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The Franchise as a Security: Application of the Securities Laws to Owner-Operated Franchise

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THE FRANCHISE AS A SECURITY: APPLICATION OF THE SECURITIES LAWS TO OWNER-OPERATED FRANCHISES

The American business community utilizes the franchise system as one of the primary methods of supplying the public with goods and services.[1] Since franchising enables a business to multiply its marketing outlets at much less cost and effort than would be necessary to equip company-owned dealers, there has been an increase in the frequency and variety of its use by legitimate businessmen. Unfortunately, there has been a concomitant increase in illegitimate practices employed by certain franchisors in the sale and control of certain franchises. These practices have been most prevalent among the smaller, family-owned and operated franchise.[2] The franchisees who have invested a relatively small amount of money usually have negligible expertise in or control over their investment, and thus must depend upon the franchisor for the success of the investment.[3] Often this dependence leads to abuses, especially when the franchisor's interests conflict with those of the franchisee and when the law is not sufficient to protect the franchisee.

The purpose of the comment is to analyse both the securities laws and the economic realities and abuses of the small franchise relationship with a view toward determining whether the securities laws are appropriate to protect the small franchisee.

I. THE ESSENTIAL FEATURES AND ABUSES OF THE SMALL FRANCHISE AGREEMENT

In the small franchise situation the franchisor exercises considerable control over the management and operation of the franchise. The franchisors often feel that such control over the franchise management and obedience of the franchisee are necessary if the operation is to attain full potential.[4] This control is necessary since the franchisee is often inexperienced and typical training programs do not enable him to make sound business decisions.[5] Control is easily established since the franchisee's investment usually does not provide him with sufficient economic leverage within a large franchise network to impose control on the franchisor.

Control is usually established by enforcement of the provisions

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1 H. Brown, Franchising Trap for the Trusting 1-2 (1969) [hereinafter cited as Brown]; see also H. Kursh, The Franchising Boom 1-12 (1962).

2 See generally Brown.

3 Id. at 5.

4 William Morgan, the president of Chicken Delight, is quoted as saying, "We've got our share of retired Army colonels, but I prefer the ex-sergeants and Navy chefs who know how to take an order." Levey, So You Want to Run a Franchise?, Dun's Rev., Jan. 1969, at 38.

5 An example of this problem is shown in the statement of an ex-franchise: "You don't just come off the street and do something like this. The company never taught me a thing about cost accounting. I found out that's more important than cooking chicken. Those books tell a sad tale." Levey, supra note 4, at 37.

of both the franchise agreement[6] and the operating manual. The franchise agreement determines the rights and liabilities of the parties. Provisions of franchise agreements relate to the franchise fees, advertising expenses, quality control of the products and services, sale and termination of the franchise and inspection of the franchise operation by the franchisor.[7] Most franchise agreements require the franchisee to comply with all rules and procedures promulgated by the company. The rules, which are contained in the operating manual or in periodic releases, provide specific directions for the operation of the franchise.[8] The agreement provides the means of enforcing these provisions since the franchisor may inspect the finances of the franchisee, the quality of its products, the general conditions of its premises and may impose sanctions such as termination if the franchisee fails to rectify any violations.

The termination provisions of the franchise agreement usually provide that the franchisor may terminate the agreement for failure to comply with any of the company rules.[9] A termination of the franchise places the franchisee in a highly disadvantageous situation, not only because he has lost his business, but also because he will not be reimbursed for the goodwill that has been built up at great effort and expense.[10] Termination may result in the franchisee not only losing his original investment, but actually owing money to the franchisor. Thus, the termination provisions coupled with the right of inspection provide the franchisor with a highly effective means of controlling the franchise.

Moreover, the provisions relating to the sale of the franchise also provide a means of control. Before a franchise can be sold the franchisee must pay all debts owed to the company and release the company from any claims that he has against it. Invariably the franchisee must first offer to sell his franchise to the company on the same terms.[11] The provisions also require a potential buyer to be approved by the franchisor and to agree to whatever terms are then being demanded of new franchisees. Since a franchisee may not easily recoup his investment and withdraw from the franchise agreement, he is forced to continue to operate the franchise and submit to company control.

The advantages of such control coupled with the success of franchising as a means of business expansion has lead to an increase in illegitimate practices in the sale and management of franchises. The investor in the small franchise is usually inexperienced and unlikely to recognize misrepresentations. Projections by the franchise promoters of the expected volume of business, profits and work required

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6 An entire franchise agreement is reproduced in Brown 112-27.

7 Id.

8 Id. at 20.

9 See id. at 26 for situations that have resulted in termination.

10 Id. at 25.

11 This often occurs when the franchisor feels that it would be more profitable to operate the franchise himself. See Brown 23-24.

to operate the franchise have often been significantly incorrect.[12] Promises of a substantial return on investment are often misleading, and in fact the return on the investment may be insignificant in relation to the considerable amount of work required to operate the franchise. The promoters may also misrepresent the amount of control the franchisee will have over the business. The franchisee is offered an opportunity to become an independent businessman, yet the franchisor controls the operation of the franchise while the franchisee merely adheres to the rules of the company and supplies the labor.

Abuses often occur in the management of the franchise network. The franchisee relies on the franchisor to provide services and supplies, yet these services are often either non-existent or quite insignificant in relation to the fees paid by the franchisee. In fact, the terms of most agreements bind the franchisor to no specific duties, so that the franchisor need do nothing and still be within the agreement, and the franchisee would nevertheless be required to pay the fees.[13] One of the most frequent abuses arises from the requirement that certain supplies be purchased from the franchisor or designated suppliers. Franchisors have taken unreasonable profits from these sales and received kickbacks from the designated suppliers.[14] If the franchisee attempts to obtain similar supplies elsewhere, the franchisor may force him to cooperate by rejecting those products on the grounds of quality.[15] Another abuse occurs when the small franchisor feels that absolute obedience is needed if the franchise is to achieve full potential, although the rules are so complex that strict compliance with them is extremely difficult.[16] Moreover, the rules are subject to interpretation and enforcement by "supervisors" who are often unqualified.[17] This, coupled with threats of termination and the difficulty of selling the

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[12] An example of the disastrous consequences which can flow from such exaggerations involves a well-known ice cream franchisor who sold a franchise to a husband and wife. As one of the inducements, the company assured them that the "average franchise holder enjoys a $50,000 volume." On the basis of this projection they agreed, in their contract, to buy 800 cans of ice cream mix a month from the franchisor. Although the projected volume of business never materialized, they were obligated to buy the mix which could not be used. In the end they were forced into bankruptcy. Levey, supra note 4, at 38.

Typical advertisements for franchises appear frequently in "The Mart" in the Wall Street Journal.

[13] "There has not been found a single franchise agreement in which the franchisor stated either what it has done or what it promised to do in the future." Brown 7.

[14] See Brown 14-18.

> In the case of one well-known national chain of restaurants, in which the commissary list covered almost every requirement of the franchisees, the extra mark-up ranged from 10% to 300%. . . . The tawdry fact is that in such a situation the suppliers are both accustomed and willing to give "kickbacks" to the franchisor based upon the dollar amount of the purchases by the franchisees.

Brown 16.

[15] Brown 16-17.

[16] Id. at 22-23.

[17] Id. at 21.

franchise produces a particularly intolerable situation for the franchisee.

II. The Federal Security Acts as applied to Franchise Agreements

The classification of franchise agreements as securities would prevent many of these abuses. The standard of proof required to show fraud under the laws regulating securities is much less strict than under common law, where proof of fraud requires a showing of a knowing misrepresentation of a material fact, and actual damage to a person acting in reliance on it.[18] Moreover, the securities registration requirements, if applicable, would prevent many misrepresentations from being made.

A. *The Federal Securities Laws in General*

Securities laws are in effect on the federal level, in the District of Columbia, in Puerto Rico, and in all the states except Delaware.[19] The federal Securities Act of 1933[20] and Securities and Exchange Act of 1934[21] are similar to most state acts, yet cover more transactions than any single state act.

Sections 6 and 8 of the Securities Act of 1933[22] set out the requirements and procedure for the registration of securities offered for sale.[23] The prospective issuer of a security is required to file a registration statement setting forth and supporting all material facts about the enterprise and copies of a prospectus containing all of these facts. A copy of this prospectus must be made available to every buyer. The accuracy of the facts contained in the statement is ascertained by the SEC before the registration is approved. Registration assures every prospective buyer of access to objective information about the investment.

The anti-fraud provisions of these statutes offer considerable protection to the buyer of a security. These provisions are contained in Section 17(a)[24] of the Securities Act of 1933, Section 10(b)[25] of

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18 W. Prosser, Torts 700 (3d ed. 1964).

19 See state statutes in CCH Blue Sky L. Rep.

20 15 U.S.C. § 77 (1964).

21 15 U.S.C. § 78 (1964).

22 15 U.S.C. §§ 77e,f,g,h,j (1964).

23 The question of registration might raise serious policy questions if the increased work from the registration of franchise agreements would hamper the operation of the SEC. However, franchise agreements, if they were classified as securities, might be entitled to exemption from the registration requirements, as, for example, where the sale is to a limited number of offerees who do not intend to resell. This would probably be the case with franchise agreements. 15 U.S.C. § 77d (1964).

24 15 U.S.C. § 77q(a) (1964) provides:

> It shall be unlawful for any person in the offer or sales of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
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> (1) to employ any device, scheme, artifice to defraud, or
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> (2) to obtain money or property by means of any untrue statement of

the Securities and Exchange Act of 1934, and SEC Rule 10b-5.[26] They provide, generally, that it is unlawful to make any misrepresentation, omit any material fact or employ any device or scheme that would serve to mislead or deceive any party to the sale of a security. These provisions are broader in scope than common law fraud.[27] The rules not only forbid deceit and half-truths in the sale of securities, but also require the seller to supply information relevant to the value of the investment.[28] They do not compel the revelation of all information which the buyer might desire,[29] but forbid some of the glaring omissions which are present in franchise promotion.[30] Moreover, unlike common law it is not necessary to show that the buyer showed reasonable judgment in entering into the arrangement.[31] Under the securities laws the most blatant "puffing" might be fraudulent. Also, under these laws the statement of an opinion by one who knows it to be untrue may be fraud.[32] The most important aspect of these provisions is the clear condemnation of half-truths and omissions of important facts.

The abuses which gave rise to the securities acts are explained in the committee report on the 1933 bill which stated:

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material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

25 15 U.S.C. § 78j (1964) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

26 17 C.F.R. § 240.10b-5 (1969) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

27 L. Loss, Securities Regulation 817 (1951) [hereinafter cited as Loss].

28 Id. at 819.

29 Id.

30 See Brown 10, for examples of hidden damages. An example of such an omission is the failure of a franchisor to tell a prospective franchisee that he might be required to buy supplies from the franchisor or his designee at inflated prices.

31 Loss 818-19.

32 See id. at 818.

> The necessity for the bill arises from the fact that billions of dollars have been invested in practically worthless securities, both foreign and domestic, including those of foreign governments, by the American public through incomplete, careless, or false representations. The result is dire national distress. In the protection of the public in its purchase of securities, the United States lags far behind other nations. This is true in spite of the fact that 47 of our states have blue-sky laws.[33]

These conditions were brought about by the great disparity in both economic power and access to information between the large dealers and the general public. The public was often defrauded by inflated promises, falsified reports and rumors. Thus Congress determined the necessity of federal legislation to protect the public.[34]

B. *The Definition of a Security Under the Federal Securities Laws*

Similar conditions now prevail in the promotion and sale of small food and service franchises. Before the securities statutes can be applied, however, an analysis must be made to determine whether franchise agreements are included in the definitions of securities provided in the federal securities acts of 1933 and 1934.[35] Both statutes contain substantially similar definitions, which include terms which describe types of securities covered by the acts, such as notes, treasury bonds, and stocks.[36] Although most of these terms describe particular devices and present no questions of interpretation, the term "investment contract" is included in the federal and many of the state securities acts as a "catchall" for schemes which ought to be covered by the act but which do not fit into any of the common classes of securities.[37]

1. The Judicial Definitions of "Investment Contract"

Although none of the statutes define the term "investment contract," courts, in interpreting the statutes, have developed definitions. The Supreme Court in *SEC v. W. J. Howey Co.*[38] supplied such

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33 S. Rep. No. 47, 73 Cong., 1st Sess. 2 (1933).

34 See Loss 1-7, 56-103, for a detailed background.

35 15 U.S.C. §§ 77b(1), 78c(a)(10) (1964).

36 The entire definition is as follows:

> The term "security" means any note, stock, treasury bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77(b) (1964).

37 Loss 314.

38 328 U.S. 293 (1946).

a definition. The Court said that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[39] In order for there to be an investment contract there must be an expectation of profits, a common enterprise, and reliance that the profits will come from the efforts of a party other than the investor. This construction of the term has been adopted, with some modification, by federal and state courts. An examination reveals that each of these elements is present in the agreements establishing small franchises.[40] The elements of expectation of profits and common enterprise are clearly present in a franchise agreement. In all franchise agreements there is on both sides an expectation of profits. A common enterprise exists where the continuing success of one party to the enterprise is dependent on the efforts and success of the other. This is in contrast to a simple sale of goods or services, where, after the transaction occurs, the parties have no further dealings with each other.[41] The franchisee is dependent on the franchisor for advertising and the beneficial reputation of the network. He also depends upon the franchisor for guidance in the operation of the franchise and a steady flow of the goods and supplies necessary to run the franchise. The franchisor, in turn, relies on both the franchisee's capital to pay for advertising and promotion, and on cooperation in maintaining the good reputation of the franchise network. This is clearly a common enterprise within the meaning of the statutes[42] and, with individual variations, is an attribute of all franchise arrangements.

The requirement that profits be made solely from the efforts of another is not so easily met. Where a prospective franchisee agrees to provide money to establish a franchise which will be operated and controlled entirely by the promoter or a third party, or where the franchisee is a shareholder or silent partner in an established franchise, there is little difficulty in classifying the agreement as an investment contract.[43] However, in small franchises the owners and their families usually provide labor. Although these franchisees generally need the most protection, it is more difficult to apply the Supreme Court definition to this arrangement. However, an examination of the judicial

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39 Id. at 298-99.

40 It is uncertain whether all of the elements must be present for a given scheme to be an investment contract. Loss states that "[t]he line is drawn, however, where neither the element of common enterprise nor the element of reliance on the efforts of another is present." Loss 328. This would seem to indicate that where one element is not present there may still be a security.

41 For a discussion of the term "common enterprise" see Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960).

42 See Coleman, A Franchise Agreement: Not a Security Under the Securities Act of 1933, 22 Bus. Law. 493 (1967).

43 Brown 74-75. See also Coleman, supra note 42, at 510. The Attorney General of New York has moved against franchisors advertising this sort of arrangement, and has obtained an injunction ordering them to cease selling their franchises in New York, on the grounds that they were selling unregistered securities. 3 CCH Blue Sky L. Rep., Report Letter No. 386, at 2 (Aug. 6, 1969).

application of this requirement demonstrates that it is within the requirement that profits be solely from the efforts of a third party.

SEC v. W. J. Howey Co.,[44] the first federal case to interpret the term "investment contract," involved the sale of unspecified plots in a citrus grove, after the purchase of which the plots could have been managed either by a subsidiary of the promoter or by a person chosen by the buyer. Buyers were urged and most agreed to allow the promoter's subsidiary to manage the plots. Since almost all the buyers were unable, whether they chose the first plan or not, to operate their holdings themselves, the Supreme Court held that they expected profits "solely from the efforts of another."[45] Although in *Howey* the investors had no hand in any aspect of the operation of their portion of the groves, in later cases courts held that there was a security in spite of the fact that investors took part in some aspect of the enterprise.

In *Blackwell v. Bentsen*[46] the facts were nearly identical to those of *Howey*, except that the investor was permitted to give the managing company binding instructions concerning the marketing of his portion of the crop. Although this allowed the owner to contribute his efforts to the success of the enterprise, the Court of Appeals for the Fifth Circuit found the agreement to be an investment contract.[47] The court cited *Howey* without elaborating on how the arrangement envisioned profits solely from the efforts of another.

In *SEC v. Addison*[48] the District Court for the Northern District of Texas found an investment contract in spite of the fact that the investor clearly contributed effort to the enterprise. The defendant company in that case proposed to form an enterprise to mine low-grade uranium ore and up-grade it by special process for sale to the government. Investors were invited to advance money in return for a share of the profits. Interested workers were also invited to actually mine the ore in return for a share of the profits. With little discussion the court held that those who had accepted both invitations had bought securities.[49] These cases indicate that "solely" has not received a literal interpretation, and that "efforts" does not preclude an agreement from being a security if the investor has contributed some labor to the enterprise.[50] Thus, an investment could be a security even if the investor

[44] 328 U.S. 293 (1946).

[45] Id. at 299.

[46] 203 F.2d 690 (5th Cir. 1953), cert. dismissed, 347 U.S. 925 (1954).

[47] Id. at 693.

[48] 194 F. Supp. 709 (N.D. Tex. 1961).

[49] Id. at 721-22.

[50] Other cases in which this issue is considered adhere closely to the language of *Howey* and involve fact situations which permit a literal interpretation of profits "solely from the efforts of another." Additional cases are cited in Goodwin, Franchising in the Economy: the Franchise Agreement as a Security under Security Acts, Including 10-b-5 Considerations, 24 Bus. Law. 1311, 1316-17 nn. 17, 18 (1969). Concerning situations where promoters offer to acquire and manage deeds and mortgages for members of the public, the SEC has stated:

> The wider the range of services offered and the more the investor must rely on the promoter or third party, the clearer it becomes that there is an

was able to control the enterprise to some degree or was able to contribute to its success by providing labor.

This is further indicated by the fact that the opinions defining investment contract contain much discussion of the flexibility of that term. In *Howey* Justice Murphy stated, "It involves a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek use of the money of others on the promise of profits."[51] And in a more recent case, Chief Justice Warren stated that in defining a security "form should be disregarded for substance and the emphasis should be on economic reality."[52] This flexibility of interpretation should be emphasized and applied to the franchise situation, since an examination of the realities of the franchise arrangement indicates that the investor in the small franchise may not expect to make profits from his own efforts.

2. Application of the Judicial Definitions of "Investment Contract" to Franchises

The expectations of the prospective franchisee are first formed by the advertisement and other promotional materials. Promoters of franchises direct their offers explictly to people with no experience in managing the sort of business offered, and propose to make up for this inexperience by training and supplying the franchisee with the goods and services necessary to run the franchise. The prospective franchisee is led to believe that he is not expected to make management decisions or do any of the more complicated chores involved in turning profit from the franchise. It is true that he will be expected to supervise the operation and probably to do some or most of the routine labor, but, other than performing these tasks competently, he cannot expect to have much influence on the success or failure of his business. He does not, in any meaningful sense, plan to rely on his own abilities to realize a profit. Despite the fact that most franchisors exhort their prospects to "be your own boss," it is the help they will receive that is emphasized.[53]

> investment contract. While there may be circumstances under which one or more of these elements are present without constituting an investment contract, it is the position of the Commission that each of them has a bearing on whether the investor is relying "solely on the efforts of the promoter or third party" to use the investor's money and through these efforts to return a profit to the investor—the essential test of an investment contract.

SEC Securities Act Release No. 3892 (Jan. 31, 1958).

51 SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

52 Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Although the general rule is that criminal statutes should be strictly construed, these statutes go beyond criminal sanctions. Their main function is to provide civil and equitable relief to private persons who have been harmed. Since this is their more important aspect, the rule will be followed that remedial statutes should be broadly construed to provide the fullest measure of protection to injured parties. SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943).

53 It is not important that these promised services may not materialize since it is enough to constitute a breach of the statutes dealing with securities if an improper offer be made. Therefore, a security might exist if it could be shown that the franchisor

After the franchise is in operation, the franchisee's control over his property is illusory, and thus the profit of the franchise depends upon the efforts of the franchisor. Once he is in business, the franchisee usually has little freedom of choice. The agreement gives the franchisor power to control almost every aspect of the business, under the guise of helping an inexperienced owner or maintaining standards of quality. The franchisee must abide by these decisions even if he disagrees. The franchisor's judgment can be enforced by termination clauses in the agreement which sometimes allow the franchise to be terminated for even minor infractions of the rules set up for the operation of the franchise.[54] Thus, the franchisee must rely for his profit entirely on the judgment and efforts of the franchisor. In this respect he is at a greater disadvantage than the owner of common stock, who can at least vote to change the composition of a management with which he disagrees.

The franchisee has no more freedom to chart the course of his business than a salaried manager in an establishment owned by the franchisors. In fact, franchisors themselves feel that they have more control over a franchisee than over a salaried manager.[55] Yet a manager of a single branch of a large chain owning stock in that chain would be protected by the securities laws.[56]

Thus, it may be concluded that the sale of small owner-operated food and service franchises can be afforded the protection of the securities laws. However, there are few opinions in which courts and state officials have indicated that franchise agreements may be securities.

III. Cases Determining Whether Certain Franchise Agreements are Securities

Several cases have decided that a particular franchise agreement was not a security. Although the franchise agreements that were before these courts are not the type of franchise that is the concern of this comment, an examination of these cases will be helpful in showing the manner in which courts have handled related problems.

Chapman v. Rudd Paint & Varnish Co.[57] involved an agreement in which a hardware store owner was given the exclusive right within a territory to display and sell a varnish product, and in which the manufacturer agreed to advertise the product. The Court of Appeals for the Ninth Circuit found that the agreement was not a security, since the hardware store owner had complete discretion in managing the sale of the product. Thus, the profits had to be made by his own ef-

offered a prospective franchisee such an arrangement even if he never intended to perform it. Coleman, supra note 42, 507.

[54] H. Brown, Franchising Trap for the Trusting 26 (1969).

[55] The NLRB has found that despite the form of the agreement, the franchisor may so control his franchise that the franchisee is an employee under the terms of the Wagner Act. Mister Softee, Inc. v. Oil Workers Union, 162 N.L.R.B. 354 (1966).

[56] SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953).

[57] 409 F.2d 635 (9th Cir. 1969).

forts.[58] This case was concerned with the problem of lack of control since the license to display and sell one product could not give the franchisor control of the franchisee's business.

The North Carolina Supreme Court in *State v. Heath*[59] was presented with a situation similar to that of the small franchise. There, a company had developed a system to promote the rental and sale of real estate. The company licensed the use of this system to an investor who agreed to retain 80 percent of his profits and remit the rest to the franchisor. The court found that the agreement was not a security.[60] There was no evidence to show that the franchisor retained any control over the franchisee or contributed in any way to the enterprise after the sale of the license. Indeed, there was nothing to indicate that they had any further dealings beyond the payment of the royalties.[61]

Two opinions have found that a franchise may be a security. One such opinion was rendered by the Attorney General of California[62] at the request of that state's Department of Corporations. The opinion found that if the franchisee does not operate or control the franchise it is a security. The opinion also found that if the franchisee participates actively in the franchise, and the franchisor does not need the franchise fees in order to provide goods and services, there is no security, but, if the franchisor needs these fees in order to provide goods and services, then the arrangement is a security. Thus, if the franchisee receives a profit only from the income of the franchise operation there would be no security, for the profit would be generated by his own efforts. The opinion found that the typical franchise involves, in effect, two contracts, one to operate a franchise, the other to provide goods

58 Id. at 640.

59 199 N.C. 135, 153 S.E. 855 (1930). Since this case was decided other courts have shown a tendency to interpret the term "investment contract" in a more flexible manner. E.g., SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961). See supra p. 235.

60 199 N.C. at 139-40, 153 S.E. at 857-58.

61 Some commentators have also dealt with this question. Michael Coleman, an SEC staff member, concluded that a franchise agreement is not a security. However, he cautioned that his conclusions were applicable only to franchises similar to a hypothetical one set up in the article—a motel franchise. The conclusion was based on the fact that, because of the considerable amount of money involved, the franchisee could hardly be expected to either enter into the arrangement without complete information or to relinquish control of the business. Coleman admits that if a franchise represents a smaller investment and if the franchisee does not run the business, the arrangement might be a security. Coleman, supra note 42.

A comment by Bernard Goodwin criticizes the Coleman argument and concludes that where the franchisee supplies only the labor and the franchisor directs the business there is a security. Goodwin rejects Coleman's conclusion that any active participation by the franchisee may preclude a franchise from being a security. Since the purpose of the securities laws is to protect investors who are unable to protect themselves, he reasons that the franchisee is protected by the securities laws unless he controls the arrangement sufficiently to protect his investment. Goodwin, supra note 47. Coleman does not adequately consider the question of what is meant by the term "efforts" in the *Howey* definition of an investment contract; thus his conclusions that the operation of a small franchise by the franchisee precludes the arrangement from being a security were rightly criticized by Goodwin.

62 49 Op. Att'y Gen. 124 (Cal. 1967).

and services.[63] It is the second which may constitute the security. If the franchisor needs the franchisee's fees as working capital, then the franchisee is turning money over to the franchisor in the hope that he will create a profit for the franchisee-investor. The profit will not be in money, but in goods and services available on favorable terms. The fact that the franchisee is providing initial or risk capital[64] determines whether the agreement is a security or a simple contract for the sale of goods. This speculative element makes the investment a security.

There are several difficulties with the reasoning of this approach. One problem is that it is impossible to determine when a venture ceases to be speculative and when the franchisor has sufficient capital of his own to provide the goods and services. Conceivably, a franchisor expanding rapidly could be in existence for years without acquiring sufficient capitalization to preclude its franchise agreements from being securities. Just as conceivably, a man buying a franchise from a given franchisor one day might have a security, while one buying the next day might not, as the franchisor's cash position fluctuates daily.[65]

There is also a question as to the validity of the distinction between new businesses and established concerns, since even an established business will not allow the investment to remain idle but will use it in the operation of the network. Moreover, the franchise agreement is not two contracts, but an integrated whole. Reliance on the fiction of two contracts can produce precedents that are extremely difficult to apply.[66]

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63 Id. at 129.

64 For a discussion of the meaning of "risk capital" see Note, Franchise Regulations Under the California Corporate Securities Law, 5 San Diego L. Rev. 140, 152-55 (1968).

65 Cal. Div. of Corp. Bull. No. 67-8 (July 14, 1967) sets out guidelines to be used in making this determination. It states in part:

> Where the franchisee actively participates in the operation of the franchised business, all circumstances must be considered in determining whether the franchise constitutes a security. Ordinarily the existence of all of the following factors will lead to the conclusion that a particular franchise is not a security:
>
> 1. The franchisor, without resort to funds contributed by the franchisee, has sufficient capital to operate the franchising program, to provide facilities, paraphernalia, and services promised to the franchisees, and to continue these activities for an indefinite period of time.
> 2. The franchisor's business has a history of successful operation for sufficient length of time to adequately demonstrate the public demand for the franchise product or service.
> 3. The franchisor has adequate organization, facilities, management, and other experienced personnel available or on call, justifying the conclusion that he will be able to successfully administer the franchising program and to confer upon the franchisee the benefits offered by the program.
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> If any one of foregoing factors is lacking, the franchise may be a security. If the factor mentioned in paragraph 1 is lacking, the franchise ordinarily will be deemed a security.

It has been suggested that if paragraph 1 is stringently applied, all franchises might be classified as securities, since money collected as franchise fees will not lie dormant for "an indefinite period of time," but will be used in the franchise operation. See Note, supra note 64, at 167.

66 The "double investment approach" and the protection it offers investors has

In an unwritten opinion the Supreme Court for the County of New York arrived at a similar conclusion and granted an injunction against the sale of franchises in New York by Dutch Inns, a hotel firm.[67] Dutch Inns had been selling franchises to owners of land deemed suitable for hotels. The franchisee then erected, to Dutch Inns' specifications, a hotel on the sight which Dutch Inns agreed to lease. There was a difference of $4500 between the franchise fee and the amount actually expended by Dutch Inns to set up the franchise. The state argued that the defendant was selling an unregistered security under the New York Real Estate Syndication Act.[68] The court found for the state. Plaintiff's argument, which the court found persuasive, stated:

> It is noteworthy that by obtaining capital funds in the form of franchise fees, a franchising company may be considered to be the offeror of a security (in the form of franchises) measured by the portion of franchise fees in excess of such direct costs. Accordingly, to the extent that the company or its principles may claim to justify their solicitations of $12,500 fees from the public landowner-investors on the ground that they issued actual consideration in the form of franchises, such consideration nevertheless involved issuance of securities within the meaning of Article 23-A of the General Business Law.[69]

This argument expands on the California opinion by saying that there is risk capital where the cost of the franchise exceeds the cost of actually setting up the franchise. Although this approach is easier to apply than that of the California Attorney General, the court should consider more than the price of the franchise. The fact that the price exceeds the tangible services should not be the only consideration in judging whether a franchise is a security. All of the terms of the agreement should be analysed in making this determination.

These opinions demonstrate that state governments are beginning to apply the protection afforded by the securities laws to certain franchises.[70] Hopefully this indicates a trend which will include, at least to some extent, the SEC. However, rather than follow the methods adopted in California and New York, a better approach would be for courts to fully analyze the terms and conditions of the franchise agreement, and to realistically determine whether that agreement is

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been criticized as being inadequate. It has been suggested that the approach based on the control aspect as shown above is more realistic. Note, supra note 64, at 161-62, 168-69.

67 New York v. Dutch Inns of America, No. 41795/1969 (N.Y. County Sup. Ct., May 28, 1969).

68 N.Y. Gen. Business Law § 352-e (McKinney 1968).

69 New York v. Dutch Inns of America, No. 41795/1969 (N.Y. County Sup. Ct., May 28, 1969) (complaint).

70 The Attorney General of New York is quoted in 3 CCH Blue Sky L. Rep., Report Letter No. 386, at 3 (Aug. 6, 1969) as saying that his office would prosecute any party guilty of selling franchises in contravention of the securities laws.

within the judicial definition of an investment contract. The primary determination should be whether profits are expected solely from the efforts of another. This determination should take into account all the circumstances of the agreement including the labor contributed to the enterprise by the franchisee.

CONCLUSION

Whatever the test used it is clear that many franchise agreements can and should be classified as securities. This is possible since the requirement that there be profits solely from the efforts of another is met where the franchisee merely labors but does not control or guide the enterprise. A realization of the manner in which many franchises are promoted and operated makes this clear. Thus, by a straightforward application of the definition of a security contained in the securities laws, protection can be afforded the franchisee.

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