

Franchising: Probable Impact of the New Federal Trade Commission Rule

The Federal Trade Commission recently published a rule entitled Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures.¹ This rule, as its title suggests, generally requires disclosure, in an offering circular, of material information concerning the franchise being promoted.² In support of the rule, the Federal Trade Commission (FTC; Commission) has conducted the most searching and significant study of the character of franchising and its abuses yet undertaken.³

The study reveals that the currently unregulated offering and sale system of franchises is riddled with abuse by franchisors. Prior attempts to correct this abuse of the system through franchise litigation relying on common law fraud, federal antitrust, and securities law theories, have proven only marginally helpful. The Commission has thus concluded that prophylactic measures at a national level are necessary.

In order to assess the probable impact of the Rule upon franchisee-franchisor litigation, this Comment will take up three topics. First, the practical and legal character of the franchise relationship as found by the Commission will be examined. Second, although the Commission urges that the courts recognize an implied private right of action under section 5 of the Federal Trade Commission Act,⁴ there are significant substantive and procedural difficulties with this remedy. These will be identified by testing the remedy against those available to investors under the federal securities laws.⁵ Third, this Comment will focus upon the reason behind judicial disfavor of securities antifraud claims in the context of franchise litigation. Because the Commission's findings confirm that the courts' reasoning is without factual foundation, this Comment will suggest a test that recognizes the economic realities of franchising as a security.

I. DISCLOSURE AS DETERRENCE: IMPACT UPON FRANCHISOR ABUSE AT THE POINT OF SALE

A. *Franchising*

Recognizing that franchising takes many forms, the Commission

1. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,614 (1978) (to be codified in 16 C.F.R. § 436 [hereinafter cited as *Disclosure Requirements*]).

2. *Id.* at 59,614 (to be codified in 16 C.F.R. § 436.1).

3. The Commission's record comprises over 30,000 pages. Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,621 (1978) [hereinafter cited as *Statement of Basis and Purpose*].

4. 15 U.S.C. § 45 (1971).

5. See Securities Act of 1933, 15 U.S.C. § 77a (1976); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh (1976).

defined it simply as "a method of doing business or a method of distribution."⁶ But franchising is not so mutable that its elements never have continuity. Thus, it might be further defined as a device whereby one purchases the right to promote a product, process, or service directly to consumers in exchange for which the purchaser virtually relinquishes control over his capital investment.⁷

Franchises may be divided into two classes: conventional and unconventional. In the conventional form, the franchisee purchases the use of the franchisor's name and services and, additionally, invests in real estate, fixtures, equipment, and inventory. Generally, the consumer comes to the franchisee's place of business, although some conventional franchises are mobile service businesses. Typical examples of conventional franchises are fast-food shops, tax return preparation offices, candy shops, and florist shops. Virtually any product or service used by the public is a candidate for franchising.

The unconventional franchise, on the other hand, generally requires a negligible capital investment beyond the franchise fee. The franchisee often is little more than a peddler. The appeal of the unconventional franchise is that, by recruiting others to the plan, the franchisee may earn a commission or "override" on all sales made by his recruits. Mathematically, the returns from this system can be tremendous. The unconventional franchises have been generally labelled as pyramid sales plans, referral schemes, and founders' contracts.⁸

Whatever form the franchise takes, however, marketing always follows roughly the same pattern. Conventional franchise prospects are initially contacted through advertising, direct mailings, trade shows or franchise brokers.⁹ Unconventional franchisors rely almost exclusively on contacts between existing franchisees and the public.¹⁰

Following the initial contact, the prospect is generally supplied with a franchise package containing promotional material, and frequently contacted personally by an employee of the franchisor. If the prospect shows interest, the franchisor frequently employs a "headhunter" to close the deal. This independent contractor works on commission for every franchise sold,¹¹ and uniformly employs a hard-sell technique. He extolls the virtues of independence enjoyed by franchisees, describes fantastic profit potentials, introduces the prospect to selected "friendly" franchisees—some of whom have received kickbacks from the franchisor

6. *Statement of Basis and Purpose*, *supra* note 3, at 59,621.

7. See Goodwin, *The Name of The Franchising Game Is: The Franchise Fee, The Celebrity or Basic Operations*, 25 BUS. LAW. 1403 (1970); *Statement of Basis and Purpose*, *supra* note 3, at 59,701.

8. Discussed in detail at note 115 and accompanying text *infra*.

9. *Statement of Basis and Purpose*, *supra* note 3, at 59,623.

10. See note 115 and accompanying text *infra*.

11. The author of this Comment has personal knowledge of one case in which the headhunter received one-third of the initial franchise fee for every sale closed.

for their cooperation—and generally excites the prospect's greed in every conceivable manner.¹²

After the prospect has orally committed himself, the franchisor ordinarily requires him to produce a credit report and a statement of net worth satisfactory to the franchisor. The franchisor may purport to conduct an investigation to determine if the prospect can meet its "standards."

After a satisfactory report is obtained, the conventional franchisee is presented with a skillfully drafted agreement delineating the entire relationship of the parties. The document often covers twenty pages or more,¹³ but despite its complexity, less than one-half of all franchisees seek legal advice before signing.¹⁴

Although the agreement varies somewhat between franchisors, the basic provisions are uniform.¹⁵ The franchisee agrees to pay an initial fee, in consideration of which the franchisor grants the use of a trademark or process. In consideration of certain services to be performed by the franchisor, the franchisee covenants to (1) pay royalty and advertising fees based upon a percentage of gross income; (2) set up and maintain his premises to the specifications of the franchisor; (3) purchase goods only as specified by the franchisor; (4) provide monthly, quarterly, semi-annual, and annual statements of income and expenses; (5) provide an audited annual balance sheet; (6) maintain insurance coverage as required by the franchisor; and (7) grant the franchisor first refusal if he wishes to sell the business, or, if the franchisor declines to repurchase, sell only to buyers whom the franchisor accepts as satisfactory. Generally, the agreement provides that the franchisor may seek injunctive relief against the franchisee if any provision is breached, but requires that the franchisee submit any dispute to arbitration.

The franchisor covenants to (1) provide training for the franchisee, at the franchisee's expense; (2) advise and counsel the franchisee; (3) provide experienced personnel to help the franchisee's opening; and (4) conduct reasonable advertising and promotional services in the franchisee's area. The agreement may contain a provision granting the franchisee an exclusive area of operations, and may also contain language to the effect that the franchisor agrees to use its best efforts to provide wholesale discounts to the franchisee.

The agreement never alludes to the claims and representations made

12. Numerous examples of these practices appear in the text of the *Statement of Basis and Purpose*, *supra* note 3.

13. *Id.* at 59,626.

14. *Id.* at 59,626-27 n.20.

15. The characteristics of the "typical" franchise agreement which follow in the text are derived from an agreement currently in use and from provisions that appear in the reported cases. For particularly detailed opinions, see *Chapman v. Rudd Paint and Varnish Co.*, 409 F.2d 635 (9th Cir. 1969); *Higbie v. Kopy-Kat, Inc.*, 391 F. Supp. 808 (E.D. Pa. 1975); *Wieboldt v. Metz*, 355 F. Supp. 255 (S.D.N.Y. 1973).

by franchisor sales people with respect to "guarantees" of profits or success. Moreover, the agreement always contains provisions disclaiming any guarantees and designating the franchisee as an independent contractor. Merger clauses are universal. Also, the agreement may contain a provision wherein the franchisee expressly waives liability for any representations or statements made outside the document.

Although this agreement obligates the franchisor to do almost nothing, but imposes immense obligations on the franchisee, franchisees are seldom dissuaded from concluding the sale.¹⁶ This phenomenon indicates that the hard sell works, that the prospect is committed to the arrangement before he sees a contract.

It can no longer be doubted that the franchise agreement is frequently "one-sided and unfair,"¹⁷ or that the franchisor wields "tremendous control" over the franchisee.¹⁸ The Commission's report confirms that this control is not fortuitous, but results from franchisor marketing strategy. This strategy aims precisely at those who are least able to make informed decisions—unsophisticated investors.

As the Commission noted:

[I]t was reported that ". . . 68 percent of our sample of franchisees did not own a business prior to their franchised business and half the franchisees had incomes below \$10,000 prior to buying their franchise." This relative lack of business experience and low capitalization is quite striking in light of the nature of franchising—a ". . . highly complex, dynamic and changing area, with varied sophisticated business, financial and legal techniques and complications."

Given the complex nature of most franchising operations, it is somewhat surprising that a group of relatively "unsophisticated" persons enters a field which requires such a significant degree of business acumen.¹⁹

The Commission did not, however, rely upon substantive bargaining disparities of franchisors and franchisees in support of the Rule.²⁰ It focused instead upon the "informational imbalance" created by franchisor marketing strategies.²¹

B. *The Rule*

Perceiving the problem as one of "informational imbalance," the Commission has attempted corrective measures that require disclosure of material facts and prohibit material misrepresentations in the offering and

16. See *Statement of Basis and Purpose*, *supra* note 3, at 59,626-27.

17. *Id.* at 59,627 n.22.

18. *Id.*

19. *Id.* at 59,625. See also *Franchise Legislation: Hearings on S.R. 26 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. 356 (1968) (statement of Jerome Shuman); OHIO LEGISLATIVE SERVICES COMMISSION, *FRANCHISING: ALLEGED ABUSES AND POSSIBLE STATE REMEDIES* Rep. No. 111, at 7 (1974); H. BROWN, *FRANCHISING—REALITIES & REMEDIES* 11 (1st ed. 1973).

20. *Statement of Basis and Purpose*, *supra* note 3, at 59,627 n.22.

21. *Id.* at 59,625.

sale of franchises.²² The Commission will enforce the Rule under the authority granted it by section 5 of the Federal Trade Commission Act.²³ The Commission has pointedly suggested that an implied private right of action should be recognized by the courts.²⁴

The Rule requires that the franchisor furnish to the franchisee, before the sale,²⁵ a single offering circular²⁶ that contains the disclosures mandated by the Rule. Affirmative disclosure is required of the franchisor in a number of critical areas: (1) the business experience of the franchisor's management,²⁷ (2) the business history of the franchisor,²⁸ (3) past and pending material litigation involving the franchisor or its management,²⁹ (4) the number of franchise units currently operating, (5) past acquisition and termination of units by the franchisor,³⁰ (6) audited balance sheets, income statements, and statements of changes in the franchisor's financial position, for the preceding three years.³¹ The Rule also prohibits the franchisor from making projections relating to a unit's potential income, unless "a reasonable basis exists for such representation."³² Prior to the closing, the franchisor must, on demand, provide the prospective franchisee with a document that discloses the informational base upon which the projection was developed.³³

In addition to furnishing the prospective franchisee with this document and the prospectus, the franchisor must provide a copy of the agreement itself at least five business days prior to the date the agreement is to be executed.³⁴ Finally, the franchisor is prohibited from making any claims or representations, either oral or written, that contradict information required to be disclosed by the Rule.³⁵

C. *Impact of the Rule*

The Rule addresses other disclosures and prohibitions, but the provisions just outlined are most central to the intended purpose of

22. Franchisee complaints on the record include material omissions and misrepresentations, as well as what the Commission described as "conduct wherein the franchise offering itself was fraudulent." *Id.* This apparently means that the seller was never engaged in business at all, but merely practiced flimflam that took the form of a franchise offering.

23. 43 Fed. Reg. 59,614 (1978) (to be codified in 16 C.F.R. § 436.1); see 15 U.S.C. § 45 (1976).

24. *Statement of Basis and Purpose, supra* note 3, at 59,723.

25. *Disclosure Requirements, supra* note 1, at 59,620 (to be codified in 16 C.F.R. § 436.2(g) & (o)).

26. *Id.* at 59,617 (to be codified in 16 C.F.R. § 436.1(a)(21)).

27. *Id.* at 59,614-15 (to be codified in 16 C.F.R. § 436.1(a)(2)).

28. *Id.* at 59,615 (to be codified in 16 C.F.R. § 436.1(a)(3)).

29. *Id.* (to be codified in 16 C.F.R. § 436.1(a)(4)).

30. *Id.* at 59,616 (to be codified in 16 C.F.R. § 436.1(a)(16)).

31. *Id.* at 59,616-17 (to be codified in 16 C.F.R. § 436.1(a)(20)).

32. *Id.* at 59,617 (to be codified in 16 C.F.R. § 436.1(b)(2)).

33. *Id.* (to be codified in 16 C.F.R. § 436.1(b)(3)).

34. *Id.* at 59,619 (to be codified in 16 C.F.R. § 436.1(g)).

35. *Id.* (to be codified in 16 C.F.R. § 436.1(f)).

investor protection. Indeed, a disclosure statement will appear strikingly similar to the registration statement and prospectus required in an offering of registered securities.³⁶ This is hardly a surprising result, given that the Commission drew heavily upon rules and documents of the Securities and Exchange Commission (SEC), and upon the body of federal securities antifraud case law.³⁷

In short, the central elements of the Rule represent a wholesale codification of SEC rules and court decisions. This is not fortuitous, however. In requiring full disclosure, prohibiting misrepresentations, and urging recognition of a private right of action in the offering and sale of franchises, the Commission was simply adopting the policy underlying federal securities law. The Supreme Court in effect presaged the Commission's objectives when it stated that "[t]he Securities Act of 1933 was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."³⁸

Given the underlying policy objectives of the Commission, and the similarity between the franchise offering circular and the securities prospectus, it can be safely predicted that the impact of the Rule at the point of sale will parallel that of the prospectus in the securities field. Significantly, the prospectus alone has not extinguished securities fraud. The prospectus and registration statement are defensive documents, not selling tools. The prospectus has become a lawyer's weapon, drafted with intent to avoid civil liability under the Securities Act and common law.³⁹

It is probably inevitable that the franchise offering circular will become much the same type of document. Clearly there is some deterrent effect in requiring disclosure, but franchisors are even less likely to be dissuaded from fraud by the prospectus requirement than is the issuer of securities. There are a number of reasons for this conclusion.

First, unlike the issuer of securities, which cannot commence an offering until the SEC has approved its registration statement,⁴⁰ the franchisor need not obtain prior review of the franchise offering circular by the Commission.⁴¹ This allows the franchisor greater leverage in drafting a circular and commencing an offering. Although the Rule requires that the

36. See Securities Act of 1933 § 7, 15 U.S.C. §§ 77g, 77aa (1976).

37. See *Statement of Basis and Purpose*, *supra* note 3, 59,643 n.58 (to be codified in 16 C.F.R. § 436.1(a)(4)) (material litigation disclosures); 59,680 n.432 (to be codified in 16 C.F.R. § 436.1(a)(20)) (audited financial reports); 59,683 n.455 (to be codified in 16 C.F.R. § 436.1(a)(22)) (material changes in financial position of franchisor); 59,685 n.482, 59,687 nn.500-03, 59,691 n.543 (to be codified in 16 C.F.R. § 436.1(b)-436.1(d)) (basis for projections of unit income); 59,715-16 (to be codified in 16 C.F.R. § 436.2(i)) ("affiliated person" defined); and 59,718 (to be codified in 16 C.F.R. § 436.2(n)) ("materiality" defined).

38. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citations omitted).

39. L. LOSS, *SECURITIES REGULATION* 262 (temp. student ed. 1961)

40. *Id.* at 269-70.

41. *Statement of Basis and Purpose*, *supra* note 3, at 59,682 n.448.

document be drafted "accurately, clearly and concisely,"⁴² there is no bright-line rule regarding the inferences that can be drawn from the English language. A franchisor may prepare a questionable offering circular, but consider the possibility of *post hoc* Commission action worth the risk of commencing operations. Second, although the offering circular may comply in all respects with the requirements, the franchisor may "bury" it among other documents furnished to the prospective franchisee. Third, the franchisor may continue to conduct a "hard sell," confining material misrepresentations to its oral presentations. If later challenged, the franchisor is in a position to deny that the statements were made. Fourth, because the franchisor actively seeks out only unsophisticated prospects,⁴³ it is unlikely that the impact of even the honest circular's unfavorable contents will be perceived by the franchisee until he or she has signed the agreement.

Recognizing these limited benefits of the Rule and the administrative limitations upon its own enforcement power, the Commission urged that the courts accord an injured franchisee a private right of action to redress violations of the Rule.⁴⁴ Assuming that the courts are favorably disposed to the Commission's suggestion, there are, nevertheless, significant problems for a plaintiff who relies exclusively upon this implied right of action. On the other hand, there are strong reasons for the courts to recognize that at least some franchises are securities within the coverage of federal securities law, and grant private relief under that well-developed body of national antifraud law.

II. LIMITATIONS OF THE IMPLIED RIGHT OF ACTION UNDER SECTION 5 OF THE FTC ACT

A. *Substantive Deficiencies*

Franchisor abuse of the system is not a new phenomenon. Capitalizing on the initial success of legitimate franchisors, the flimflam artist quickly used the device to his advantage.⁴⁵ Because of franchising's

42. *Disclosure Requirements*, *supra* note 1, at 59,614 (to be codified in 16 C.F.R. § 436.1(a)).

43. See notes 13 & 14 and accompanying text *supra*.

44. See *Statement of Basis and Purpose*, *supra* note 3. The limits on the Commission's enforcement power are both practical and procedural. First, because the Commission does not have a prior review capability, notice of any violations of the Rule must come from injured franchisees, followed by Commission investigation. Second, even if the Commission concludes that a franchisor is violating the Rule, there are procedural limits on its powers. Before issuing a cease and desist order, the Commission must conduct an adjudicatory proceeding. 15 U.S.C. § 45(b) (1976). The franchisor may further delay enforcement by filing a petition for review in the United States Court of Appeals. 15 U.S.C. § 45(c) (1976). Penalties do not begin accruing, in the case of a contested order, until time for review by petition of certiorari have expired. 15 U.S.C. § 45(g) (1976).

45.

The ingenious marketing and distribution device of franchising, that extraordinary symbiosis of big and small business, so necessary in the current age of gargantuan public corporations and turbulent, urbanized, untrained and unskilled ethnic minorities, has also attracted the promotional fermentations of unscrupulous or shortsighted entrepreneurs. We have, at best, confusion, and, at worst, deceit or misrepresentation, in the purposes, goals and actions of

unique characteristics as a hybrid business form⁴⁶ and the interstate character of the offerings, however, the common law proved ineffective against the problems created by franchisor abuse.⁴⁷

Two substantive barriers of the common law have defeated franchisee fraud actions. First, franchisor offerings rely heavily upon income projections for potential units. The franchisee who is induced to enter an agreement in reliance upon the projections later finds that they are not actionable, no matter how distorted. Under state law of fraud, such representations are merely "trade talk" or "dealer's talk"—not fact.⁴⁸

Second, what the franchisor omits to say about the offering often is more critical to the offeree than what is said. But the courts have held that nondisclosure is not actionable absent some special relationship between offeror and offeree.⁴⁹ Moreover, courts have held that fiduciary status giving rise to a duty to speak is not generally present in a franchise relationship.⁵⁰

Franchisees have turned for relief to federal forums under two bodies of law. First, franchisees have obtained some relief under the antitrust laws, although the application is limited.⁵¹ Second, federal securities antifraud laws offer a range of remedies for the kind of manipulative practices endemic to franchise offerings.⁵² The course of franchise securities litigation is examined in the third part of this comment. It is appropriate at this point, however, to develop securities law antifraud

those franchisors who prefer to get rich quickly at the expense of their franchisees or stockholders, instead of organizing and building a long term sound business for the benefit of all concerned. That is why the public interest has become paramount, requiring full disclosure to prevent fraud and manipulation.

Goodwin, *supra* note 7, at 1403 (citations omitted).

46. See *Statement of Basis and Purpose*, *supra* note 3, at 59,698.

47.

Common law fraud and state antifraud statutes are so beclouded by vestigial variations, straightjackets and anachronistic requirements, rarely compatible with the complex manipulations of business today, that they have become an obstacle course hindrance rather than a help to plaintiffs involved with the intricacies and imaginative devices of modern business operators and entrepreneurs [*sic*], especially if they operate interstate rather than intrastate.

Goodwin, *supra* note 7, at 1413.

48. See cases discussed in Annot., 64 A.L.R.3d 6, 28 (1975) (discussing fraud associated with franchise and distributing relationships).

49. *Id.* at 23-26.

50. See H. BROWN, *FRANCHISING: A TRAP FOR THE TRUSTING* 41 (1969). *But see* *Broomfield v. Kosow*, 349 Mass. 749, 212 N.E.2d 556 (1965); *Mobil Oil Corp. v. Rubinfeld*, 72 Misc. 2d 392, 339 N.Y.S.2d 623 (Civ. Ct. 1972), *aff'd*, 77 Misc. 2d 962, 357 N.Y.S. 2d 589 (App. Term. 1974), *rev'd*, 40 N.Y.2d 936, 390 N.Y.S.2d 57, 358 N.E.2d 882 (1976).

51. See *Siegel v. Chicken Delight*, 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972); *Susser v. Carvel Corp.*, 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd* 332 F.2d 505 (2d Cir.), *cert. dismissed*, 381 U.S. 125 (1964).

52. See, e.g., 15 U.S.C. § 77k (1976)(express civil action for false registration statement), § 77l(2)(express civil action for misleading statements), § 77o (liabilities of controlling persons), § 77q (implied right of action for fraud), § 78j(6) & SEC Rule X-10(b)-5, 17 C.F.R. § 240.10(b)(5)(b) (1978) (implied right of action for fraud); 15 U.S.C. § 78n (1976) (implied right of action for violation of proxy rules).

measures vis-à-vis the Commission's suggested remedy under section 5 of the FTC Act.

The salient feature of the securities antifraud law is its flexibility. The courts have consistently recognized the remedial nature of the statutes⁵³ and thus have been liberal in their construction.⁵⁴ Private plaintiffs are generally free of the proof problems imposed by the common law. For example, in an action brought against a seller of securities under section 12(2) of the Securities Act,⁵⁵ the plaintiff need only prove that the seller made a material misstatement or omission, or created a "half-truth," in order to obtain rescission. Proof of scienter is not required; the plaintiff is relieved of the common law obligation of reasonable care. Furthermore, the plaintiff need not prove that he relied upon the misstatements or omissions.⁵⁶ Moreover, the defendant is denied the defenses of contributory negligence and assumption of risk.⁵⁷ Although it is now settled that some elements of fraud are a necessary⁵⁸ part of an action brought pursuant to section 10(b) of the Securities Exchange Act and Rule 10(b)-5,⁵⁹ the plaintiff proceeding under those provisions may reach parties not within the scope of section 12 of the Securities Act of 1933.⁶⁰ In short, the federal securities antifraud law has developed a tightly-woven web in which a plaintiff may find the strand suited to the injury that he or she has suffered.

The franchisee-plaintiff who attempts to exercise a private right of action under section 5 of the FTC Act will face significant substantive barriers. Foremost among these are: (1) the reluctance of the courts to recognize a private right of action under that section; (2) the complete absence of a substantive body of law applicable to the franchise relationship; and (3) the limitation of liability granted to directors and controlling shareholders of franchisors.

First, the federal courts have consistently held that a private right of action cannot be implied from the FTC Act.⁶¹ The courts may now reverse themselves, but franchisors have a powerful argument that if a private right is to be granted, it is Congress, and not the Commission, that wields the authority. Moreover, the federal courts are engaged in what one

53. *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

54. *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954).

55. 15 U.S.C. § 77f(2) (1976).

56. *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1222 (D. Md. 1968), *aff'd in part*, 422 F.2d 1124, 1129 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

57. *Id.*, 297 F. Supp. at 1221-22.

58. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

59. 15 U.S.C. § 77j(b) (1976); SEC Rule X-10(b)(5), 17 C.F.R. § 240.10(b)(5)(b) (1978).

60. Section 12 liabilities attach only to the plaintiff's seller, but privity is not a requirement of Rule 10(b)-5. Moreover, sellers as well as purchasers may sue under Rule 10(b)-5.

61. *See, e.g., Holloway v. Bristol-Myers Corp.*, 485 F.2d 986 (D.C. Cir. 1973); *but see Guernsey v. Rich Plan of the Midwest*, 408 F. Supp. 582 (N.D. Ind. 1976).

observer terms a "quasi-counterrevolution,"⁶² reversing a long period during which implied rights of action were freely recognized. Whether or not the courts are disposed to adopt the Commission's conclusions, franchisees clearly face expensive legal battles to avoid dismissal for failure to state cognizable claims.

Second, no body of substantive decisions applicable to the franchisor-franchisee arrangement now exists under the FTC Act. It is therefore an open question whether the courts will require proof of fraud or merely negligence for private recovery under section 5. The Commission spoke to this issue in discussing the legal standards that it will follow in its enforcement activities: "The resulting legal standard is clear and direct: A seller's claim or representation violates Section 5 of the Federal Trade Commission Act if it has a tendency to deceive the consumer in any particular which could reasonably influence the latter's buying choice."⁶³ Under this test, proof of reliance is not required,⁶⁴ nor is the intent of the franchisor material.⁶⁵ Moreover, deceptiveness is proved by the "substantial capacity or tendency to deceive," not actual deception.⁶⁶ The Commission's test clearly would impose liability for negligent misstatements and omissions. The courts may be inclined to agree.

Section 5(a)(1) of the FTC Act declares that unfair or deceptive acts or practices in commerce are unlawful.⁶⁷ In the context of misleading advertising and labelling, the courts have upheld Commission determinations of unfairness and deception without a showing of elaborate proof.⁶⁸ To require the Commission to show consumer reliance upon the deceptive contents would clearly thwart the mission of protection, for the expense of gathering such evidence would be prohibitive.

It remains to be seen, however, if the standard proposed to be applied in administrative actions will be carried over to private civil suits. In private franchise litigation, unlike injunctive FTC action, the plaintiff normally will seek rescission of the agreement and restitution of fees paid. With respect to remedies, private franchise litigation thus seems more closely related to private litigation under the securities laws than to administrative action by the FTC. This relationship is underscored by the fact that the language of the Rule clearly is drawn heavily from section 12

62. Unpublished lecture of Prof. Morgan Shipman, The Ohio State University College of Law, Jan. 23, 1979. *Cort v. Ash*, 422 U.S. 66 (1975) marks the opening of this counterrevolution. In *Piper Aircraft Corp. v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977), the Supreme Court held that a defeated tender offeror had no cause of action under either § 14(e) of the Williams Act (15 U.S.C. § 78n(e) (1976)) or section 10(b) against a rival successful tender offeror. The trend is clearly to limit private rights of action to those expressly granted by Congress.

63. *Statement of Basis and Purpose*, *supra* note 3, at 59,631.

64. *Id.*

65. *Montgomery Ward & Co. v. FTC*, 379 F.2d 666, 670 (7th Cir. 1967).

66. *Id.* See *Statement of Basis and Purpose*, *supra* note 3, at 59,631.

67. 45 U.S.C. § 45(a)(1) (1976).

68. See *Montgomery Ward Co. v. FTC*, 379 F.2d 666 (7th Cir. 1967).

of the Securities Act, which accords the remedy of rescission upon a showing of mere negligence. The difficulty is that section 5 of the FTC Act, which authorizes the Rule, reads more like section 10(b) of the Securities Exchange Act than like section 12 of the Securities Act. The Supreme Court has held in *Ernst & Ernst v. Hochfelder*⁶⁹ that a private civil recovery under section 10(b), which prohibits manipulation and deception in securities transactions, can be had only upon proof of scienter.⁷⁰ The discrepancy between the language of the franchise Rule and the language of section 5 of the FTC Act combines with the dissimilarity between administrative enforcement and private litigation to present the courts with a difficult question: must private franchise plaintiffs show scienter to recover, or will a showing of negligence suffice?

A third significant problem for plaintiffs is that "controlling persons" of the franchisor are exempted from secondary liability for violations of the Rule.⁷¹ Although it expressly adopts the securities law definition of "affiliated person" for purposes of disclosure,⁷² the Commission inexplicably limits liability for material misrepresentations and omissions to the franchisor alone. This omission is especially puzzling in light of the reach of securities law with regard to "insiders" and controlling persons. Section 15 of the Securities Act⁷³ imposes joint and several liability upon controlling persons, and liability under section 10(b)(2) of the Securities Exchange Act extends to those who "aid and abet" securities fraud.⁷⁴

Section 15 was enacted to "supplement, and extend beyond, common law principles of agency and *respondeat superior*."⁷⁵ Moreover, the controlling person cannot escape liability by proving that it acted in good faith, or did not directly or indirectly induce the violation.⁷⁶ Not only has the imposition of controlling-person liability eased the plaintiff's burden of proof,⁷⁷ it has promoted the underlying objective of investor protection by requiring a high standard of care in the directors' activities relative to securities matters.⁷⁸

It thus appears that, by specifically excluding controlling persons from the reach of the Rule, the Commission has relegated plaintiffs to the common-law doctrine that directors and controlling shareholders of a corporation can be held personally liable to third persons only for

69. 425 U.S. 185 (1975).

70. *Id.* at 214.

71. *Statement of Basis and Purpose*, *supra* note 3, at 59,716 n.166.

72. *Disclosure Requirements*, *supra* note 1, at 59,620 (to be codified in 16 C.F.R. § 436.2(i)).

73. 15 U.S.C. § 77o (1976).

74. *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974).

75. *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968), *aff'd in part*, 422 F.2d 1124 (4th Cir. 1970), *cert. denied*, 416 U.S. 916 (1974).

76. *Id.*, 297 F. Supp. at 1213.

77. *See id.*

78. *See Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

corporate fraud in which they directly participated.⁷⁹ This standard is incompatible with the underlying purposes of the Rule, which is protection of the investor. Once again, it is open to question whether the courts will follow the Commission's lead.

B. *Conflicts Between Coverage of Section 5 and the United States Arbitration Act*

Even assuming that the foregoing problems can be resolved, the courts must still face a more basic problem—the reconciliation of the two competing federal policies. Virtually all contemporary franchise agreements contain broad contractual arbitration provisions. The United States Arbitration Act⁸⁰ extinguished a longstanding judicial disapproval of contractual arbitration provisions, directing that such agreements are specifically enforceable in the federal courts.⁸¹ Section 3 of the Act confers primary jurisdiction over contract disputes to the arbitrator, and allows jurisdiction of the courts only to the extent necessary to determine the arbitrability of the issues before it.⁸² Furthermore, any party to a contract has a specific right to petition the district court for an order compelling arbitration.⁸³

The enormous impact that the Arbitration Act has had upon federal court jurisdiction of commercial disputes in general, and franchisee claims in particular, resulted from the United States Supreme Court's holding in *Prima Paint Corp. v. Flood & Concklin Manufacturing Co.*⁸⁴ *Prima Paint* had purchased Flood & Concklin's (F&C) paint business and entered into a long-term contract for the consulting services of F&C's president. The agreement contained a "broad" arbitration clause.⁸⁵ Shortly thereafter, F&C filed a petition in bankruptcy. *Prima Paint* then filed suit in federal district court against F&C, alleging that it was induced to enter into the agreements by F&C's fraudulent representation of solvency and seeking rescission of both contracts.⁸⁶ F&C moved pursuant to the Arbitration Act for a stay pending arbitration of *Prima Paint's* claims. The district court granted the stay.⁸⁷

On appeal, the Supreme Court affirmed, stating that:

Under § 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to

79. W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 1137 & 1143 (rev. perm. ed. 1975).

80. 9 U.S.C. §§ 1-14 (1976).

81. See *Albatross S.S. Co. v. Manning Bros.*, 95 F. Supp. 459 (S.D.N.Y. 1951).

82. 9 U.S.C. § 3 (1976).

83. *Id.* § 4.

84. 388 U.S. 395 (1967).

85. *Id.* at 398.

86. *Id.* at 399.

87. *Id.*

order arbitration to proceed once it is satisfied that "the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue." Accordingly, if the claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the "making" of the agreement to arbitrate—the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally.⁸⁸

Because the franchise agreement involves transactions "in commerce" and ordinarily contains an arbitration provision like that of *Prima Paint*, it is clear that the Arbitration Act governs these types of arrangements. Considering that the new Rule proscribes conduct with the attributes of fraudulent inducement, the courts must initially determine if the Arbitration Act limits jurisdiction over the franchisee's section 5 claims—jurisdiction that they would otherwise be free to exercise fully.

In the arena of securities fraud litigation, the Supreme Court, in *Wilko v. Swann*,⁸⁹ held that the Arbitration Act did not limit jurisdiction over claims sought to be asserted under section 12 of the Securities Act. The Court's analysis suggests, however, that the courts will have significant difficulty in obtaining the same results in a section 5 case. In *Wilko*, a customer brought suit against his brokerage firm under section 12(2) of the Securities Act, alleging that the firm's false representations induced him to purchase stock.⁹⁰ Without answering, the firm moved for a stay pending arbitration of the dispute pursuant to a clause in the parties' margin agreements.⁹¹ Holding that "the agreement to arbitrate deprived the petitioner of the advantageous court remedy afforded by the Securities Act . . . ,"⁹² the district court denied the motion.

The Supreme Court affirmed on the ground that the agreement constituted a waiver, impermissible under section 14,⁹³ of the plaintiff's right to select a judicial forum for resolution of section 12 claims. The Court stated that "[t]his arrangement to arbitrate is a 'stipulation,' and we think the right to select the judicial forum is the kind of 'provision' that cannot be waived under § 14 of the Securities Act."⁹⁴ It concluded that: "As the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended § 14 . . . to apply to waiver of judicial trial and review."⁹⁵ Thus, the Securities Act provided two bases upon which the

88. *Id.* at 403-04 (citations omitted).

89. 346 U.S. 427 (1953).

90. *Id.* at 428-29.

91. *Id.* at 429.

92. *Id.* at 430.

93. 15 U.S.C. § 77n (1976) provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

94. 346 U.S. at 434-35.

95. *Id.* at 437 (citation omitted).

Wilko Court anchored its analysis: first, the express right of action (under section 12) and the forum selection grant provided by section 22(a);⁹⁶ and second, the express prohibition against waiver found in section 14.

The scheme of section 5 of the FTC Act utterly fails to supply the basis for an analysis like that of *Wilko*. Hence, it is possible that the implied right granted under section 5 may be effectively extinguished by franchisors who invoke sections 3 and 4 of the Arbitration Act. But whatever the resolution of this question, franchisee-plaintiffs face expensive and time-consuming litigation over this issue at the procedural level before they can go to trial on the merits.

In summary, the Commission realizes that the Rule cannot effectively end abuse in the offering and sale of franchises without the sanctions of a private civil remedy. But the only remedy that the Commission can suggest is fraught with procedural and substantive barriers for admittedly underfinanced franchises.

This Comment has suggested that, given the recognition that franchises are "strikingly similar" to traditional securities,⁹⁷ the interests of both private plaintiffs and judicial economy would be served by direct application of federal securities antifraud laws to the problem of abuse in that arena. The writer will now examine the court's historically rigid treatment of franchise security litigation and suggest a reasonable test for determining whether a particular offering represents a security.

III. THE FRANCHISE AS A SECURITY

A. *The Investment Contract*

Section 2(1) of the Securities Act⁹⁸ defines a "security" as, *inter alia*, an "investment contract." That the reach of the Act extends far beyond instruments such as stocks and bonds is evident, for "security" was further defined in the same section to include "in general, any instrument or interest commonly known as a 'security.'"⁹⁹ Congress intended by this language to provide flexibility to the Act, and encompass devices that would, in the future, come to be regarded as investments. Thus, the Supreme Court, in its initial consideration of this language in *SEC v. C.M. Joiner Leasing Corp.*¹⁰⁰ asserted that:

[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in

96. 15 U.S.C. § 77v(a) (1976) (prohibiting removal of an action brought in state court under § 12).

97. *Statement of Basis and Purpose*, *supra* note 3, at 59,699.

98. 15 U.S.C. § 77b(1) (1976).

99. *Id.*

100. 320 U.S. 344 (1943).

101. *Id.* at 351.

commerce as "investment contracts," or as "any interest or instrument commonly known as a "security.'"¹⁰¹

In *Joiner*, the Court applied the Securities Act to a scheme in which the defendant raised capital for drilling an exploratory oil well by offering adjacent parcels of its lease for as little as \$5.00 per parcel.

Three years later, in *SEC v. W.J. Howey Co.*,¹⁰² the Court refined its application of the "investment contract" language. In *Howey*, the defendant was offering Florida citrus groves to out-of-state professionals who wintered in that state. It was not this aspect of the sale alone that the Court found objectionable, however, but the contemporaneous offering of a "service contract."¹⁰³ This service contract, which the buyer was free to accept or reject, gave the defendant absolute control over the citrus crop, entitling the buyer to receive an allocation of annual net profits.¹⁰⁴ The Court first determined that:

[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.¹⁰⁵

It held that "[t]he investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors."¹⁰⁶

The Supreme Court later mandated that "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."¹⁰⁷ The apparent flexibility embodied in this passage is sharply curtailed, however, by the legal strictures found in the *Howey* Court's "solely through the efforts of others" language. Indeed, although a franchise security case has never been decided by the Supreme Court, the lower courts have applied the *Howey* test with a vengeance in the context of conventional franchise litigation. Just how the courts have distinguished conventional from unconventional franchises, and found the latter subject to the sanctions of the securities law, is the beginning point for any analysis of this area.

B. Franchise Security Litigation

1. The Conventional Franchise

The franchising "boom" that began in the '60s¹⁰⁸ marked the

102. 328 U.S. 293 (1946).

103. *Id.* at 296.

104. *Id.*

105. *Id.* at 298-99.

106. *Id.* at 300.

107. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

108. *Statement of Basis and Purpose*, *supra* note 3, at 59,623.

beginning of efforts by franchisees to obtain a nationwide remedy for a national problem. They quite naturally turned to federal securities antifraud laws; all sought at the threshold to have their agreements declared to be investment contracts. Every attempt thus far has failed.¹⁰⁹

The dismissals have come at the jurisdictional level, for lack of a federal question. It is clear that the *Howey* test requires the plaintiff to prove three elements— (1) an investment or “initial value,” (2) a common enterprise, and (3) that the plaintiff *was led to believe* that profits would result solely from the efforts of others. In the context of franchise litigation the *Howey* test has been interpreted as *subjective*, and judicial inquiry has been directed to whether the plaintiff believed, when *he paid over his money*, that someone else would be using managerial and entrepreneurial skills to produce a profit. The first two elements of the test have presented little problem to the plaintiffs,¹¹⁰ but the third element has uniformly proved to be the stumbling block.

The courts have first engaged in a brief examination of the franchise documents in order to determine what the franchisee *should “reasonably” have believed* were his obligations under the agreement.¹¹¹ Second, they have turned their attention to the franchisee’s actual expectations.¹¹² Finally, the courts have read the “solely through the efforts of others” language with such literalness that no conventional franchise can pass muster. Even in the cases of “turn key” franchises,¹¹³ in which franchisee

109. See, e.g., *Crowley v. Montgomery Ward & Co., Inc.*, 570 F.2d 877 (10th Cir. 1978); *Lino v. City Investing Co.*, 487 F.2d 689 (3rd Cir. 1973); *Nash & Assoc. v. Lum’s of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973); *Plum Tree, Inc. v. Frasz*, 433 F. Supp. 537 (E.D. Pa. 1977); *Plum Tree, Inc. v. Seligson*, 383 F. Supp. 307 (E.D. Pa. 1974); *Beefy Trail, Inc. v. Beefy King Int’l, Inc.*, 348 F. Supp. 799 (M.D. Fla. 1972).

110. See *Los Angeles Trust Deed and Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1961), *cert. denied*, 366 U.S. 919 (1962), in which the court of appeals stated that “a common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties.” *Id.* at 172. This definition is little more than surplusage to the third element of *Howey*, because if the investor depends upon the efforts of others, then the third element is necessarily met. Therein appears to lie the reason why the courts have uniformly presumed a common enterprise and concentrated on *Howey’s* third element.

111. See, e.g., *Crowley v. Montgomery Ward & Co.*, 570 F.2d 877 (10th Cir. 1978); *Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635 (9th Cir. 1969).

112. Consider this excerpt from the trial court transcript in *Chapman*, 409 F.2d at 640 n.3 (emphasis added):

Q ***Did you consider when you make [sic] your payment to Rudd Paint that you had made an investment such as you might make in General Motors or American Telephone & Telegraph?

A No sir. . . .

Q In this instance, you recognized that the success or failure of the sales of Run Guard in Colorado were primarily dependent upon your efforts, isn’t that correct?

A Combined efforts of the company, with their cooperation, and myself, yes.

Q That is correct. And you were mindful of the provision in Paragraph XXI of the agreement, . . . which says, ‘Distributor understands and agrees that the success of this distributorship is directly related to the efforts of the distributor, and therefore no guarantees of sales profit or volume can be made.’

A That is true.

Q You understood that when you entered into the agreement?

A Yes.

113. A “turn key” operation is one in which the franchisor assumes responsibility for all phases

control is virtually nonexistent, franchisees have failed to meet *Howey's* third element.¹¹⁴ A reading of many cases indicates that franchisors may escape liability merely by inserting provisions designating the franchisee an independent contractor and obligating it to pay expenses.¹¹⁵

2. *The Unconventional Franchise*

The analysis employed in the conventional franchise cases differs sharply, however, from that applied to litigation concerning the unconventional franchise. Unconventional franchises comprise a group of schemes generally known as pyramid sales plans, founders' contracts and referral schemes.¹¹⁶ The salient feature of all unconventional franchise devices, but especially of the pyramid sales plan, is that the buyer is led to believe that he or she can get rich quickly by convincing other prospects to buy the plan. Although these schemes flourished in the "boomtown" atmosphere of the last decade, the most prominent ones have been extinguished by federal injunctive actions brought by the SEC and by state legislation outlawing pyramid plans.¹¹⁷

The two leading cases are *SEC v. Koscot Interplanetary, Inc.*¹¹⁸ and *SEC v. Glenn W. Turner Enterprises, Inc.*¹¹⁹ In both cases, the government contended that the plans were investment contracts, and sought injunctions against any offering prior to registration with the SEC. As in the cases of conventional franchises, the battle centered around the third element of the *Howey* test.

In *Turner*, the court quickly disposed of *Howey's* first two elements.¹²⁰

of development and construction of the franchisee's unit, and retains virtually complete control over financial and other aspects of the unit after operation has commenced. Thus, the franchisee need only "turn the key" to be in business. This, incidently, is all the franchisee has the *right* to do under the agreement.

114. See, e.g., *Wieboldt v. Metz*, 355 F. Supp. 255 (S.D.N.Y. 1973); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640 (D. Colo. 1970), *aff'd on common law grounds*, 460 F.2d 666 (10th Cir. 1972).

115. See *Wieboldt v. Metz*, 355 F. Supp. 255, 256 (S.D.N.Y. 1973).

116. A pyramid sales plan is a multi-level "distributorship" scheme in which the prospect pays a fee to the parent company that entitles him to sell distributorships to other prospects. At the end of the distributorship chain are those who for a nominal fee may distribute the parent company's product. The primary emphasis, however, is not upon the sale of the product, but upon the sale of more distributorships, which mathematically "pyramids" the organization to infinity. For a specific discussion of the sales scheme, see Note, *Dare To Be Great, Inc.: A Case Study of Pyramid Sales Plan Regulation*, 33 OHIO STATE L. J. 676 (1972).

Founders' contracts are similar. The parent company proposes to establish a retail department store in which only "members" may shop. Once a prospect becomes a member, he has the right to sell further memberships, from which he received "commissions" on each sale. See *Hawaii v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971). Another form of the founders' contract is the referral scheme in which a consumer buys a product at an exorbitant price and receives a fee from the seller for every successful sale made thereafter to customers "referred" by the buyer. See *Emery v. So-Soft of Ohio, Inc.*, 30 Ohio Op. 2d 226, 199 N.E. 2d 120 (1964).

117. Typical of these statutes is the Ohio pyramid sales plan or program law, OHIO REV. CODE ANN. §§ 1333.91-.96 (Page Supp. 1978).

118. 497 F.2d 473 (5th Cir. 1974).

119. 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

120. 474 F.2d at 481.

But the court was faced with the problem that the franchisee actually expended effort in canvassing for more prospects, selling the plan and conducting prospects to the franchisor's meetings.¹²¹ The court had no difficulty in rejecting *Howey's* third element for a more realistic test: "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."¹²² Applying this test, the court had no difficulty in finding the plan in *Turner* to be an investment contract.

Koscot elaborated upon *Turner's* theme. Meticulously analyzing the franchisee's obligations, the court found that the franchisee was "to lure prospects to meetings,"¹²³ after which his role was "little more than a perfunctory one."¹²⁴ That the franchisee actually closed sales of the distributorships did not impress the court. This act was, in the court's view, "essentially a ministerial . . . one."¹²⁵ It followed *Turner's* test.¹²⁶ The court reversed the court below, which had refused to enjoin offers of the plan without prior registration.¹²⁷

It is clear that the *Turner-Koscot* test significantly extends the reach of *Howey*. First, it *objectifies* the third element of the latter by focusing the inquiry not on the "reasonable belief" of the prospect, but upon an objective *post hoc* evaluation of the actual duties performed. Second, it strikes out the "solely through the efforts of others" language and inserts instead a qualitative analysis.

The potential application of this test at least to conventional "turn key" franchises is obvious. But the courts have expressly limited its application to cases that deal with unconventional franchises.¹²⁸ *Koscot* imposed this limit by stating that:

We confine our holding to those schemes in which promoters retain immediate control over the essential managerial conduct of an enterprise and

121. *Id.* at 482.

122. *Id.*

123. *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 484 (5th Cir. 1974).

124. *Id.* at 485.

125. *Id.*

126. *Id.* at 483.

127. *Id.* at 486. In *United Hous. Found'n v. Forman*, 421 U.S. 837, 852 n.16 (1975), the Supreme Court specifically withheld judgment on the *Turner-Koscot* test, although the Court reaffirmed *Howey* in litigation *not* concerning franchises.

Prior to *Forman*, two courts had expressed approval in dicta of the "risk-capital" test. *Nash & Assoc. v. Lum's of Ohio, Inc.*, 484 F.2d 392, 395 (6th Cir. 1973); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 646 (D. Colo. 1970). This test has taken two forms. Compare *Hawaii v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971) with *Sobieski v. Silver Hills Country Club*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961). Both focus upon the character of the franchisee's investment in the hands of the franchisor. If part of the investment becomes risk capital of the franchisor, quite likely a security will be found. The reaffirmation of *Howey* in *Forman*, coupled with the specific footnote reference to the *Turner-Koscot* test and omission of any reference to the risk-capital test, indicates that the latter test will not be a factor in further federal franchise litigation.

128. See *In re Bestline Prods. Sec. and Antitrust Litigation*, 412 F. Supp. 732, 751-52 (S.D. Fla. 1976); *Wieboldt v. Metz*, 355 F. Supp. 255, 256 (S.D.N.Y. 1973); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 645 (D. Colo. 1970).

where the investor's realization of profits is inextricably tied to the success of the promotional scheme. *Thus, we acknowledge that a conventional franchise arrangement, wherein the promoter exercises merely remote control over an enterprise and the investor operates largely unfettered by promoter mandates presents a different question than the one posed herein.* But the Koscot scheme does not qualify as a conventional franchising arrangement.¹²⁹

The courts have thus based the discriminatory treatment of conventional franchises entirely on the premise that the franchisee retains such control over his operation that "the [franchised] enterprise stands or falls independently of the [franchisor's] success or failure."¹³⁰ In short, the courts believe that "the franchisee's risk is not sufficiently integrated with that of the franchisor to bring such franchises within the scope of the Federal securities laws."¹³¹ The Commission's findings, however, confirm that the courts are in error.

IV. UTILITY OF THE RULE

A. *Integration of Risks in the Conventional Franchise*

The primary utility of the new Rule is that the extensive findings upon which it is based amply discredit the myth that the franchisee's risk is independent of the franchisor's. In its description of the general characteristics of franchising, developed from a record of 30,000 pages,¹³² the Commission concluded that:

These three distinct conceptual characteristics of franchising—increased potential for success, loss of independence, and a payment of capital to the franchisor by the franchisee—are characteristics which make entering into a franchise strikingly similar to the purchase of a security. The attraction of securities and franchising is the same: a promise of a substantial return on capital investment.¹³³

Although the Commission acknowledged a "significant difference between a franchise and a security"¹³⁴ in that the franchisee contributes labor as well as capital,¹³⁵ it never questioned the conclusion of Professor Urband B. Ozanne that

[t]he franchisee depends upon the business expertise of the franchisor. In fact, the franchisee gives up substantial control over elements of his business operation to the franchisor. The franchise relationship assumes that the franchisee knows little or nothing about site selection, market conditions, work layout, product mix, business management, and the many other

129. SEC v. Koscot Interplanetary, Inc., 497 F.2d 476, 485 (5th Cir. 1974) (emphasis added).

130. Wieboldt v. Metz, 355 F. Supp. 255, 260 (S.D.N.Y. 1973).

131. *In re Bestline Prods. Sec. and Antitrust Litigation*, 412 F. Supp. 732, 751 (S.D. Fla. 1976).

132. *Statement of Basis and Purpose*, supra note 3, at 59,622.

133. *Id.* at 59,699 (citation omitted).

134. *Id.*

135. *Id.*

ingredients in a successful franchise. Because of the level of control exerted by the franchisor, the success or failure of the franchisee depends on the competence, judgment and financial soundness of the franchisor.¹³⁶

There could be no clearer statement of the integration of risk between franchisor and franchisee. This conclusion, which provided the basis for the Rule's requirement of disclosure of the business experience of the franchisor's officers and directors,¹³⁷ confirms the view of the overwhelming number of commentators who have considered franchising's integration of risk.¹³⁸

In light of the Commission's persuasive findings and conclusions, the courts should now discard the judicial presumption that the franchisee stands independent of the franchisor's success or failure. The courts might fashion a test, along the lines of *Turner-Koscot*, that takes into account the practical realities of franchising. Such a test might be articulated as follows:

Given all the facts concerning the franchisor claims and its true financial condition, and given the economic reality of the franchisee-franchisor relationship, would a reasonably prudent investor expect his success to depend significantly upon the entrepreneurial and managerial skills of the franchisor?

The courts could adopt another course, however, and recognize that franchises have come to be, "in general, any interest or instrument commonly known as a 'security.'" ¹³⁹ This would open the way for the holding that conventional franchises evidenced by written instruments (which are covered by the Rule) are securities. This course is clearly preferable to the application of the suggested test on a case-by-case basis. First, it would allow franchisors the certainty that their offerings are subject to at least the antifraud provisions of federal securities law. Second, it would enable the trial court to dispense with a protracted examination of the franchisor's offering at a pretrial stage. The only preliminary question would be whether the offering fell within the ambit of the Commission's Rule.

The franchisors need not be concerned with an onerous burden of registration with the SEC in addition to compliance with the Commission's Rule. The SEC, pursuant to its plenary power under section 3(b)

136. *Id.* at 59,640.

137. *Disclosure Requirements*, *supra* note 1, at 59,614 (to be codified in 16 C.F.R. § 436.1(a)(2)).

138. See, e.g., Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 BUS. LAW. 493 (1967); Goodwin, *Franchising Law Matures*, 28 BUS. LAW. 703 (1973); Goodwin, *Franchising in the Economy: The Franchise Agreement as A Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1975); Note, *The Franchise As a Security: Application of the Securities Laws to Owner-Operated Franchises*, 11 B.C. INDUS. & COM. L. REV. 228 (1970).

139. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1976).

of the Securities Act,¹⁴⁰ would no doubt move quickly to create an exemption. Since its exemption power applies to aggregate offerings up to \$1,500,000, franchises clearly would be relieved of any registration requirements.

B. *Impact Upon State Case Law*

The Commission's Rule has an important secondary utility—its impact upon franchise fraud litigation at the state level. First, the evidentiary importance of having many franchisor representations in writing cannot be underestimated. Second, and more important, state courts should be willing to relax the anachronistic common-law proof requirements when the franchisor has assumed a higher standard of care under federal laws. For example, it has already been stated that projections of income (no matter how distorted) are not actionable misrepresentations under the common law.¹⁴¹ By contrast, section 5 is violated when the franchisor makes such projections without a reasonable basis in fact upon which to support them.¹⁴² The franchisor, by commencing an offering, impliedly asserts to prospective franchisees that it has assumed a high standard of care in preparing the offering circular and making its oral presentations. The state courts could, and should, adopt the position that this implied assertion creates a special duty to the prospect *under state common law*. Given this fiduciary-like relationship, distorted income projections in violation of the Rule should be actionable under common-law theories of fraud.¹⁴³

V. CONCLUSION

The new FTC Rule concerning disclosure requirements and prohibitions in the offer and sale of franchises will affect franchisor abuse in three ways. First, the disclosures themselves will have a deterrent effect at the point of sale. Second, there is some hope that courts will follow the suggestion of the Commission and recognize an implied right of action under section 5 of the FTC Act. This possibility presents serious substantive and procedural problems. Third, and most important, the record produced by the Commission destroys the long-held judicial presumption that a franchise is fundamentally unlike a security. The policies underlying the Rule and the securities law are indistinguishable. Moreover, every franchise presents the potential for full integration of risk between franchisor and franchisee. This removes the lynchpin of prior case

140. *Id.* § 77c (b).

141. See notes 48 & 49 and accompanying text *supra*.

142. See note 32 and accompanying text *supra*.

143. Hence, omissions and half-truths in the offering of franchises would also be actionable. See notes 49 & 50 and accompanying text *supra*.

law, which has arbitrarily distinguished conventional from unconventional franchises. Therefore, the courts should acknowledge economic realities in the determination of franchise litigation.

Michael G. Moore