SMU | Dedman School of Law

SMU Law Review

Volume 23 | Issue 3 Article 10

January 1969

Book Review: Franchising: Trap for the Trusting

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BOOK REVIEW

FRANCHISING: TRAP FOR THE TRUSTING. By HAROLD BROWN. Boston, Massachusetts: Little, Brown & Co. 1969. Pp. vi, 180. $15.00.

Franchising was born to fill the need of small independent businessmen for professional assistance and group buying power in what has become a chain store age. Through the medium of franchising the small businessman, the franchisee, is able to utilize the franchisor's proven format for business success. The franchisor is able to charge for the use of his name, his method of doing business and for his services; and may further benefit from increased sales of his product and greater market acceptance of his business image.[1] As an ideal, franchising is a combination of the best features of both big and small business in which the individual entrepreneurial zeal of the franchisee is backed by the franchisor's business organization, superior knowledge and buying power.

The franchise concept can be applied to practically any type of business. The number of franchise outlets is increasing at the rate of approximately fifteen per cent a year.[2] There are now about 500,000 franchise outlets in the United States, grossing $90 billion a year, or about twenty-eight per cent of retail sales.[3] Not surprisingly, the rapid growth of franchise operations has created numerous thorny legal problems. However, to date very little has been written on franchising, and most of what has been written is designed to encourage potential franchisees to purchase franchises.[4] Only three books have confronted the legal aspects of franchising.[5] *Business and Legal Problems of the Franchise*[6] is the edited transcript of an excellent Practicing Law Institute conference on franchising. The second book, a fairly complete legal exposition, is Volume 15 of the Cavitch and Zolman work on Business Organizations, entitled *Franchising*.[7] The third book, by Harold Brown entitled *Franchising: Trap for the Trusting*,[8] is the subject of this Review. Basically the book is a critical analysis and discussion of the possible legal remedies available to franchisees in controversies with their franchisors.

The overall theme of the Brown book is that franchising is hardly the nirvana many franchisors have made it out to be. According to Brown the prospect of quick success has lured hundreds of thousands to purchase franchises, but all too often the franchisee has found himself working

[1] For a more complete definition of franchising, *see* Fels, *Franchising: Legal Problems and the Business Framework of Reference—An Overview*, in BUSINESS & LEGAL PROBLEMS OF THE FRANCHISE (J. McCord & I. Cohen eds. 1968).

[2] TIME, April 18, 1969, at 88.

[3] *Id.*

[4] J. ATKINSON, FRANCHISING: THE ODDS-ON FAVORITE (1968); J. CURRY, PARTNERS FOR PROFIT: A STUDY OF FRANCHISING (1966); H. KURSH, THE FRANCHISE BOOM: HOW YOU CAN PROFIT IN IT (1967); D. SHERER, FINANCIAL SECURITY AND INDEPENDENCE THROUGH A SMALL BUSINESS FRANCHISE (1967).

[5] H. BROWN, FRANCHISING: TRAP FOR THE TRUSTING (1969) [hereinafter cited as BROWN]; BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE (J. McCord & I. Cohen eds. 1968); G. GLICKMAN, FRANCHISING (1969).

[6] BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE, *supra* note 5.

[7] G. GLICKMAN, *supra* note 5.

[8] BROWN.

long hours with little to show for his efforts. The author observes that even though the prospective franchisee takes the franchise contract to a lawyer and the lawyer decides that the terms are too onerous or burdensome, the franchisor probably will not be willing to change the terms of the contract—if for no other reason than that the success of franchising often depends upon uniformity of operation. In any event, the franchisee, with little business or management background and in the glow of his expectations of great profits, is unlikely to examine the specifics of the contract, and is probably invulnerable to criticism of its terms. It is only in the actual operation of the contract that the franchisee may finally appreciate what he has undertaken. Since the contract is written by the franchisor, it is unlikely to impose any definite burdens on him, but rather to place all the obligations and responsibilities upon the franchisee. Consider, in addition, the basic lack of any specifically developed franchise law and the relative dearth of understanding of franchise law among most lawyers; then one can perceive the serious nature of the problems facing franchisees in their dealing with their franchisors.

At first blush, the business lawyer would hastily pass this book by as simply an ivory tower indictment of the franchising industry. But it is a thinking man's book, a pioneering endeavor that pictures the problems rather than the glories of franchising. Perhaps most valuable are the chapters which deal with the legal remedies available to franchisees in their disputes with franchisors. Under present law the franchisees' potential remedies are as follows:

Common Law Fraud.[9] The franchisee must show that the franchisor made an intentional misrepresentation of a material fact which the franchisee relied on to his detriment. The fraud often occurs in the inducement to contract, specifically in the advertisements. For example, seldom does a franchisor promise anything less than full return of the franchisees' equity investment in the first year. One recent Wall Street advertisement spoke of "fantastically high earnings," "guaranteed sales," and "complete assurance of total occupancy."[10] Usually such statements are not actionable in fraud—some because they are ambiguous and thus do not technically constitute representations, and others because they amount to mere "puffing."[11] Brown points, however, to the willingness of a few courts to take special cognizance of the unequal bargaining power of the two parties, and to place a duty higher than the morals of the market place upon the franchisor.

In Texas a suit for fraud would stand a better chance for success than in most states since a few cases have dispensed with the need for proof of scienter, or intent to commit a false impression.[12] All that is necessary is an

[9] *Id.* at 35-38.

[10] Wall Street Journal, July 17, 1969, at 12.

[11] *See* Comment, *Deceptive Advertising*, 80 HARV. L. REV. 1005, 1016-17 (1967).

[12] *See* Wilson v. Jones, 45 S.W.2d 572 (Tex. Comm'n App. 1932) (sale of note); Baker v. Moody, 219 F.2d 368 (5th Cir. 1955) (inducing investment).

innocent misrepresentation, intended to induce a business transaction and relied upon by the plaintiff to his damage.

Statutory Fraud Under State "Blue Sky" Laws or the Federal Securities Acts.[13] This would necessitate that the franchise be treated by the courts as a security. Such a holding is not as improbable as it might at first appear.[14] A franchise often closely resembles the definition of a security which under the Federal Securities Act of 1933 and most state blue sky laws includes investment contracts.[15] In many instances, the franchise involves absentee ownership where the franchisee participates only nominally in management. Following the language of the leading Supreme Court case in this area, *SEC v. W.J. Howey Co.*,[16] a franchise might be held to be a security because there has been an investment in a common enterprise in which the investor has been led to expect profits solely from the efforts of the promoter or a third party. There are also instances where the franchisors raise their initial risk capital through the sale of the franchises just as in the initial public stock offering of a new corporation. The Attorney General of California in 1967 held, on the basis of several federal decisions, that a franchise agreement in just such a situation could be a security.[17] It should be noted that, subsequent to the discussion of this opinion by Brown, California has enacted a new securities act which in its regulations exempts from security status franchise offerings of franchisors with at least a half million in net worth.[18] This regulation does not, however, lessen the significance of the opinion in situations where the franchisor has less than the requisite risk capital. The New York State Attorney General has recently followed the lead of the California Attorney General,[19] and one authority has suggested that the history of Texas security regulation indicates that Texas might well do likewise.[20] The significance of such a holding lies in the fact that in Texas, as in most other states, failure to comply with cumbersome registration requirements creates an irrebuttable presumption of fraud.[21] Under federal law, a holding that a franchise agreement is a security opens the door to actions under rule 10b-5 of the Federal Securities Act of 1934.[22] Under this provision, once jurisdiction is established, liability requires only a showing of negligent misrepresentation or omission of a material fact. Liability under this

[13] BROWN at 36-38, 70-76.

[14] *See, e.g.*, 49 OP. CAL. ATT'Y GEN. 124 (1967) (reproduced in BROWN at 128-35) and the cases cited therein.

[15] *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula*, 18 W. RES. L. REV. 367 (1967); Comment, *Investment Contracts Under Federal and State Law*, 17 W. RES. L. REV. 1108 (1966).

[16] 328 U.S. 293 (1943).

[17] *See* note 14 *supra.*

[18] Regs. Cal. Sec. Comm'r 260.105.4.

[19] In 3 RESTAURANT NEWS No. 14, July 7, 1969, at 1, it was reported that the New York Attorney General had secured several cease and desist orders in the New York supreme court against a number of franchisors.

[20] Goodwin, *The Franchise as a Security*, in BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE 185 (J. McCord & I. Cohen eds. 1968).

[21] *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 581-33 (1964).

[22] BROWN at 70-76. *See generally* Goodwin, *supra* note 20, at 193-206.

fraud provision might extend even beyond the franchisor to the common situation where the franchisee sells interests in (or mortgages) the franchise.

An Equitable Proceeding for Breach of a Fiduciary Relationship.[23] Brown is unable to cite judicial decisions involving franchise agreements in this respect, but he does point to several National Labor Relations Board decisions holding that the franchisor's control of his franchisees makes them mere employees.[24] In another vein, he cites a Massachusetts decision involving a claim by a nursing home operator against a lender-builder, holding that a fiduciary relationship is created where there is a substantial disparity of bargaining power and the weaker party reposes trust and confidence in the other.[25] If a fiduciary relationship is established, a franchisee could, of course, enforce very strict standards of performance and integrity on the part of the franchisor. Possible support for this proposition can be found in several Texas decisions although none involves a franchise situation.[26]

Remedies Under the Antitrust Laws.[27] The reach of federal antitrust law continues to grow. For example, the category of per se violations such as price fixing (applicable to Texas and all other states which do not have fair trade laws) has recently been extended in one decision to include sales by a manufacturer to a retailer where the manufacturer sought to limit the retailer's sales and the customers to whom he could sell.[28] This case, in conjunction with another, has probably included in the per se category any form of closed territorial clauses not primarily for the benefit of the franchisee.[29] And the defense of *in pari delicto* has been rejected by the *Perma Life Mufflers* decision,[30] with the result that a non-innocent franchisee can recover treble damages from his co-conspirator franchisor.

Closely allied with the antitrust law is the very extensive power of the Federal Trade Commission (FTC) to regulate "unfair methods of competition and unfair or deceptive acts or practices."[31] In recent years the FTC has become increasingly active in the franchise field and the standard under which it operates is flexible and permits, as Brown points out, the FTC to "declare practices unfair, in the light of Antitrust policies, even

[23] BROWN at 41-44, 92.

[24] *Id.* at 41.

[25] Broomfield v. Kosow, 349 Mass. 749, 212 N.E.2d 556 (1965).

[26] Meacham v. Halley, 103 F.2d 967 (5th Cir. 1939) (misrepresentation of law not just expression of opinion, and can be actionable, if one party has used his superior knowledge or information to obtain an unconscientious advantage over another who is confessedly ignorant); Johnson v. Peckham, 132 Tex. 148, 120 S.W.2d 786 (1938) (a partner selling his interest to other partner occupies a fiduciary position and his conduct must be measured by standards higher than those applicable between strangers).

[27] Brown at 45-69. *See also* BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE, *supra* note 5, at 277-321; Franchise Symposium, 15 N.Y.L.F. 1 (1969). The *Southwestern Law Journal* will publish in the October 1969 issue an extensive student Comment entitled "Antitrust Limitations on Price Maintenance, Market Division, and Quality Controls in Franchise Agreements."

[28] United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).

[29] *See* United States v. General Motors, 384 U.S. 127 (1966).

[30] Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968).

[31] 15 U.S.C. § 45 (1965); *see* BROWN at 47-50, 90, 141-51.

though such practices may not actually violate the Antitrust laws or may only be incipient violations."[32]

The franchisor can encounter even harsher restrictions under Texas antitrust law.[33] In this area, unlike most of the law applicable to franchising arrangements, the law is possibly too favorable to the franchisee. For example, if any provisions of a Texas franchise agreement violate state antitrust law, the entire contract is null and void, and any amounts owed by the franchisee, even if embodied in a separate obligation, are cancelled.[34] And, in general, the scope of possible state law violations is far more extensive than that under federal law, especially in the areas of exclusive dealing where the franchisor requires the franchisee to purchase his supplies from the franchisor and where the franchisor attempts to establish an exclusive territory for the franchisee.[35]

Damage Claims for Automobile Dealers Under the Automobile Dealer Franchise Act of 1956.[36] This Act gives an automobile dealer a cause of action if the manufacturer fails "to act in *good faith* in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer . . . ."[37] Senator Philip A. Hart, Chairman of the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, who wrote the forward to Brown's book, has for several years tried to secure extension of a modified version of this Act to all franchises.[38] If a significant amount of franchise fraud is exposed, the odds for passage of Senator Hart's bill would greatly increase.

There are some methods of attack that Brown does not mention, especially in the case of fraudulent franchisors. The Post Office Department, for example, has been active in investigating and prosecuting fraudulent franchise sales as violations of the mail fraud laws.[39] Unfortunately these provisions have long received restrictive judicial interpretation with the courts requiring a showing of intent to defraud as in common law fraud.[40] However, in a letter to this writer dated February 5, 1969, the Chief Inspector reported that since 1964 the Post Office Department had completed 524 full field investigations of alleged fraud in the franchise field and at that time had 196 such cases under investigation. A total of 288 persons or corporations had been indicted and 226 convicted. Most of

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[32] BROWN at 49.

[33] TEX. BUS. & COMM. CODE §§ 15.01-.04 (1968).

[34] *Id.* § 15.04.

[35] *See generally* Moody & Wallace, *Texas Antitrust Laws and Their Enforcement—Comparison with Federal Antitrust Laws*, 11 Sw. L.J. 1 (1957); Note, *Texas Antitrust Laws—Enforceability of Exclusive Dealership Contracts*, 13 BAYLOR L. REV. 295 (1961). As an example of the difficulties involved in trying to write an exclusive territory agreement in Texas, *compare* Patrizi v. McAninch, 153 Tex. 389, 269 S.W.2d 343 (1954), *with* Smith v. Waite, 424 S.W.2d 691 (Tex. Civ. App. 1968), *error ref. n.r.e.*

[36] BROWN at 77-86.

[37] 15 U.S.C. § 1222 (1965) (emphasis added).

[38] *See* BROWN at 87-94, 108-111.

[39] 18 U.S.C. § 1341 (1965); 39 U.S.C. § 4005 (1965).

[40] United States v. Rabinowitz, 327 F.2d 62 (6th Cir. 1964); United States v. Harrison, 200 F. 662 (6th Cir. 1912).

these investigations and actions were initiated on the basis of complaints from actual victims.

Similarly, many states have specialized divisions within the attorney general's department to handle consumer problems and complaints.[41] These bureaus, acting primarily on consumer complaints, operate on two levels: first, education of the consumer to increase his awareness of deceptive practices, and second, enforcement in varying degrees of the state's consumer and advertising laws. For example, penal provisions in most states, including Texas, proscribe untrue, deceptive or misleading statements.[42] Often the bureaus can obtain restitution by mere threat of prosecution and public exposure. It is known that many of these bureaus have been looking into the sale of the franchises. In New York, the Attorney General recently moved against several franchisors on the basis that they were selling securities without complying with the New York Real Estate Syndicate Act and the prospectus requirements of the New York securities laws.[43]

In Texas, the Attorney General, apparently in response to complaints from defrauded buyers, has issued an opinion concerning "chain" or "pyramid" selling plans, which depend primarily on the sale of distributorships and only secondarily on the sale of merchandise.[44] In effect it held that such plans could constitute lotteries and, in addition, might violate the deceptive trade practice provisions of the Texas Consumers Credit Code or the Texas Antitrust Act.

Thus there are remedies for the overreaching franchisor but these remedies are diverse and relief under them is not particularly easy to obtain. This book is the first source to catalogue these remedies albeit in a very brief summary fashion and with extremely poor organization. A recent review of the book and interview with the author, published in *Restaurant News*,[45] made mention of the fact that Brown had suggested 101 ways in which to sue a franchisor, making it appear to be a manual for lawsuits. The previous paucity of litigation on this subject has, according to Brown, placed the franchisee in an inadequate bargaining position. Brown is out to change this. According to the review in *Restaurant News*, this book: "will encourage franchisee rebellion and litigation like nothing ever has and it may change the very nature of the food franchising industry."[46]

If our economy encounters a business slowdown, and in the summer of 1969 this appears likely, a shakeout of marginal businesses can be expected. Especially vulnerable would be those that have been over-promoted and have slight substance and inadequate financial backing. Many franchise organizations are in this category. A major franchisor, Frank Thomas, President of Burger Chef, has predicted trouble by 1970 for

[41] *See generally* Comment, *Deceptive Advertising*, 80 HARV. L. REV. 1005, 1124-35 (1967); Comment, *Translating Sympathy for Deceived Consumers into Effective Programs for Protection*, 114 U. PA. L. REV. 395 (1966).

[42] *See, e.g.*, TEX. BUS. & COMM. CODE § 17.12 (1968).

[43] *See supra* note 19.

[44] TEX. ATT'Y GEN. OP. No. M-343 (1969).

[45] 3 RESTAURANT NEWS No. 15, July 21, 1969, at 14.

[46] *Id.*

many franchising operations.[47] Should this occur many lawyers would certainly appreciate knowing 101 ways to sue a franchisor.

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[47] Reported in 3 RESTAURANT NEWS No. 13, June 23, 1969, at 7.

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