible collateral for lending to a going concern.
steady decline. Moreover, franchise loans, in general, do not seem to ensure protection for the franchisor or the franchisee, at least vis-à-vis loans for other business formats; while all business loans from 2001–2006 had a failure rate of 5.9%, franchise loans actually failed at a higher rate of 6.5%. These figures should not be surprising, however, as at least one study has shown that franchisees actually average a business failure rate higher than that of independent businesses.

Although there is a plethora of law discussing “sophisticated franchisees,” no court has specifically delineated the distinction between these franchisees and their unsophisticated counterparts. The


176. Laura Tutor, The It List: Companies on the Small Business Administration’s Franchise Registry have Lower Loan Failure Rates than National Average, QSR MAG., at http://www2.qsmagazine.com/articles/features/108/sba-1.phtml (reporting statistics from FRANdata President Darrell Johnson, including, inter alia, that the rate of charge-offs and loan loss for Small Business Administration Franchise Registry companies is lower than business as a whole, with loans coming through the Franchise Registry having a rate of 5.7%).

177. Timothy Bates, A Comparison of Franchise and Independent Small Business Survival Rates, 7 SMALL BUS. ECON. 377 (1995); Timothy Bates, Analysis of Survival Rates Among Franchise and Independent Small Business Startups, 13 J. SMALL BUS. MGMT. 113 (1995). Bates observed a 34.7% failure rate for franchised business over a five-year span, but only a 28% rate, in the same time period, for independents.

178. One example would be Papa John’s Int’l, Inc. v. Dynamic Pizza, Inc., 317 F. Supp. 2d 740 (W.D. Ky. 2004). There, the defendant franchisees, having been sued for breach of a franchise contract, counterclaimed against Papa John’s for fraudulent inducement, specifically, that false oral representations by a representative of Papa John’s caused the premature closing of defendant’s restaurants. Id. at 744. The parties, two corporations, entered into a number of franchise agreements during their transactions, which contained merger and integration clauses that provided that the written agreement contained the entire agreement between the parties and superseded all prior understandings or agreements. Id. at 744. The court held, “if any misrepresentations fraudulently induced Defendants into entering the Development Agreement, i.e., misrepresentation made prior to the signing of the agreement, the merger and integration clause prevents this action from being brought.” Id. at 745. The court placed emphasis on the fact that the contract had been agreed upon by two sophisticated parties. Id.; see also Owens v. Cumberland Mortg., Inc., No. 1:05-CV-135R, 2006 U.S. Dist. LEXIS 83667, at *13–14 (W.D. Ky. Nov. 16, 2006) (distinguishing Papa John’s Int’l, Inc. v. Dynamic Pizza, which involved mutually sophisticated parties, and thereby holding that unsophisticated home mortgagors could assert their claim of fraud against the sophisticated business defendant, a mortgage brokerage).

179. See infra note 227 and accompanying text. Three examples of cases in which courts found against franchisees claiming franchisor fraud, at least in part because of the franchisee’s own sophistication, are: Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, 970 F.2d 273, 281 (7th Cir. 1992) (finding that business people who purchased a franchise as an investment opportunity were sophisticated franchisees); North Am. Fin. Group, Ltd. v. S.M.R. Enters., Inc., 583 F. Supp. 691, 698 (N.D. Ill. 1984) (holding that a franchisee with a background in
law’s presumption (or at least a number of court findings on the facts) that franchisees are generally “sophisticated” can be understood in light of some general requirements for becoming a franchisee. For instance, the APlus® franchise lists several requirements that it expects potential franchisees to have, including the ability to make and implement a business plan along with a minimum investment of two hundred and fifty thousand dollars. While this is just one example, one could argue that an individual needs a certain level of sophistication before entering into such an agreement. The FTC Franchise Rule and some state statutes allude to such a distinction. As noted in the revised FTC Franchise Rule, there is a “sophisticated franchisee” exemption that frees franchisors from the need to provide disclosure to sophisticated franchisees. Nonetheless, the Rule does not explicitly define a “sophisticated franchisee.”

Two examples of courts holding in favor of franchisees that might be deemed “unsophisticated” are Payne v. McDonald’s Corp., 957 F. Supp. 749, 761 (D. Md. 1997) (finding a franchisee sophisticated due to its extensive knowledge of the franchisor’s business). Two examples of courts holding in favor of franchisees that might be deemed “unsophisticated” are Nagrampa v. MailCoup, Inc., 469 F.3d 1257, 1282-83 (9th Cir. 2006) (noting the inequality in power generally favoring franchisors over franchisees, as well as the “substantially weaker bargaining position” of the franchisee vis-a-vis the franchisor in that particular case—a franchisee with a yearly salary of around $100,000, someone who had “never owned her own business,” versus a franchisor parent company with over $208,000,000 in assets and over one billion dollars in revenues), and Fisher v. Mr. Harold’s Hair Lab, Inc., 527 P.2d 1026, 1034 (Kan. 1974) (discussing the unequal bargaining power of the parties). See also AM. JUR. 2D PRIVATE FRANCHISE CONTRACTS § 260 (1990) (discussing that franchisee may not be able to claim reasonable reliance when franchisee is a sophisticated investor).


181. All franchise agreements, of course, involve business relationships and, as such, are distinguishable from consumer contracts, which receive stricter review by the courts in favor of the consumer. All prospective franchisees must understand that would be opening a business and taking a risk. Their willingness to take the risk is probably, but not always, supported by analysis of and reflection upon an array of information available from the franchisor in making their decision to own and operate a franchise. For more analysis of franchisees and sophistication, see Emerson, Franchise Contract Interpretation, supra note 150, at 34-40; Robert W. Emerson, Franchising and the Parol Evidence Rule, 50 AM. BUS. L.J. ____ (forthcoming 2013) (on file with author).

182. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,444 (Mar. 30, 2007) (codified at 16 C.F.R. pts. 436-37) (2009) [hereinafter, FTC Disclosure Requirements and Prohibition]; GARNER, supra note 152, at § 5A:32 (discussing state exemptions in which (1) the franchisee is experienced in that business, Michigan (MICH. COMP. LAWS § 445.1506(1)(h) (2010)), or (2) the initial minimum investment of a franchisee is $750,000, Maryland (MD. CODE REGS. tit. 02, § 02.02.08.10E (2010))).

183. Infra note 227 and accompanying text.

184. See David J. Kaufmann, The New York Franchise Act, 2007–2008, 20 MCKINNEY’S GENERAL BUSINESS LAW 33 (2009). Notably, the FTC Rule does not explicitly enumerate this as the “sophisticated franchisee” exemption but rather states that a franchisee who has “been in
the distinction between sophisticated and unsophisticated franchisees with respect to disclosure requirements of franchisees by denoting such franchisees as “experienced” rather than “sophisticated.”\textsuperscript{185}

As discussed above,\textsuperscript{186} franchise applicants may not have the chances to acquire and then successfully build upon a business opportunity. Surely an advanced judicial, regulatory, and contractual (i.e., franchisor) approach to sophistication could produce better financing and greater opportunities for potential franchisees.\textsuperscript{187}

\textbf{D. The Importance of Insulating Businesses from Consumer-Oriented Protections}

Seemingly, with every chance for profit comes as well the prospect of litigation. There are many ways that financing, or a lack thereof, can cause franchise disputes. One can easily foresee controversies in the financing of franchise investments if, generally, the franchising concept fails or if, in particular, the business for one or more of the franchisees fails, such as due to a stream of revenue that simply is insufficient to repay loans, especially high-cost fringe loans. If defaults are likely to occur, and perhaps even to be exacerbated by fringe lending, then it could be argued that the franchisees’ use of fringe loans should be limited or monitored to ensure repayment. The cost of such monitoring should not be much, as an assessment of repayment ability should be undertaken, anyway, by the franchisee and franchisor in consultation with one another. The franchise relationship itself could provide protection for franchisees, with less need for governmental oversight of financing arrangements.\textsuperscript{188} For instance, a franchisor usually should

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\textsuperscript{185} C AL. CORP. CODE § 31106 (West 2009) (defining “experienced franchisees” and applying that definition to the initial sale of a franchise to sophisticated buyers).

\textsuperscript{186} See supra notes 167 &174-174 and accompanying text.

\textsuperscript{187} All franchises can be summarized as contractual relationships between a franchisor and franchisee. This business relationship is distinguishable from consumer contracts that receive stricter review by the courts in favor of the consumer. Surely all franchisees understand that they are opening a business and will be taking some sort of risk. The requirements to be a franchisee are too variable to sum up into basic requirements. A vague statement can be made asserting that usually a franchisee must be sophisticated enough to satisfy each individual franchisor’s specific requirements, but more research would be needed to support a more specific statement. See infra note 207 and accompanying text.

have fixed contractual duties to ensure that prospective franchisees meet the minimum standards for success. These duties should include, in general, dealing with franchisees in good faith, as well as, more specifically, providing franchisees with supervision, training, know-how, and various acts of periodic assistance. As for the standards, they might include, for example, balance sheet targets, solvency or profit requirements, and market-share goals. The franchisor’s duties would be aimed at apportioning responsibilities fairly between the franchisor and franchisee as they jointly seek to achieve their ambitions for the franchising network.

There are also good consumer guide resources that may help potential franchisees focus on important aspects of the franchise relationship, and thereby reduce the need for governmental oversight. These consumer guides provide comprehensive information regarding the benefits and responsibilities of potential franchisees, including the common sense suggestion that a franchisee engage in due diligence and research her prospective franchisor. Additionally, franchisors can impose on potential franchisees higher requirements, such as a larger initial down payment. Assuming that more franchisors follow this model and expect more—financial or otherwise—from their franchisees, the franchisee is encouraged to take more self-protective measures, as she has more at stake (more sunk costs in time and money). Furthermore, the franchisee also may get more financial oversight because she may choose to bring in outside lenders, such as fringe banking, to meet her rising costs.

With extensive regulation and policing of fringe markets on the horizon as a result of the Dodd-Frank Act, the impact on small incentive franchisors have to collect franchising fees by embellishing a franchisee’s financial projections to help underqualified franchisee’s obtain SBA loans).

190. Id. at 37-38.
192. Id.
193. Emily Maltby, Want to Buy a Franchise? The Requirements Went Up, WALL ST. J. (Nov. 15, 2010, 4:45 PM ET), http://online.wsj.com/article/SB10001424052748704361504575552803956439716.html (discussing some franchisor requirements including good personal financials, strong industry experience, and a higher initial down payment).
businesses must be considered. The U.S. Chamber of Commerce has stated that businesses’ use of these high-cost loans is a reason to oppose regulation.\textsuperscript{195} According to a bulletin published by the Federal Reserve in 2006, small businesses, which include nonfarm entities with 500 or fewer employees, created sixty to eighty percent of net new jobs annually over the previous decade.\textsuperscript{196} With such a significant role to play, the CFPB must be careful not to impede the ability of small businesses to obtain all the credit they need.\textsuperscript{197} Moreover, in the franchisor-franchisee relationship, the presence of an outsider—a third-party lender—can help, immeasurably, the franchisee, particularly inasmuch as the lender requires some comprehensive analysis of a franchise’s prospects. In turn, the lender is engaged in its own review of the franchise purchase. The franchisor’s role in helping the franchisee, therefore, suggests that less regulation of fringe lenders is needed because the franchisor itself can create a safety buffer, helping the franchisee to make an informed decision and thereby reducing the risks the franchisee may incur with respect to fringe lending.\textsuperscript{198}

To understand further why the franchisee’s enlisting of financial support can be aligned with whatever franchisor support the franchisee receives, and thus removed from consumer lending protections, consider what the principal federal regulator of franchising has concluded. The FTC discussed why the franchisor’s lending of money to the franchisee is not counted toward the monetary amount ($1 million) for someone to be a “sophisticated” franchisee to whom a franchisor need not meet the FTC Rule disclosure requirements.\textsuperscript{199} While money from other sources

\textsuperscript{195} Durkin, supra note 73, at 2-3.


\textsuperscript{197} It is important to note that, under the Dodd-Frank Act, the CFPB is empowered to “regulate the offering and provision of consumer financial products and services.” 12 U.S.C.A. § 5491(a). The Act defines “consumer” as an individual or someone acting on behalf of an individual. 12 U.S.C.A. § 5481(4). Although the Act does not specifically define individual, it does, however, limit consumer financial products or services to those “offered or provided for use by consumers primarily for personal, family, or household purposes.” 12 U.S.C.A. § 5481(5)(A); see also Jim Hawkins, \textit{The Federal Government in the Fringe Economy}, 15 CHAP. L. REV. 23, 25-26 (2011) (discussing the powers of the CFPB). As such, if the CFPB begins limiting fringe consumer credit, it will also likely, as a result, limit business credit because consumers make up the majority of revenue for fringe lenders. That is, unless those fringe lenders can make up this lost revenue, they probably will eventually fail and will no longer be an option for consumers or businesses.

\textsuperscript{198} Pattison, supra note 169.


http://ideaexchange.uakron.edu/akronlawreview/vol46/iss1/1
(besides the franchisor itself) do count, the FTC proclaimed the value of introducing another experienced, independent party, the outside lender, into the situation:

[I]t is reasonable to assume that a lender, in order to minimize its own financial risk, will ensure that a prospective franchisee will conduct a due diligence investigation of the franchise offering. Indeed, by involving a lender, the prospective franchisee effectively ensures that there is an independent, sophisticated entity inserted into the sales process. This additional safeguard would be lost if sources of financing for purposes of the exemption included the franchisor and its affiliates.200

In effect, the presence of the lender may ensure more protection for the franchisee in evaluating her franchise investment, and the franchisor’s involvement may help protect the franchisee from entering into an unnecessary, overreaching arrangement. The presence of a third party (the lender, for the franchise relationship; and the franchisor, for the loan) may be leveraged to help the franchisee. It is win-win, at least for the franchisee involving both his franchise and his loan.201

The franchisor looks after the franchisee and its arrangements with third-party financiers, if for no other reason than it is in the franchisor’s best interest to do so202— ensuring that the franchisee is not so financially strapped so as to hurt the franchisor’s chances for success.203

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201. It may also be a win-win for franchisors that have better financed franchisees. See infra, Part IV, B.

202. In some other areas of the franchise relationship, one could argue that any franchisee “protection” provided by the franchisor might be suspect. Some issues involved in franchising—the parties’ disproportionate bargaining power, the uninformed approach of many franchisees, and matters of contract language, territoriality, and independent contractor status—raise concerns for which the franchisor’s interests may diverge from the franchisee. See generally Emerson, Franchise Contract Clauses, supra note 150; Robert W. Emerson, Franchise Encroachment, 47 AM. BUS. L.J. 191 (2010); Robert W. Emerson, Franchisees Without Counsel: Pressumed Competent (2012) (unpublished manuscript) (on file with author); Robert W. Emerson, Franchise Independence: Awaiting Public Recognition (2012) (unpublished manuscript) (on file with author); Robert W. Emerson, Franchising and the Parol Evidence Rule, supra note 181. However, in the restricted area of business finance, the franchisor’s and the franchisee’s interests coincide. Indeed, franchisors ordinarily have strong incentives to have franchisees with sufficient financing.

203. See infra note 231 and accompanying text (concerning the alignment of franchisor and franchisee interests for franchise financing); cf. infra note 232 and accompanying text (noting how many aspects of the franchise relationship other than financing involve varying, indeed often
That in turn probably makes it less important that the government protect the franchisee from fringe banking fiascos, because the franchisor should assist in that regard.\textsuperscript{204} Even if there are rules intended to protect the franchisee, the FTC’s limited resources make pursuit of a rule-breaker both rare and, when undertaken, quite likely to be settled. Franchisees have no cause of action under the Franchise Rule, and they usually have little hope of successfully challenging franchisor conduct by filing suits under the “Little FTC” state laws modeled after the Federal Trade Commission Act.\textsuperscript{205} That result is because these laws tend to be rather narrowly drafted, and they have been construed so as not to permit private actions for claims constituting simply a breach of contract.\textsuperscript{206}

The proposal to depend on franchisor-franchisee oversight of any outside lending, and thereby to be distinct from consumer finance regulation, comports with case law. Most courts facing this issue have held that a franchisee is not a consumer for purposes of his franchise contract.\textsuperscript{207} As pro-franchisee attorneys have long lamented, “[t]he most frequent barrier to franchisee redress . . . is that a franchisee may not be ‘consumer’ and/or the specific issue being litigated may not be a ‘consumer transaction.’”\textsuperscript{208} This outcome is especially troubling in that

\textsuperscript{204} If franchisees are more informed, they may not need as much protection via regulation, similar to an “accredited investor” not needing as much securities law protection. See Net Worth Standard for Accredited Investors, Securities Act Release No.33-9287, Fed. Sec. L. Rep. (CCH) ¶ 89,606 (Mar. 23, 2012). \textit{But see} Inspector General Report, supra note 188, at 2 (discussing the incentive that franchisors have to gain as many franchisees as possible in order to obtain royalties and other fees).


\textsuperscript{206} \textit{Bailey Emp’ t Sys. Inc.}, 545 F. Supp. at 72.


\textsuperscript{208} Steinberg & Lescatre, supra note 205, at 280.
the popular culture, the language used in advertising, and no doubt the franchisee’s own cognitive biases all point to an emotional conclusion that the franchisee is really a type of partner with the franchisor as well as a consumer of the franchisor’s business network and method of doing business.209

Occasionally a court will observe that the franchisor-franchisee affiliation has the attributes of a consumer relationship, with the franchisee (the consumer) subject to an adhesion contract:

Although franchise agreements are commercial contracts they exhibit many of the attributes of consumer contracts. The relationship between franchisor and franchisee is characterized by a prevailing, although not universal, inequality of economic resources between the contracting parties. Franchisees typically, but not always, are small businessmen or businesswomen . . . seeking to make the transition from being wage earners and for whom the franchise is their very first business. Franchisors typically, but not always, are large corporations. The agreements themselves tend to reflect this gross bargaining disparity. Usually they are form contracts the franchisor prepared and offered to franchisees on a take it or leave it basis. Among other typical terms, these agreements often allow the franchisor to terminate the agreement or refuse to renew for virtually any reason, including the desire to give a franchisor-owned outlet the prime territory the franchisee presently occupies.210

Moreover, while most courts hold that the franchisee is not a consumer, nor does its transaction with the franchisor constitute a consumer deal, there are several state unfair trade practices statutes (Little FTC Acts) under which the franchisee has been found to be a consumer.211 The approach under foreign law produces this same result, with most holding that franchisees are not consumers, hence not

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209. Id. at 146, 155.


protected, but with a sizeable minority holding otherwise.\textsuperscript{212}

Although the franchisee needs protection in many other areas,\textsuperscript{213} it seems that the franchisee does not need the protections that come with being a consumer, at least not to the extent non-franchised, independent business owners and individuals may need protection. Moreover, the franchisee, not when compared to the franchisor but when matched up to others under the Dodd-Frank Act, may be considered relatively sophisticated. As long as there is: (1) a franchise agreement or manual specifying procedures for and limitations on the financing arrangements,\textsuperscript{214} and (2) an ongoing “relational” contract between franchisor and franchisee\textsuperscript{215} in which the franchisor can monitor the franchisee’s financial choices, then the franchisee truly is not on her own.\textsuperscript{216} Therefore, she need not receive the same measure of protection that is extended to individuals or other, independent small businesses under the Dodd-Frank Act.

With its limited resources, the CFPB must be encouraged to focus on those borrowers—ordinary consumers and the small, non-networked, truly independent businesspersons—who need a regulatory framework. Despite franchisees’ having a network of private support (their franchise system) and often a franchisee support system,\textsuperscript{217} franchisees can

\textsuperscript{212} \textsc{Int’l Bar Ass’n, Getting the Deal Through: Franchise} 18, 26, 31, 43, 52, 57, 64, 70, 76, 80, 87-88, 94, 102, 109, 117, 124, 129 143 150, 156, 165, 172, 179, 184, 190, 196, 201 & 217 (2012) (franchisees are protected consumers—Austria (sometimes), El Salvador, Germany (if obliged to purchase goods on a recurrent basis), Guatemala, Italy (sometimes), Japan (sometimes), Kuwait (sometimes), Mexico, South Africa, Sweden (sometimes), Thailand; franchisees are not—Canada, China, Finland, France (very unlikely), India, Indonesia, Netherlands (rarely), New Zealand (rarely), Romania, Russia, South Korea, Spain, Switzerland, Turkey, United Kingdom (very unlikely), and Venezuela).

\textsuperscript{213} Supra notes 202, 208-209 and accompanying text.

\textsuperscript{214} Emerson, \textit{Franchise Contract Clauses}, supra note 150, at 973-75 (noting that only 10% of the franchise contracts had provisions in which the franchisor provides assistance to the franchisee in obtaining financing); Emerson, \textit{Franchise Contract Interpretation}, supra note 150 (noting that the percentage of franchise contracts with a financing-assistance provision had risen to 12%).


\textsuperscript{216} Indeed, it is clear that reputable franchisors often act to keep would-be franchisees from getting their funding outside of the usual business lending circles.

\textsuperscript{217} On a national level, there are pro-franchisee groups, e.g., the American Association of Franchisees and Dealers (AAFD); also, among just the franchisees for that network, often are independent franchisee associations that could look after members’ interests. See Robert W. Emerson, \textit{Franchising and the Collective Rights of Franchisees}, 43 VAND. L. REV. 1503, 1505-06 (1990); Stan Turkel, \textit{Independent Franchisee Associations Grow}, BLUEMAU MAU.ORG (Nov. 7, 2011, 8:12 AM), http://www.bluemaumau.org/independentfranchisee_associations_infas_rise (reporting that the number of independent associations of franchisees—presently between 300 and
succumb to the temptations of costly, ill-considered fringe loans; that should make all the clearer to policymakers the need to protect the others (consumers and nonfranchised small businesses) who use fringe banking products. Indeed, perhaps the most vulnerable users of fringe banking are those who really are on their own while running a business and, therefore, as evidence may indicate, deserve the Dodd-Frank Act protections even more than an individual consumer would.\textsuperscript{218}

\textbf{E. Sophistication: Finding Middle Ground Between Consumer Needs and Business Growth}

It is a challenge: striking the appropriate balance between protecting consumers from egregious, extortionist financial practices and allowing individuals as well as businesses to retain their ability to obtain high-cost lending by choice. One key to accomplishing both goals is a heavy disclosure regime, but a light set of substantive regulations.

Fringe providers could be required to disclose all information related to their lending in a clear, concise, easy-to-understand format.\textsuperscript{219} This disclosure would likely need to take place in a more detailed manner, something beyond a simple written document, beyond the pro forma requirements of Item 10 in the Franchise Disclosure Document.\textsuperscript{220} For many borrowers, it would be advantageous for a lender to discuss the fees, interest rates, and loan terms orally as well as in writing to ensure the individual is fully aware of his obligations. If the lender comprehensively discloses the negative aspects of a loan, the borrower should retain the right to accept or decline. In an emergency situation, a borrower may rationally decide to accept the terms of a high-cost loan despite the drawbacks.\textsuperscript{221}

Another possible method to ease the burden on franchisees seeking access to credit would be legislative reform.\textsuperscript{222} Just like for consumer

\textsuperscript{218} To give an example of how increased connections to lending activity does not necessarily produce better loans or practices, and debtors can still be driven out of business, see Inspector General Report, \textsuperscript{supra} note 188, at 13–20 (providing many examples of how the lending process through the SBA did not stave off business failure and may, in fact, have helped to cause it).

\textsuperscript{219} See Inspector General Report, \textsuperscript{supra} note 188, at 5–6 (providing as a practical recommendation, for lenders to clearly define what a franchise loan is, and what its general terms are).

\textsuperscript{220} 16 C.F.R. 436.5(j). For a proposed disclosure rule concerning a franchisor’s obligation to disclose fringe financing related information, see infra Part IV.

\textsuperscript{221} Supra notes 15, 30–52 and accompanying text, concerning payday loans.

\textsuperscript{222} Franchisees Push Capitol Hill for Help, BLUEMAUMLAU.ORG. (Sept. 19, 2011, 9:33 PM),
lending, business borrowers should be as informed as possible about the terms upon which each financing is offered. With these increased disclosures, both business borrowers and fringe lenders could slow down, investigate each other, and fully discuss the terms of loans; the borrowers thereby would be better able to exercise choices about financing.223

On the contrary, if regulation is strict to the point that fringe lenders cannot remain profitable, individuals and businesses will lose access to funds.224 While consumers should be protected from lenders that provide false or misleading information, these consumers should be permitted to make financial decisions for themselves based on their personal assessment of the costs and benefits.225 Statistics indicate the demographics of individual, nonbusiness fringe borrowers swing strongly toward the poor and the less educated, i.e., people who may not comprehend the magnitude, let alone the specifics, of their loan obligations even when there are stronger, more comprehensive warnings and perhaps spot “checkups” by the authorities.226 It is clear that regulation would be useful to protect these borrowers from themselves. However, it is nearly impossible to regulate the borrowing activity of these individuals, but not that of the business owners and their families that understand a transaction and freely accept it despite the negative terms. A fringe lender cannot size up an individual based on her demographic characteristics and simply withhold loans from those persons that appear less experienced or intelligent. Franchising rules, along those lines, have included bright-line standards concerning when the more dependent party (the franchisee) may not need the usual

http://www.bluemaumau.org/10689/franchise_group_pushes_cantor_fdic_help (discussing the initiative franchisees are taking to ensure better access to credit and tax reform). Additionally, using usury ceilings to limit the amount of interest a fringe lender can charge may also help protect consumers who use these services. Drysdale & Keest, supra note 11, at 663–64 (discussing a possible solution in using usury ceilings to help protect consumers).

223. See supra notes 218-220 and accompanying text.
224. See supra note 197 and accompanying text.
225. A consumer’s personal assessment, however, is still not without its risks. Research shows that consumers chronically underestimate financial risks and are overconfident about their future circumstances; they become, in some cases, “hopelessly optimistic” in regard to paying back a loan. See generally, Christopher L. Peterson, “Warning: Predatory Lending”—A Proposal for Candid Predatory Small Loan Ordinances, 69 WASH. & LEE L. REV. 893, 912-13 (2012).
226. See supra notes 84-85 and accompanying text. For example, via periodic, random checks of posted online information and also of the interactions between lenders’ representatives and customers, the latter portrayed by a fair lending tester comparable to a fair housing tester or perhaps a secret shopper.
protections. Even with standards that say an applicant franchisee, to be “sophisticated,” must have invested at least a million dollars, which can be her own savings or money, which she borrowed from anyone but the franchisor itself, there are unresolved issues. Perhaps this one-million-dollars-plus threshold simply raises more questions about individual circumstances, especially the source of the prospective franchisee’s funds: “Did she re-mortgage her residence? Did he borrow from a friend or relative? Did they cash in their retirement fund? [Also,] what other assets, liabilities, and income [does] the prospective franchisee have from which one can estimate his or her financial sophistication and tolerance of risk?” Indeed, it has been suggested that, from a lender’s perspective, a franchisee can fall into one of two categories: individuals with previous business experience, and individuals with little experience who are trying to start up a franchise. The former will be deemed “sophisticated” due to their business experience, while the latter will have a much harder time obtaining traditional financing because they are seen as high-risk.

There is insufficient evidence that it would be beneficial to impose the Dodd-Frank Act protections upon franchisees as if they were consumers. In financing, franchisor and franchisee interests tend to align, and so franchisees can benefit from the knowledge and assistance

227.  Indeed, in franchising, the Federal Trade Commission (FTC) has long refrained from adopting a standard that would require franchisors to evaluate the experience and knowledge of potential franchisees. Instead, the Commission, in amending its Franchise Rule (promulgated in 1978, amended in 2007), stuck with three precise monetary figures establishing which would-be franchisees do not need to be furnished the information normally required under the Rule:
16 C.F.R. § 436.8(a)(5)(i) (2010) (the “large investment” exemption)—franchise sales where the prospective franchisee makes an initial investment totaling at least $1 million, excluding the cost of unimproved land and franchisor financing;
16 C.F.R. § 436.8(a)(5)(ii) (2010) (the “large franchisee” exemption)—franchise sale to ongoing entities, such as airports, hospitals, and universities, with at least $5 million net worth and five years of prior business experience;
16 C.F.R. § 436.8(a)(6) (2010) (the “insiders” exemption)—franchise sales to the owners, directors, and managers of an entity before it becomes a franchisor.
230.  Id. However, the SBA’s experience with lending to franchisees suggests that franchisees were defaulting at high rates because of the lending banks’ inability to get credible information; most franchisees were new and had no business history with that particular brand. See supra notes 155, 170-172, 176 and accompanying text (concerning the comparatively higher failure rate for SBA-backed loans extended to franchisees).
of the franchisor.\textsuperscript{231} This is a distinct advantage over other aspects of the franchise relationship, where the franchisor and franchisee naturally have varying, if not directly competing interests. Examples of such issues are encroachment, antitrust law, terminations, and non-compete covenants.\textsuperscript{232} Likewise, one could say that any problem in fringe banking, at least for a successful business, may be no worse than other financial issues businesses face, such as for matters of real estate and credit cards.

V. A PROPOSED DISCLOSURE RULE: FITTING THE ARGUMENT FOR DISCLOSURE OF FRINGE FINANCING INFORMATION INTO THE EXISTING MATERIALITY REQUIREMENT

A. The Materiality Requirement

The amended FTC Franchise Rule\textsuperscript{233} provides that franchisors may not “alter unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document without furnishing the prospective franchisee with a copy of each revised agreement at least seven calendar-days before the prospective franchisee signs the revised agreement.”\textsuperscript{234} More generally, though, beyond just the franchise agreement, the rule requires franchisors to disclose all material information to prospective franchisees.\textsuperscript{235} The number and scope of items that may be material is

\textsuperscript{231} Emerson, Franchise Contract Clauses, supra note 150, at 942 (arguing that franchise financing is often an area of franchisee dependence on the greater experience and knowledge of the franchisor, who is better suited to either furnish funding for the franchisee or obtain excellent financing through the franchisor’s contacts); Emerson, Franchise Contract Interpretation, supra note 150 (noting how franchisors’ and franchisees’ interests can be aligned concerning arranging the funding to start a franchise).


\textsuperscript{234} 16 C.F.R. § 436.2(b) (2010).

\textsuperscript{235} FED. TRADE COMM’N, FRANCHISE RULE COMPLIANCE GUIDE ii (2008), available at
substantial. Indeed, the FTC “considers every required disclosure in a disclosure document to be material.”  

Although materiality is thus crucial, the amended FTC Franchise Rule does not define the term “material” because the FTC considers its jurisprudence, particularly that concerning violations of Section 5 of the FTC Act, to be sufficient guidance. For franchise matters, the FTC has decided, materiality can be determined by “the reasonable prospective franchisee standard.” Regulators and courts alike apply an objective test of what a reasonable person would consider important in deciding to purchase a franchise.  

The amended rule does outline certain required disclosures the franchisor must make to the franchisee. These disclosures include, inter alia, the franchisor’s business experience, its litigation or bankruptcy history, information relating to fees and initial investment, restrictions on products, the franchisee’s obligations, and financing. Within the finance related disclosures, the franchisor must disclose the terms of the financing agreement, including what the financing covers, the interest rate, the payment period, and the number of payments, among other
items.242 In addition to these items, the franchisor must disclose any additional material financing terms.243

B. Mutual Benefits of Disclosure

The franchisee typically is linked with a larger, more experienced business, the franchisor, that bargains on behalf of the franchisee and offers better incentives244 to traditional lenders than an independent business could offer.245 Often the franchisor has existing credit relationships with traditional banking institutions that the franchisee could utilize.246 That fact may be especially important as franchisees—who typically have used their own credit resources (e.g., credit cards) more than those of traditional lenders such as banks—face more restricted and less available credit for personal lines of credit. Although sometimes the interests of the franchisee and franchisor will be at odds, it is in the interest of both parties that the franchise succeeds.247

This franchisor-franchisee mutuality of interest is a result of the business relationship, not of law.248 The FTC Rule’s mandated disclosure about financing only applies when there is a financing “arrangement” between the franchisor and the franchisee.249 If the franchisee obtains outside financing, there are no financing related items to disclose. For most franchisees, that effectively means no financing disclosures need be provided. Relatively few franchisees obtain

242. 16 C.F.R. 436.5(j).
244. E.g., guarantees.
245. In fact, given the tight credit situation, franchisors may have to provide franchisees with more financing options. Cecilia M. Falbe, Ajith Kumar & Dianne H.B. Welsh, Franchisee Use Of Bootstrapping: An Exploratory Study Of Financing Decisions, 7 SMALL BUS. INST. J. 63, 67-68 (Oct. 2011) (finding that new franchisees relied on their own credit and personal loans to finance their business; further noting that with the tightening of credit by credit card companies many potential franchisees will be locked out of a typical source for business startup funds).
247. See supra notes 202, 231, and accompanying text.
248. If it has a legal origin in addition to simple business or economic self-interest, the ties between the franchisor and franchisee arise most fundamentally through the contract that they have reached.
249. 16 C.F.R. 436.5(j)(1) (the franchisor must “[d]isclose the terms of each financing arrangement, including leases and installment contracts, that the franchisor, its agent, or affiliates offer directly or indirectly to the franchisee.”).
financing directly from the franchisor, and, indeed, the franchise relationship probably does offer the franchisee more avenues of obtaining credit than what may be available to an independent business. Franchisees seem to be better protected by their relationships with their franchisors as compared with independent businesses, which likely have fewer champions or larger entities vested in their success.

A thorough disclosure of financing possibilities may increase the franchisee’s likelihood of success, which benefits the franchisor as well in the form of a steady income stream (i.e., royalties, fees, network expansion and the resulting initial payments for new franchises). A successful franchisee supports the sustenance and growth of her franchisor’s operations and in turn prevents the franchisor from incurring the costs of finding, training, and starting a new franchise to replace a failed franchisee. Given the presence of the FTC’s disclosure requirement, it is hardly a burdensome step to require the franchisor to provide disclosures relating to financing needs that might arise in the future, including information on the risks and benefits of obtaining financing from fringe sources. If franchisors disclose information about fringe banking and the potential that a franchisee may need to turn to fringe banking in the course of its business, the franchisor-franchisee relationship is strengthened.

Extrapolating on the definition of materiality in the franchise setting, there is already an argument to be made that types of available financing are material and should be disclosed to a franchisee. In *Barnes v. Burger King Corp.*, the court defined materiality in the franchise setting as judged by an objective standard, a statutory or

250. *See supra* note 214.
251. *See supra* note 126 and accompanying text.
252. 16 C.F.R. 436.5(j).
253. *Supra* notes 202, 231, and accompanying text.
254. *See supra* notes 235-240 and accompanying text.
regulatory approach beyond the common law’s almost cavalier, laissez-faire perspective. The Florida statute interpreted in *Barnes* is similar to the FTC Rule and to many state rules or statutes in that it requires franchisor to do more than not commit common law fraud, but instructs franchisors that they must “disclose efforts to sell or establish more franchises or distributorships than is reasonable to expect the market or market area for the particular franchise or distributorship to sustain.”256

While the common law cases on fraud narrow the mandatory disclosures to “facts material to the contract at issue” and bar from consideration “mere possibilities and facts that the defendant may not think are relevant,” the franchise law “broadens the scope of information which must be disclosed to include efforts to sell or establish more franchises and imposes an objective standard of relevancy.”257

Under the proposed expansive definition of materiality, potential franchisees could mull over information related to outside types of financing. For a franchisee who needs financing quickly, traditional financing forms may not be available, and, depending on why the franchisee needs financing, the franchisee may not qualify for traditional financing. This, it turns out, is a very real problem.258 Faced with this situation, one alternative for the potential franchisee may be fringe financing. When a potential franchisee is considering what is important in deciding to purchase a business, financing information—how the franchisee will fund his business—is vital. If information relating to fringe financing were disclosed by the franchisor, the franchisee would also be more prepared when a situation entailing the need for fringe financing arises.

In summary, the benefits of a disclosure are threefold. Disclosing information related to fringe financing protects the franchisee, it benefits the franchisor, and it gives regulators the freedom to promulgate rules

256. FLA. STAT. § 817.416(2)(a)(3) (2011). Another prohibited failure to disclose, which is far beyond common law restrictions, is to not tell a prospective franchisee “the known required total investment” for a franchise. Id. at § 817.416(2)(a)(2).

257. *Barnes v. Burger King Corp.*, 932 F. Supp. 1420, 1432 (S.D. Fla. 1986). Florida law, for example, forbids franchisors from misrepresenting not just established facts (e.g., something in the past—actual results), but also “the prospects or chances for success of a proposed or existing franchise.” FLA. STAT. § 817.416(2)(a)(1)(2011).

258. The marketing director for V2K window décor & more, Paul Linenberg, reported, “[w]e were finding that people otherwise qualified can’t get financing through traditional methods,” that “[d]emand is still out there, but the availability of credit is thin.” Jonathan Maze, *Tight Credit Is Turning Franchisors into Lenders*, FRANCHISE TIMES, Apr. 2009, available at http://www.franchisetimess.com/April-2009/Tight-credit-is-turning-franchisors-into-lenders/.
that focus on true consumers of these services, the individual, without raising transaction costs and administrative hurdles for small business debtors that need to obtain financing from fringe services.

VI. CONCLUSION

Regulation of fringe lenders will likely prove a more difficult challenge than many anticipate. Most would agree that consumer protection laws will prove useful in a market where the engagement in, and continuing potential for, egregious practices is substantial. Still, the CFPB must find a way to balance its regulations with the maintenance of individual autonomy in financial decision-making and the grant of greater access to funds for the unbanked and those with poor credit. This balance should be contemplated with competing private interests in mind, namely the need for individual consumer protection from potentially predatory practices, and the unfettered access to a stream of financial support for small business debtors. The need for balance is especially clear when one gazes outside the tent of the usual “consumer” and instead looks at small business debtors, such as franchisees.

Perhaps this balance can be achieved by regulating individual consumer use more heavily, while applying fewer or lighter regulations for small business debtors. The idea would be to clarify that increased protections for debtors would only extend to completely consumer-oriented loans. Federal bank examiners might push for a slightly lower level of high-risk consumer borrowers in lender loan portfolios. This requirement likely would increase the need for banks to investigate fully the potential consumer-borrowers before lending them funds. Although that could tighten credit, at least marginally and comparatively, for a small percentage of consumers, it would have the reverse effect on small business, as the lenders can go with a lower level of “due diligence” in determining whether to lend to franchisees.

While there is a risk that potential franchisees may not be as sophisticated as their peers (other applicants or actual franchisees) and therefore may not be afforded as much protection, that is an inherent risk which an individual must take in pursuit of building a business. This two-tiered approach (CFPB regulations for consumers, and perhaps for nonfranchised, independent, small business owners; but merely franchisor disclosures to franchisees) may be the best way to balance the obvious need for individual consumer protection from predatory practices, while at the same time not stifling an important stream of revenue for small business debtors. Indeed, for franchisors and
Franchisees to focus only on disclosures may hone their attention on what matters most—the franchise network. Disclosing such information is even in the franchisor’s best interest, as the disclosures increase the level of sophistication of the franchisee, and will inform the franchisee on how to make better business decisions. Armed with this information, the franchisee will be more acutely aware of risks when seeking financing from a fringe lender.

Franchisees should not be treated as “consumers” subject to strict regulations, while non-business individuals, genuine consumers, should be afforded this greater oversight and protection because they lack the support of the franchise model. However, in order for this comparatively “hands off” approach to regulation to take hold, lenders and franchisors should both be proactive in terms of ascertaining the total amount, and the purposes behind, all financing that a franchisee obtains. For lenders not to be subject to special, consumer-oriented protections, they need to have obtained disclosures from the business debtor indicating her particular, non-consumer use of the money - that it is to help pay some of the upfront costs in becoming a franchisee of the X Corporation, with that disclosure also forwarded to the X Corporation itself. Moreover, there should be an affirmative declaration that the franchisee has consulted with the franchisor about her various financing options, including, specifically, the use of lenders other than traditional banks. So long as the franchisor is informed as to what the franchisee is doing, then franchisee protections may arise within the franchise relationship itself.

The franchisor must assist—at least with information, if not more—its franchisees insofar as they need help in finding financing. This private network of franchisor counseling can be the basis for focusing the latest public law intervention on behalf of fringe lending debtors to those who are truly consumers, not small business owners. As long as the franchisee has actively engaged the franchisor in its financing process, then the focus of limited regulatory resources can be on ordinary consumer loans, with the franchisee having other avenues to pursue fraud, breach of contract, or other claims with respect to financing gone awry.