



1-1-1971

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Recommended Citation

Franklin L. Damon, *Franchise Investment Law*, 2 PAC. L. J. 27 (1971).

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Franchise Investment Law

FRANKLIN L. DAMON*

As an increasingly popular type of business format, franchising has troubled legislators in recent years for want of a system to safeguard individual interests without infringing upon the right to engage in bona fide business risks. California has attempted to solve this problem by passing the Franchise Investment Law to provide for knowledgeable bargaining positions on the part of both the franchisee and the franchisor. The author was the Senate coordinator of the Law which was drafted by the Corporations Commission in conjunction with the Attorney General. This article reviews the purpose of the Law and the legislative intent of its provisions for regulation of transactions concerning franchise agreements.

The California Legislature, as a result of intensive study,¹ has enacted the first regulatory provisions in the field of franchise transactions² to be adopted by any state legislature in the United States.³

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¹ Franchise legislation was initiated with the introduction of Senate Resolution 196, on July 8, 1969. That resolution provided the basis for the *Interim Hearing on Franchises* [hereinafter cited as *Interim Hearing*], before the *Senate Insurance and Financial Institutions Committee*, November 7, 1969 [hereinafter referred to as the *Committee*].

² Senate Resolution 196, 1969 Regular Session. A contemporaneous definition is:

Franchising . . . is a modern form and method of doing business; a technique of distribution adopted by and used in many varied industries; a technique of integrating into the distribution system by contract instead of by centrally controlled chain ownership.

J. Fels, *Franchising; Legal Problems and the Business Framework of Reference—An Overview*, BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE, PRACTICING LAW INSTITUTE 9 (1968).

³ The only legal authority concerning the regulation of franchise offerings in

The problems giving rise to this legislative concern were first presented during hearings before the Senate Insurance and Financial Institutions Committee. Representatives from the State Department of Justice explained that public agencies were just beginning to compile statistics on franchise fraud and misrepresentation, but that even without completed statistics the Department considered fraud to be a major problem in the area of franchise sales.⁴ The Department representatives also discussed the types of conduct by franchisor's that frequently comprise the fraudulent activities. Some of the most blatant examples included misrepresentation of investment requirements; adequacy of training programs; profit projections; promised supervision and assistance; supply purchasing advantages; and advertising and promotional help.⁵

Testimony received from a franchisee, who related her experiences with a taco franchisor, brought relevance to the legislative consideration of the public need for protection.

She and her husband paid \$12,500 as a franchise fee in exchange for a franchise from which they were told they could expect to gross from \$10,000 to \$12,000 monthly, with a net of \$2,000 monthly. As it turned out that figure was based on the success of another well-established Taco Franchise, and in the first four months of operation they lost \$2,000. In the succeeding eleven months they realized a total net profit of slightly under \$4,000.⁶

California prior to S.B. 647 was an Attorney General's *interpretation* of the California Corporate Securities Law of 1968, 49 OP. CAL. ATT'Y GEN. 124 (1967). In that opinion, the Attorney General defines a "franchise" as a "security" within the meaning of the Corporate Securities Law (and thus subject to regulation under that law) in situations where the franchise participates only nominally in the franchise business or the franchisor relies on fees paid by the franchisee to provide the franchisor's initial capital, e.g., 'risk capital.' The legality of this opinion has not been tested in the courts. With the passage of S.B. 647 this issue becomes moot, because franchises subject to registration under the Franchise Investment Law are specifically excluded from the definition of "security" as defined in the Corporate Securities Law (CAL. CORP. CODE § 25019).

⁴ Richard Gilbert, Deputy Attorney General from the San Francisco office stated,

But we do know that more franchises are being sold in California than in any other state. And we do know that in our own office in the past two or three years, the franchise fraud, if we can classify that (as a) type of case, has suddenly risen from a comparatively minor place to number one in the terms of our formal investigations and work load. *Interim Hearing* at 19.

⁵ Richard Gilbert, *Interim Hearing* at 24. A franchise advertised in the Wall Street Journal with profit projections of \$40,000 a year minimum net income and up to \$324,000 personal net income, dependent upon the willingness of the franchisee to work hard. Actual practice proved the figures to be outrageously optimistic. Also mentioned was a Federal Trade Commission case which advertised low initial investment (\$9,500) in franchised restaurants and offered proven training operating methods which were to earn a projected income of \$30,000. Actually, the capital required was much higher, the training inadequate, and all franchisees employing the franchisor's techniques went out of business. *Id.* at 25.

⁶ As summarized by Senator Bradley before the Subcommittee on Urban and Rural Economic Development of the United States Senate Small Business Committee on March 30, 1970.

The franchisee was required to make a basic monthly payment plus a percentage of the gross income. The franchisor was to pay all of the creditors—but he apparently never did. The franchisee received virtually nothing that had been promised in return for his capital investment.

The atmosphere established by the disclosure of the problems of the taco franchisee remained throughout the Committee hearings and while heavily restrictive laws were not desirable, some form of regulation was felt to be necessary.⁷ As a result, S.B. 647 was introduced and, after many legislative hurdles, was signed into law September 17, 1970.⁸

The primary legislative intent of the Franchise Investment Law, as expressed, is

. . . to assure the person interested in purchasing a franchise that he has received a full and forthright disclosure of all material terms of the contract he will be asked to sign.⁹

It is important to note that there are two types of situations relative to a franchise: the initial transactions at the outset and the continuing relationship between the franchisor and the franchisee. S.B. 647 goes only to the franchise relationship at the outset and does not affect the continuing relationship—after the franchise agreement is signed and acted upon.¹⁰

Through utilization of the Franchise Investment Law prospective franchisees will henceforth be in a position to learn the details of the economic risks and obligations of the business in which they are about to invest. Based upon this information they may then decide whether or not they wish to make the investment. This concept—mandatory disclosure—is aimed at decreasing the instances of fraud and misrepresentation, which have resulted in substantial and all too frequent financial losses to innocent investors.¹¹

⁷ *Id.*

We discussed three different alternatives regarding the type of bill that would be introduced. First, a permit bill was discussed, and rejected, primarily on the basis that it was not necessary to have a law which completely regulated the franchising industry. A disclosure bill was discussed, and rejected, primarily on the basis that with just disclosure, the Commissioner would not have any powers to act over questionable franchises. Finally, we decided that a modified disclosure bill would be appropriate. This bill does provide for complete disclosure, the intent of which is to allow the investor to know exactly in what and where he is investing his money. Additionally, it gives the Corporations Commissioner certain powers to prevent abuses in the selling of franchises.

⁸ The bill, which was part of Governor Reagan's Consumer Protection Program for 1970, was a joint effort of the California Corporation Commissioner, the State Attorney General's office, and the Senate Insurance and Financial Institutions Committee.

⁹ Anthony Pierno, Commissioner of Corporations, before the Senate Insurance and Financial Institutions Committee on May 21, 1970.

¹⁰ See Senator Bradley's statement before the Senate Small Business Committee, note 6 *supra*.

¹¹ CAL. CORP. CODE § 31001 expresses the legislative intent of the Franchise In-

Disclosure, pursuant to this Act, will be accomplished by requiring the franchisor to file an application for registration of an offer to sell a franchise with the Department of Corporations. The application must contain certain specified disclosures and a prospectus containing those disclosures must be delivered to the prospective franchisee before the franchise agreement is consummated.

THE FRANCHISE INVESTMENT LAW

The Franchise Investment Law is divided into six parts. Preceding Part One, the Act creates authority in the Corporations Commissioner to regulate the sales of franchises. This delegation to the Department of Corporations was in recognition of the department's vast experience in administering similar legislation.¹² This experience, together with the familiarity the Commissioner has already derived from participation in Committee debates, will be invaluable in administering the new law.

Definitions

Franchise. The first of the six parts of the Franchise Investment Law defines the terms used throughout the Act. Formulating a definition of the word "franchise" was one of the most difficult and time-consuming tasks involved in drafting the bill.¹³ This term was intended to cover any agreement, written or oral, (a) granting the right to engage in a business prescribed in substantial part by a franchisor, (b) associated with the franchisor's mark or commercial symbol, and (c) for which the franchisee is required to pay a franchise fee.¹⁴

Franchise fee. Defined as that which a franchisee or subfranchisor agrees to pay for the right to enter into a business under a franchise agreement, with three exceptions:

- (a) The purchase or agreement to purchase goods at a bona fide wholesale price;
- (b) The payment of a service charge to the issuer of a credit card by an establishment honoring such credit cards; and
- (c) Fees paid to trading stamp companies by a person issuing trading stamps in connection with the retail sale of merchandise or service.¹⁵

vestment Law. See Appendix. Compare with the Corporate Securities Law requirement of "fair, just and equitable" disclosure, CAL. CORP. CODE § 25140.

¹² E.g., Corporate Securities Law of 1968, CAL. CORP. CODE § 25000, *et seq.*

¹³ Note the broad spectrum encompassed by the general definition in note 2 *supra*.

¹⁴ CAL. CORP. CODE § 31005. See Appendix.

¹⁵ CAL. CORP. CODE § 31011.

Hence, exempted from the Act is the situation wherein a party purchases goods at a bona fide wholesale price from another party and where such purchase is *not* for the right to enter into business under a franchise agreement.¹⁶

There are also many business arrangements whereby distributors or manufacturers sell goods to retailers for resale to consumers and call the retailer's right to re-sell the goods a "franchise." In such relationships all three elements of the term "franchise" must be met in order for such transactions to be subjected to the new law. It is irrelevant, therefore, what the parties call their business relationship; it is the substance of the relationship that is important to come within the statutory definition of franchise. Businessmen would be well advised in questionable situations to consult their attorneys since the penalties imposed by the new law far outweigh the risk of proceeding without professional assurance.¹⁷

Offers and Sales. The Franchise Investment Law applies only under circumstances where there is sufficient relationships with the state to justify its interference.¹⁸ Corporations Code section 31013(a) provides that franchise offers and sales in California are made (1) when an offer to sell is made in California, or (2) an offer to buy is accepted in California, or (3) when the franchise business is or will be operated in California, *and* the franchisee is domiciled in California. Thus, if an offer to sell a franchise is made out of state, and is accepted out of state, but the franchisee (offeree) is a domiciliary of California *and* the franchised business will be located in California, the franchise offering is subject to the disclosure law. Also, if an offer to sell a franchise is made and accepted in California, even though the franchisee is not a domiciliary of California, the law will apply regardless of where the franchised business will be located. It was contemplated that when the offer, or acceptance, occurred within the state, there would typically be some other factors within the state to justify state interest. Absent other aspects of contact, it is unclear whether the Corporations Commissioner would require the franchisor to comply with the law. If the franchisee, however, is a domiciliary, then he is entitled to protection of California laws. It is a question of transactional nexus as to whether or not California law can prevail over persons who are domiciliaries of other states due to the requisite of sufficient contacts with California.¹⁹

¹⁶ Committee Hearings, May 14, 1970.

¹⁷ For a discussion of the Enforcement Provisions see text *infra*.

¹⁸ These provisions are identical to CAL. CORP. CODE § 25008, Corporate Securities Law of 1968. CAL. CORP. CODE § 31018. See Appendix.

¹⁹ See generally *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957); *Ehrenzweig, The Transient Rule of Personal Jurisdiction*, 65 YALE L.J. 289 (1956).

Section 31013(b) defines what acts are considered to be in-state offers and acceptances. An offer to sell *is made* in this state when the offer either originates from this state, or is directed by the offeror to this state, and is received at the place to which it is directed. An offer to sell *is accepted* in this state when acceptance is communicated to the offeror in this state. Acceptance is communicated to the offeror when the offeree directs it to the offeror reasonably believing the offeror to be in this state, and it is received at the place to which it is directed.

Section 31013(c) is a special provision relating to offers made through the medium of public advertisement. This section exempts an offer to sell which is made in California through newspaper or magazine advertisements when two-thirds of its circulation has been outside the state during the past twelve months except where advertisements are in regional editions of such newspapers and magazines. With respect to airwave advertisements, an offer to sell a franchise is not made when "a radio or television program originating outside this state is received in this state." A literal interpretation of section 31013(a)(2) would lead one to believe that such offers, if accepted in California, would be subject to the new franchise law; however, this section specifically excludes such attempted offers. An acceptance in California by a California domiciliary would not be valid in the instance of radio advertising because there would be no valid offer.

REGULATION OF THE SALE OF FRANCHISES

Part 2 of Division 5 of the California Corporations Code contains the key provisions of the Franchise Investment Law and provides for the regulation of the sale of franchises.

After January 1, 1971, it will be a violation of this law to offer or sell a franchise in California unless the offer is either registered with the Department of Corporations or exempt from such registration.²⁰ There are three classes of exemptions:

- (1) Those which the Corporations Commissioner might by rule exempt as not necessary in the public interest or to protect prospective franchisees;²¹
- (2) Those franchisors meeting certain minimum financial criteria,²² and

²⁰ CAL. CORP. CODE § 31110.

²¹ CAL. CORP. CODE § 31100.

²² CAL. CORP. CODE § 31101. The criteria that a franchisor must meet, to be exempt from filing under this section, is:
(a) that the franchisor has a net worth of at least \$1,000,000 and is at least 80% owned by a corporation with a net worth of at least \$5,000,000; and (b) the parent or subsidiary company whichever the case may be, has had at least 25 franchisees con-

- (3) The offer or sale of a franchise by a franchisee by his own account.²³

If the offer and the sale of the franchise is not exempt from registration an application for registration, signed and verified by the franchisor²⁴ accompanied with a \$200 filing fee,²⁵ must be filed with the Department of Corporations. The application for registration must contain certain information relative to the franchisor's business experience and business practice.²⁶ In addition, the franchisor must file a proposed offering prospectus which must contain such "material information set forth in the application for registration, as specified by rule of the Commissioner."²⁷ The prospectus must be given to the prospective franchisee before the franchise agreement is signed thereby effecting the necessary disclosure to the franchisee.

In addition to filing an application for registration and a prospectus, a consent for service of process (if the franchisor is not a California Corporation),²⁸ a copy of a typical franchise contract or agreement,²⁹ a copy of any proposed advertisement,³⁰ and a recent financial statement³¹ must be filed with the Department of Corporations. The purpose of these requirements is to reduce the incidence of fraud and misrepresentation upon unsuspecting franchisee's, and to provide them access to relief should the need arise.

Disclosure Requirements

The information which must be contained in the application for registration, and which serves as a basis for what will be required in the prospectus, is set forth in the Corporations Code in twenty-one subdivi-

ducting business continuously for at least five years immediately preceding the sale of the franchise, or the parent or subsidiary company, whichever the case may be, has conducted business which is the subject of the franchise continuously for at least five years preceding the sale of the franchise. If a franchisor meets the above requirements, and is thus exempt from filing, section 31101 provides that the franchisor must disclose, in writing, to each prospective franchisee, at least 48 hours prior to the execution of the franchise agreement or the receipt of any consideration, the information as set forth in § 31101(c)(1-14). (See Appendix). The rationale for these exemptions is that such franchisors will be solvent, will have experience in their field, and if any business problems develop with the franchise the franchisor will have assets which are readily obtainable.

²³ CAL. CORP. CODE § 31102.

²⁴ CAL. CORP. CODE § 31112.

²⁵ CAL. CORP. CODE § 31500. There is also a \$50 annual renewal fee and a \$50 fee for filing any amendments to the application for registration. The purpose of the fee is to make the law self-supporting, rather than to use money from the General Fund of the State of California.

²⁶ CAL. CORP. CODE § 31111.

²⁷ CAL. CORP. CODE § 31114.

²⁸ CAL. CORP. CODE § 31155.

²⁹ CAL. CORP. CODE § 31111(h).

³⁰ CAL. CORP. CODE § 31156.

³¹ CAL. CORP. CODE § 31111(g).

sions of section 31111. The substance of these provisions is:

Subdivision (a) requires the franchisor to disclose his name, the name under which he does or will do business, and the name of any parent or affiliated company which will engage in business transactions with franchisees.

Subdivision (b) requires the franchisor to disclose his principal business address, and the name and address of its agent in California that is authorized to receive process.

Subdivision (c) requires the franchisor to disclose the form of his business; corporate, partnership or other.

Subdivision (d) requires disclosure of such information concerning the identity and business experience of persons affiliated with the franchisor as the Corporations Commissioner "may by rule prescribe." This requirement is closely affiliated with subdivision (e), as it was hoped that this provision would disclose persons with prior unfavorable business experience so that the Corporations Commissioner could then deny effectiveness to the franchise application.³²

Subdivision (e) seeks to determine whether any person identified in the application for registration, such as the franchisor or those persons listed in subdivision (d),

- (1) Has been convicted of a felony, or pleaded nolo contendere to a felony charge, or held liable in a civil action by final judgment if such felony or civil action involved fraud, embezzlement, fraudulent conversion or misappropriation of property, or
- (2) Is subject to any currently effective order of the Securities and Exchange Commission . . . or any national securities association or national securities exchange . . .; or
- (3) Is subject to any currently effective order or ruling of the Federal Trade Commission; or
- (4) Is subject to a currently effective injunctive or restrictive order relating to business activity as a result of an action brought by any public agency or department. . . .

The purpose for requiring this information was to aid the Commissioner in determining whether or not he may have reason to deny the effectiveness of the registration application. Section 31114 does not require the inclusion of this information in the prospectus. The Committee felt that such information would be unduly prejudicial to the franchisor if required in the prospectus.³³

³² Hearings on S.B. 647, before the Senate Insurance and Financial Institutions Committee, May 14, 1970 [hereinafter cited as *Hearings II*].

³³ *Id.*

Subdivision (f) requires the franchisor to disclose how long he has been in a business of the type to be operated by the prospective franchisee, the length of time he has granted franchises for such business and the length of time he has granted franchises for any other type of business. The purpose of this subdivision was to prevent franchisors from misleading their prospective franchisees concerning their former franchise experience. It was decided before the bill was introduced not to require the franchisor to disclose the length of time he had been in other types of non-franchise businesses. The fact that the franchisee would know how long the franchisor had been granting franchises is the important consideration. The fact that the franchisor may have previously been in other non-franchise type businesses is not as pertinent as franchise experience and consequently such disclosure is not required by the Franchise Investment Law.

Subdivision (g) requires the franchisor to file with the Department of Corporations a dated, recent financial statement, together with a statement noting any material changes in the franchisor's financial condition subsequent to the date of compilation.

Disclosure of financial statements is perhaps the single most important item on the list of disclosures. It is directed at an area where there have been many reported instances of misrepresentation as to financial stability. Since the franchisee would have this information presented to him, it was the voiced hope of the author of the new franchise law that this disclosure would leave little chance for franchisors to misrepresent the financial stability of their business.³⁴

Subdivision (h) requires that a "copy of the typical franchise contract or agreement proposed for use or in use in this state" be filed with the Department of Corporations.

When the disclosure law was introduced this subdivision did not contain the words "typical" and "or in use." They were inserted in the first set of amendments to the bill in the Senate Insurance and Financial Institutions Committee.³⁵ It was the author's opinion that such terms might create a loophole around which non-reputable franchisors could take advantage. Instead the phrase "contract . . . proposed for use in this state" was used. The drafters of the bill felt that this latter phrase would be adequate to assure disclosure of all but those special contractual clauses which would undoubtedly be inserted in various individual contracts. The Committee members, however, felt that this phrase could allow franchisors to legally omit important clauses from

³⁴ *Id.*

³⁵ S.B. 647, 1970 Regular Session, as amended May 12, 1970.

their proposed contracts. The author overcame this problem by introducing two amendments to the bill. The first amendment added the word "typical."³⁶ The second amendment related to section 31123.³⁷ This section, as amended, would require all material changes in the application to be promptly filed with the Department of Corporations. Additions or deletions to the basic franchise contract would be considered material changes. As a result, the section requiring disclosure of "typical contracts" was strengthened and a valuable benefit was provided for prospective franchisees. The words "or in use" were amended into the Act to include those franchisors conducting business in California under existing contracts.³⁸

Subdivision (i) provides for the disclosure of the franchise fee which is to be charged to the franchisee, disclosure of information concerning the application of the proceeds of the fee, and the formula upon which the fee is based. The reason for these requirements was to let the franchisee know the exact amount he would be charged as a franchise fee and what specific benefits he could expect to receive in return for this fee, *i.e.*, how much of the fee would be applied for training, equipment, location, experience, advertising and other promised performances. The franchisee would also learn how much of the fee would be specified as profit for the franchisor. These disclosures would also aid the Corporations Commissioner in determining how much, if any, of the franchise fee he should order to be placed in escrow.

It is important to point out that because of the type of disclosures required by this section, the franchisee could find himself in a position to bargain for the amount of the fee to be paid and the services to be received as *quid pro quo*. For example, if a franchisee learns that 75% of the fee is going toward equipment, training, and advertisement, and the remainder is going for the franchisor's expertise, experience and profit, he may want to bargain over that 25% (or even the 75%) and possibly retain part of his capital investment.

Subdivision (j) requires a statement describing any payments or fees (other than the franchise fee) which the franchisee is required to pay to the franchisor. This statement must include payment of royalties and any payment collected by the franchisor on behalf of a third party.³⁹ This subdivision was inserted to inform the franchisee of where and to whom his money was being paid. The section was also intended to en-

³⁶ *Id.*

³⁷ CAL. CORP. CODE § 31123.

³⁸ S.B. 647, 1970 Regular Session, as amended May 12, 1970.

³⁹ This section is intended to include payments for rent, insurance, facilities, equipment, advertising, etc.

able the franchisee to learn if he is being charged fairly or excessively for fees other than franchise fees,⁴⁰ or at least provide the franchisee with the opportunity to investigate the situation if the need should arise.

Subdivision (k) requires the franchisor to provide the franchisee with a statement of the conditions under which the franchisor may terminate, repurchase, or refuse to renew a franchise agreement.

The practice of terminating a franchise has been traditionally held as an enforceable contract right as long as the franchisor does not use the power of termination to coerce conduct that would otherwise be in violation of federal or state antitrust laws.⁴¹ There have been complaints made, however, that some franchisors have arbitrarily cancelled franchise contracts without giving any notice to the franchisee.⁴² This subdivision was designed to give fair notice to the franchisee (in the prospectus) that the franchisor has the right to cancel or not renew the contract and under what specific conditions the termination may occur. It was decided that disclosure of termination clauses in both the application and prospectus was warranted by the mere existence of the possibility that a franchisee might not read such a clause in his contract, or that he might not understand its severe implications. This area of franchise termination in and of itself, was the subject of a bill introduced in the United States Senate in 1969.⁴³

During the pre-introduction meetings held on S.B. 647, the idea of providing a specified number of days before a franchisor could cancel a franchise agreement was discussed. However, the Act does not, and is not intended to, cover the continuing relationship aspect of franchising. Thus, since a termination clause with a specified "limbo" period of non-cancellation goes to the continuing relationship of a franchise, it was decided not to include it in the Franchise Investment Law.

Subdivision (l) requires the franchisor to disclose to the franchisee whether he is required to purchase supplies, products, fixtures or other

⁴⁰ Many franchisees have entered contracts exacting excessive fees for supplies. Even after discovery of such excess charges, time required to obtain legal remedy through extensive litigation would deter most injured parties. See *Siegel v. Chicken Delight, Inc.*, 5 CCH TRADE REG. REP. ¶ 73,146 (N.D. Cal. 1970).

⁴¹ *Packard v. Webster Motor Car*, 243 F.2d 418 (D.C. Cir. 1957). See generally *United States v. Colgate*, 250 U.S. 300 (1919) from which the traditional rule of termination arises: A person (franchisor) can refuse to deal or stop dealing with another party or the public at large so long as he acts unilaterally; cf. *Broussard v. Socony Mobil Oil Co.*, 350 F.2d 346 (5th Cir. 1965), failure to renew lease could be illegal form of coercion if used to enforce policies that were otherwise in violation of antitrust laws (price fixing).

⁴² *Interim Hearing* at 30; *Wall Street Journal*, July 14, 1970, at 11, col. 1.

⁴³ The bill, S. 1967, 91st Cong., 1st Sess. (1969), was introduced by Senator Philip Hart of Michigan. The bill provides for the giving of ninety days' notice prior to cancelling, terminating, or failing to renew a franchise contract. It is unlikely, however, that this bill will get out of the Senate during the 91st Congress, which ends in December, 1970.

goods from the franchisor as a condition of the franchise sale.

While tie-in arrangements have in the past been said to be *per se* violations of the Sherman Act⁴⁴ as restraining free competition in the market for the tied product,⁴⁵ a more rational view is now prevalent in light of the franchising trends in the economy.⁴⁶ Tie-in arrangements are permitted by antitrust laws when justified as being in the exercise of sound business (secret recipes, etc.) and when the arrangement does not constitute an unreasonable restraint of trade.⁴⁷ Therefore, rather than become involved in protective regulation concerning tie-in arrangements this section leaves open the opportunities for the small businessman to contractually exploit trade secrets and peculiar supplies while apprising him of the restrictive controls that may be legally placed upon him.⁴⁸ With this disclosure, such tie-in agreements may even be subject to negotiation by the franchisee.⁴⁹

Subdivision (m) requires the franchisor to make disclosure to the franchisee regarding all limitations imposed concerning the goods and services the franchisee may sell or provide to his customers. Situations giving rise to this problem may be illustrated with a hypothetical franchisee in the fast food business who may want to install a cigarette machine on his premises; or a fast food franchisee who primarily sells tacos, and who may be desirous of selling fish sandwiches. The franchisor may not want this to occur, and there may be a clause in the agreement prohibiting it. It may be in the best interests of the franchisee to limit expansions since they may tend to downgrade the quality, reputation and uniformity of the business. Such prohibitions will of course, have to be a part of the franchise agreement, but this disclosure, by being incorporated into the prospectus, will at least provide the franchisee with a clearer understanding of his rights under the franchise agreement.

Subdivision (n) provides that the franchisor must disclose to the franchisee the terms and conditions of any financing arrangements offered by the franchisor or his representative. The rationale for this subdivision is simply that the franchisee has a right to know the amount of money he must borrow, the interest rate he is obligated to pay, to whom he must make payment, and when payments must be made. If after disclosure he is unhappy or displeased with such arrangements he

⁴⁴ 15 U.S.C.A. §§ 1-3.

⁴⁵ *Times Picayune Publishing Co. v. United States*, 345 U.S. 594 (1953).

⁴⁶ *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964); *Siegel v. Chicken Delight, Inc.*, 5 CCH TRADE REG. REP. ¶ 73,146 (N.D. Cal. 1970).

⁴⁷ *Carvel*, *supra* note 46 at 508.

⁴⁸ Pollock, *Antitrust Problems*, THE FRANCHISING PHENOMENON 115 (1969).

⁴⁹ See *Chicken Delight*, *supra* note 46. See also *Carvel*, *supra* note 46.

may shop around and go elsewhere for his financing.

Subdivision (o) requires the franchisor to tell the franchisee of any past or present practice, or intent to sell, assign, or discount to a third party any note, contract or obligation entered into by the franchisee. This disclosure is made to inform the franchisee of business practices of the franchisor so that the franchisee will have a better understanding of the business relationship, and the possible entry of third parties through assignment of finance rights.

Subdivision (p) relates to one of the most sensitive and important areas in the sales of franchises. It requires the franchisor to disclose a copy of any estimated or projected franchisee earning reports that are prepared for presentation to prospective franchisees along with the data upon which the estimation or projection is based. Many complaints have been voiced that franchisors have deliberately used misleading and untruthful information in describing profit earnings to prospective franchisees.⁵⁰ It is easy, and sometimes tempting, for franchisors, or their salesmen, to falsify such information when attempting to make a sale. It is easier, however, for investors to fall into the trap and be lulled into a false sense of security when hearing something they want to hear without knowing whether or not the information is based upon fact. With the disclosure of the projected earnings *and* the data upon which it is based, the investor will at least have an opportunity to know how much income he may anticipate and whether or not such amounts are based upon realistic grounds.

Subdivision (q) requires the disclosure of the amount of compensation to be given or promised to a "public figure" for the use of his name, symbol, endorsement or recommendation of a franchise. During the pre-introduction hearings on the disclosure law this particular disclosure requirement was deemed important in light of the increasingly significant role of movie stars, television stars, athletes, and other celebrities for endorsements in the franchising field.⁵¹ The intent of this subdivision was to disclose to the franchisee information relating to the public figure, whether he is in fact the franchisor or if his name is merely being used by the franchisor as a sales gimmick.

Subdivision (r) requires the franchisor to disclose the number of franchises that are presently operating and that are proposed to be sold. Before the law was introduced the question was raised as to whether

⁵⁰ One witness before the *Interim Hearing* told the Committee that the prospective earnings she was to receive on her taco franchise was based upon the earnings of another well known and better established franchise. See *Interim Hearing* at 130.

⁵¹ See Hearings on Franchising Before the Subcommittee on Urban and Rural Economic Development of the Senate Small Business Committee, January 27, 1970.

the law would accomplish any useful purpose by requiring franchisors to disclose the number of franchises operating or proposed to be sold outside of the state. The prevailing argument was that such information would probably be irrelevant and could possibly confuse investors; however, it was decided to give the Commissioner authority to make the determination. Therefore, if the Corporations Commissioner finds at some future point in time that it is important for franchisees to know how many franchises are in operation or proposed to be sold outside of California, he has the authority to require such disclosure. This provision will enable the Commissioner to prevent misrepresentations as a result of the franchisor overstating the number of franchises in operation. In addition, the franchisee will now be able to evaluate the degree of competition he might encounter from his own franchisor.

Subdivision (s) requires the franchisor to disclose whether or not the franchisee will receive an exclusive area or territory for the location of his business. Territorial exclusivity is a common franchising practice intended to alleviate the franchisee's fear of competition from sister franchisees or from the franchisor. If the franchisee is granted territorial exclusivity he at least will not have to worry about competing sister businesses.⁵²

Subdivision (t) allows the Commissioner to require disclosure of such other information as the Commissioner, in his judgment, feels is reasonably related to the application of registration. In its original form, this subdivision allowed the Commissioner to require the disclosure of *any other information*.⁵³ There was some feeling that the original language may have constituted an unconstitutional delegation of the legislature's authority without the imposition of adequate standards.⁵⁴ Consequently the provision was amended to provide that if the Commissioner did require additional information, such additional information had to reasonably relate to the application for registration.

This subdivision was included in the Act in order to give the Commissioner the latitude to act as necessity dictates in situations not contemplated by the legislature during the 1970 Regular Session.

Subdivision (u) gives to the franchisor the privilege of disclosing in his application such additional information as he may desire to present. This subdivision was included in the Act simply to allow some freedom

⁵² See *United States v. Arnold, Schwinn & Co.*, 388 U.S. 350 (1967); and *White Motor Co. v. United States*, 372 U.S. 253 (1963), for examples of the permissible limits of territorial exclusivity.

⁵³ S.B. 647, 1970 Regular Session, as introduced, March 18, 1970.

⁵⁴ Hearings on S.B. 647 before the Assembly Commerce and Public Utilities Committee on July 2, 1970. See S.B. 647, 1970 Regular Session, as amended July 2, 1970.

to the franchisor in filing additional information as he deems appropriate and to assure that he would not be precluded from doing so by any implications of the Act.

Procedure for Sale of Franchises

As previously mentioned, before any franchise may be offered for sale in California (unless exempted) an application for registration must be filed with the Commissioner.⁵⁵ The application must be accompanied with a prospectus containing material information disclosed in the application "and such additional disclosures as the Commissioner may require." Thus, the application for registration serves as a basis for what must be contained in the prospectus but does not represent a limitation on what information may ultimately have to be disclosed. The only limitation on the Commissioner regarding what additional disclosures he may require in the prospectus is that he may not, under any circumstances, require disclosure of the information required in subdivision (e) of section 31111.⁵⁶

The prospectus must also state in bold type that "registration does not constitute approval, recommendation or endorsement by the Commissioner."⁵⁷ This language, which is also found in the Securities Exchange Act of 1934 and many other regulatory laws, was placed in the franchise law to preclude prospective franchisees from believing that the State of California was placing its stamp of approval on the franchise.

In order to prevent unnecessary delays in selling franchises, the Commissioner will have no more than 15 business days after the filing of the application for registration (and prospectus), to issue a stop order, the effect of which is to prevent the sale of a franchise.⁵⁸ If no stop order is issued, the registration is deemed to be "effective" and the franchisor may offer and sell his franchise. It is anticipated that the Commissioner will not always need the entire fifteen business days to re-

⁵⁵ The application for registration forms will be furnished by the Department of Corporations. The applications can be filed in any of the offices of the Department of Corporations, either in Los Angeles, San Francisco, San Diego or Sacramento.

⁵⁶ CAL. CORP. CODE § 31114. See text accompanying note 33 *supra*.

⁵⁷ CAL. CORP. CODE § 31114.

⁵⁸ CAL. CORP. CODE § 31116(a). The only exceptions to this fifteenth day provision will be with the first franchise filings when this law goes into effect on January 1, 1971. Accordingly, section 31116(b) gives the Commissioner up to April 15, 1971, to deny the effectiveness of registration of franchises which are filed between January 1, 1971, and March 15, 1971; and with any application filed after March 15, 1971, and before May 10, 1971, the Commissioner has up to June 1, 1971, to deny the effectiveness of the registration. This system is designed to give the Department of Corporations the time necessary to check the franchise after original filing. It is unknown at this time exactly how many franchises will be filed under the Franchise Investment Law, but the Legislative Analyst estimates that there are 2,000 to 5,000 franchisors that are subject to the law.

view applications, particularly after the law has been in effect for a few years. The law, therefore, provides for this contingency by stating that registration may become effective "at such earlier time as the Commissioner determines."⁵⁹

The legislature delegated the stop order power to the Commissioner to provide a basis upon which to enforce the registration provisions of the law. Accordingly, the Commissioner may issue a stop order pursuant to section 31115 if he finds that at least one of four circumstances exist:⁶⁰

- (1) There is a failure to comply with any provision of the law, or any rules promulgated by the Commissioner;
- (2) That the offer or sale of a franchise would constitute misrepresentation to, or deceit or fraud upon the purchasers;
- (3) That the franchisor has failed to escrow or impound the franchise fee (or furnish a surety bond) pursuant to the commissioner's order; or
- (4) That any person identified in the application has been convicted of an offense, is subject to an order, or has had a civil judgment entered against him pursuant to section (e) *and* the involvement of such person in the sale or management of the franchise creates an unreasonable risk to prospective franchisees.

The rationale for the subdivision empowering the Commissioner to prevent a franchisor from selling a franchise if that person has not complied with the disclosure law is to prevent intentional or inadvertent oversights in the franchisor's application for registration. If the application is, for example, incomplete or in error, then a stop order may be issued.

The legislature's feeling when they included subdivision (2) was that a franchise sale should not be consummated if such sale would result in misrepresentation, deceit or fraud upon the purchaser. A typical example of this would be where the franchisor files erroneous information in his application or prospectus. If the error would amount to a misrepresentation a stop order could be issued pursuant to section 31115(2).

Subdivision (3) relates to the Commissioner's power to require escrowing of franchise fees. A significant problem in franchising frequently occurs when the franchisor promises to deliver goods and services that are financed by the payment of the franchise fee and the franchisor

⁵⁹ CAL. CORP. CODE § 31116(b).

⁶⁰ CAL. CORP. CODE § 31115. The stop order will deny the effectiveness of the registration, thereby precluding a sale of the franchise.

does not fulfill his obligations. The legislature attempted to overcome this problem by providing for the escrowing of franchise fees.⁶¹ After the application for registration has been filed and before the 15 business days have expired, the Commissioner may require the escrowing or impounding of franchise fees and other fees paid by the franchisee (or the Commissioner may require the furnishing of a surety bond by the franchisor, if he finds that two conditions exist:

- (1) That the franchisor has failed to demonstrate that adequate financial arrangements have been made to fulfill certain obligations,⁶² and
- (2) That such requirement is necessary and appropriate to protect prospective franchisees.

This subdivision does not make escrowing or impounding of franchise fees, or the furnishing of a surety bond mandatory. It is merely a discretionary device that the Commissioner may use under limited circumstances. For example, if the legitimacy of the franchisor may be subject to question and in need of further review, the Commissioner may require the franchisor to escrow his franchise fees. Or, if a franchisor promises to provide the franchisee with a business location and he fails to demonstrate that he has done this, the franchise fee may be ordered to be placed in escrow. Other possible escrow situations include failures to provide equipment, inventory goods, training classes, or any other item included in the offering.

The escrowed funds will be required to be placed with a third party, such as a bank, and not with the Commissioner. Any funds placed in escrow may not be held longer than the opening date of the franchise business. The rationale for this limitation was that when the franchisee is ready to open his doors for business, the two situations under which franchise fees may be escrowed would presumably no longer exist. The Commissioner may issue a stop order if the franchisor fails to escrow or impound the franchise fee (or furnish a surety bond)—and if it is found necessary and appropriate to protect prospective franchisees by preserving franchisor capital. In most cases an escrow will be necessary and appropriate to protect prospective franchisees when the franchisor does not or has not fulfilled his obligations.

Subdivision (4) of section 31115 contains two elements, offense and risk, both of which must be satisfied before a stop order may be issued. The Committee felt that it would be unfair to penalize a person who has been involved in certain business-related offenses in the past, and who

⁶¹ CAL. CORP. CODE § 31113.

⁶² These obligations are: to provide real estate, improvements, equipment, inventory, training or other items included in the franchise offering. *Id.*

has paid his debt to society for committing the wrong. But, the Committee also felt that if that person has been involved in certain business-related offenses, *and* the involvement of that person in the sale or management of the franchise creates an unreasonable risk to prospective franchisees, then there would be a sufficient basis upon which to issue a stop order.

If a section 31115 stop order is issued, the Commissioner must promptly notify the applicant of such action and the reasons therefore. The franchisor may request a hearing on the stop order which must be set within fifteen days after the receipt of the written request, or later if agreed upon by the applicant.⁶³ The Commissioner has the power to modify or vacate the stop order even though no hearing is requested or held if he finds that the conditions causing it have changed or that it is in the public interest to do so.⁶⁴

It must be emphasized that this provision was not intended to give the Commissioner an approval power or the power to pass judgment on the merits of a franchise through his issuance of stop orders. His power is strictly negative in that he may only issue stop orders which deny the effectiveness of a franchise registration (thereby preventing its sale). The franchisor, however, is given every opportunity to cure the defects which resulted in the issuance of the stop order.

If a stop order is not issued, the registration becomes effective and the franchise may be offered for sale. However, before a sale may be consummated, one further step must be taken. No franchise may be sold unless a copy of the prospectus, together with a copy of all proposed agreements relating to the sale of the franchise, are given to the prospective franchisee at least 48 hours prior to the sale of the franchise, or at least 48 hours prior to the receipt of the consideration, whichever occurs first.⁶⁵ The reason for this section is to give prospective franchisees a period of time within which to think over and review the prospectus and proposed agreements before binding themselves to the duties and obligations of the franchise agreement. Only after the expiration of the 48 hours may the agreement creating the franchise relationship be signed.

Registration is valid for one year,⁶⁶ and may be renewed for one year periods by filing an application for renewal,⁶⁷ a proposed offering

⁶³ CAL. CORP. CODE § 31117.

⁶⁴ CAL. CORP. CODE § 31118.

⁶⁵ CAL. CORP. CODE § 31119.

⁶⁶ CAL. CORP. CODE § 31120.

⁶⁷ CAL. CORP. CODE § 31121.

prospectus,⁶⁸ and a \$50 fee.⁶⁹ The same stop order provisions which apply to original applications apply to renewals. If any material change, as defined by the Commissioner, occurs in the original, renewed, or amended application, the franchisor must promptly notify the Commissioner's office in writing, and amend the application.⁷⁰ The amendment must be accompanied by a \$50 fee.⁷¹ If the Commissioner feels that the amendment is important and warrants a revised offering prospectus, he may so order.

GENERAL PROVISIONS

Most of the general provisions relating to the regulation of the sales of franchises were adopted from the Corporate Securities Law of 1968.⁷² All franchisors offering franchises for sale in California must maintain a complete set of books, records and accounts of such sales.⁷³ The original language of the disclosure law provided that such books, records and accounts must be kept "within this state." Since the purpose of this provision is to enable the Commissioner to verify the accounts of franchise sales in California, it is doubtful whether franchisors would refuse to comply with the Commissioner's request if he requests to see the books of franchisors whose main office is out of state. The author of the Act felt it would be too burdensome for the out-of-state franchisor to maintain two sets of books, and consequently it was amended out.⁷⁴

In making determinations on applications, the Commissioner may use the reports of outside experts to help him determine whether or not the franchise to be offered for sale is properly represented in the application. The Commissioner is also given the authority to use experts to investigate the franchises.⁷⁵

Any document, to the extent that it is currently up to date, which has been filed with the Department of Corporations within four years prior to the filing of an application for registration may be incorporated by reference.⁷⁶ This provision was designed to minimize the paper work for both the applicant and the department.

Section 31420 is the "long arm" provision of the law. It provides that any franchisor doing business in this state, including non-residents

⁶⁸ CAL. CORP. CODE § 31122.

⁶⁹ CAL. CORP. CODE § 31122.

⁷⁰ CAL. CORP. CODE § 31123.

⁷¹ CAL. CORP. CODE § 31500(d).

⁷² Corporate Securities Law of 1968, CAL. CORP. CODE § 25000, *et seq.*

⁷³ CAL. CORP. CODE § 31150.

⁷⁴ S.B. 647, 1970 Regular Session, as amended, May 12, 1970.

⁷⁵ CAL. CORP. CODE § 31151.

⁷⁶ CAL. CORP. CODE § 31152.

who engage in conduct prohibited by this law, may be served with process in any noncriminal action filed against them. If a California corporation is involved, service is made by serving the main office of the corporation. Every other applicant must file, along with the application for registration, an irrevocable consent appointing the Commissioner as his attorney to receive service of process in any noncriminal action or proceeding under this law.⁷⁷ Service is made by leaving a copy of the process in the Commissioner's office, but it is effective only upon plaintiff's sending notice by registered or certified mail to the last filed address of the defendant and filing with the court an affidavit of compliance with this section.

Franchise offering advertisements will not be allowed to be used in California if the offer is subject to this Law unless a true copy of the advertisement⁷⁸ is filed with the Commissioner's office at least three business days prior to the first publication.⁷⁹ This three day time period may be shortened by the Commissioner if he feels such action is necessary.⁸⁰ This provision applies only to *first* publications and it will not be necessary to file again prior to subsequent publications of the same advertisement. The legislature saw no reason to compel filings of the same advertisements if the Commissioner's office already had a copy on file.⁸¹ During the three day period, if the Commissioner finds that an advertisement contains false or misleading statements, or omits necessary statements, he may prevent its publication.⁸² If the Commissioner so determines he must notify the affected party, who may request a hearing on the matter. Judicial review on appeal from the hearing is pursuant to Government Code section 11523.

Fraudulent and Prohibited Practices

There are four sections in the Franchise Investment Law making certain acts unlawful and providing grounds for civil liability. The first is section 31200 which makes it unlawful for any person to willfully make any untrue statement or omit a required statement of a material fact in any application or report filed with the Commissioner. The effect of this section is to create a cause of action on the part of a franchisee who has been defrauded by reason of the franchisor placing false or misleading information in the application (or prospectus).

⁷⁷ CAL. CORP. CODE § 31155.

⁷⁸ CAL. CORP. CODE § 31003 defines "advertisement." See Appendix.

⁷⁹ CAL. CORP. CODE § 31016 defines "publish". See Appendix.

⁸⁰ CAL. CORP. CODE § 31156.

⁸¹ S.B. 647, 1970 Regular Session, as amended, May 12, 1970.

⁸² CAL. CORP. CODE § 31157.

The second fraudulent practice is specified in section 31201 which makes it unlawful for any person to offer or sell a franchise in California by means of any written or oral communication not enumerated in Section 31200, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading.

Whereas section 31200 creates a cause of action for fraudulent information contained in an application or prospectus, this section creates a cause of action for fraudulent information used outside the application or prospectus. This section is primarily intended to apply to situations involving franchise salesmen.

Section 31202 is the third enumerated fraudulent practice and is substantially similar to the language in section 31200 but it applies to statements required in section 31101. The difference is that section 31200 applies to applications filed with the Commissioner, and section 31202 applies to franchises exempt from filing applications.⁸³

Section 31203 defines the fourth fraudulent practice which makes it unlawful for any person to violate any order of the Commissioner, or any condition precedent to the effectiveness of the registration. The effect of this section is to create civil liability on the part of any franchisor who violates a stop order issued against him.

Enforcement of the Law

The Franchise Investment Law creates two civil remedies for violations of disclosure requirements or for fraudulent or prohibited practices. Corporations Code section 31300 goes to the pre-offer or pre-sale stage by providing that any person who offers or sells a franchise in violation of sections 31101, 31110, 31200, or 31202 of the Corporations Code is liable to the franchisee for damages. But if the violation is willful, the franchisee may also sue for rescission. To understand the pre-offer-sale aspect of this section it is necessary to look to the four code sections that this subdivision was designed to compliment—sections 31101, 31110, 31200 and 31202. Section 31101, in addition to exempting certain franchises from registration, provides that the exempted franchisor must still make certain disclosures to the franchisee at least 48 hours prior to signing an agreement. If the franchisor fails to comply with this provision he will be liable to the franchisee for damages, or rescission and damages if such violation is willful.

⁸³ This provision applies to franchises which are exempt under section 31101.

Section 31110 provides for the filing of the application for registration. If a franchisor fails to make a filing, and he is not exempt, he will be liable to the franchisee in damages. Willful failure to file will result in an action for damages and rescission.

Section 31200 makes it unlawful to willfully make untrue statements of material facts in any application, notice, or report filed with the Commissioner. Willful omissions are also declared by the law to be unlawful. In order for this section to be violated, an element of willfulness must already exist.

Section 31202 is designed to cover the same contingencies as section 31200 except this section applies to exempt franchisors who must still make disclosures to prospective franchisees.

Section 31300 provides that knowledge on the part of the franchisee is a defense for cases of alleged violations of sections 31200 and 31202. The franchisor has a total defense to actions under these sections if he can prove that the franchisee knew the facts concerning the untruth or omission, or that the franchisor exercised reasonable care and the franchisor did not know or would not have known the facts had he exercised reasonable care. The Committee's intent in including this provision was to do equity to all parties. If a franchisor has willfully avoided his disclosure obligations he should be made to suffer the consequences of an action for damages; however, the Committee did not want to penalize franchisors who exercised reasonable care.

The statute of limitations for failure to file registration applications before sales or failure to make the required disclosures, *i.e.*, actions under section 31300, is (a) four years after the act or transaction constituting the violation, or (b) one year after discovery by the plaintiff (franchisee) of the fact constituting the violation, or (c) ninety days after delivery to the franchisee by the franchisor of a written notice disclosing any violation of sections 31110 or 31200.⁸⁴

Section 31301 is the second civil remedy provided by the Franchise Investment Law. This section provides a remedy for fraud or misrepresentation through mediums other than the registration information filed with the Commissioner. Section 31301 provides that any person violating section 31201 (the section referring to untruths or omissions by means other than through an application, notice or report) is liable for damages to any person who, while relying upon the untruth or omission, purchased a franchise, if that person did not know or did not have cause to believe that such untruth or omission was false or misleading. When S.B. 647 was introduced, this section allowed the franchisee to

⁸⁴ CAL. CORP. CODE § 31303.

sue for rescission as well as damages.⁸⁵ It was amended in the Senate Insurance and Financial Institutions Committee to limit the available remedy to damages since the Committee felt that rescission of the franchise agreement would be excessively harsh.

The statute of limitations for actions brought under section 31301 is (a) two years after the act constituting the violation, or (b) one year after discovery by the plaintiff (franchisee) of the facts constituting the violation, or (c) ninety days after delivery to the franchisee by the franchisor of a written notice disclosing any violation of sections 31201 or 31202.

Section 31202 provides that all individuals directly involved in the act or transaction constituting the violation of the law shall be jointly and severally liable. However, liability does not extend to an individual who had no knowledge or reason to believe the law was being broken.⁸⁶

In addition to the civil remedies there are two sections in the Franchise Investment Law that create criminal liability. Corporations Code section 31410 provides that the willful violation of any provision, rule or order under the law may result in a fine of not more than \$10,000, or imprisonment in the state prison for not more than 10 years, or imprisonment in the county jail for not more than one year, or by both fine or imprisonment. However, if a defendant violates a rule or order, and if he can prove that he had no knowledge of the rule or order he allegedly violated, he may only be fined and not imprisoned.

The second criminal provision was borrowed from the Securities Exchange Act of 1934⁸⁷ and the Corporate Securities Law of 1968.⁸⁸ The terms of this section were designed to punish those franchisors who defrauded a person in connection with the sale of a franchise and provides that

any person who willfully employs, directly or indirectly, any device, scheme, or artifice to defraud in connection with the offer or sale of any franchise or willfully engages, directly or indirectly, 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 offer, purchase, or sale of any franchise shall upon conviction be fined not more than ten thousand dollars (\$10,000) or imprisoned in the state prison for not more than 10 years or in a county jail

⁸⁵ See note 54 *supra*.

⁸⁶ This provision is adopted from the Corporate Securities Law of 1968, CAL. CORP. CODE § 25504.

⁸⁷ 15 U.S.C.A. § 78(j).

⁸⁸ CAL. CORP. CODE § 25541.

for not more than one year, or be punished by both such fine and imprisonment.⁸⁹

For a determination of what actions or conduct would operate as fraud or deceit the Committee had in mind the type of conduct so proscribed by the Securities Exchange Act of 1934 and the Corporate Securities Law of 1968 and relevant interpretations of those laws.

Prohibited Sales Practices

There are two sections in the Franchise Investment Law which relate to franchise salesmen.⁹⁰ The first section relates to the three classes of persons who may effect or attempt to effect a sale of a franchise in California. The salesman may be a person who is either identified in the application for franchise registration, licensed as a real estate broker or salesman, or a broker-dealer or agent licensed pursuant to the Corporate Securities Law.⁹¹ The Commissioner may issue a desist and refrain order if he finds that any person engaged in the sale of franchises is not within one of the three classes.

There are no separate licensing provisions in the Franchise Investment Law for franchise salesmen. The licensing of franchise salesmen was discussed during the interim hearing⁹² and in the preliminary meetings prior to the bill's introduction. The author and the Committee concluded that it was not necessary to license franchise salesmen in that persons licensed under the California Real Estate Law or the Corporate Securities Law had sufficient competence, knowledge, and expertise in the selling of real estate and securities to enable them to be competent franchise salesmen. However, it was felt that a situation could arise where a franchisor or his representative would want to sell his franchise, but neither of them possess a real estate or securities license. The Committee provided for that contingency by allowing franchises to be sold by persons identified in the franchise application for registration.⁹³ The Commissioner through section 31111(e) would have background knowledge of all non-licensed persons involved in the sales of franchises in California and, if necessary, could deny such persons from engaging in franchise sales.

The second section relating to salesmen gives the Commissioner the power to issue a desist and refrain order for any person not complying with the provisions of section 31210, and provides an adequate safe-

⁸⁹ CAL. CORP. CODE § 31411.

⁹⁰ CAL. CORP. CODE §§ 31210, 31211.

⁹¹ CAL. CORP. CODE § 31210.

⁹² *Interim Hearing.*

⁹³ CAL. CORP. CODE § 31111(d).

guard against "fast-buck" salesmen or "suede-shoe" operators.⁹⁴ It is also important to note that the Commissioner, through his stop order power, will be able to prevent a person from selling a franchise, though otherwise qualified by section 31210, if that person (1) has been convicted of certain business-related crimes, found liable in certain types of civil actions, or is subject to a court order of certain regulatory agencies, and (2) the involvement of that person in the sale of a franchise creates an unreasonable risk to the prospective franchisee.⁹⁵

Powers of the Commissioner

Much of the language giving the Commissioner the power to enforce and administer the disclosure law was adopted from the Corporate Securities Law of 1968.⁹⁶ The Commissioner has the authority to adopt such "rules and regulations as may be necessary to carry out the purposes of the Franchise Investment Law."⁹⁷ The Commissioner is also authorized to render opinions to interested parties interpreting the various sections of the law in order to provide for those cases when franchisors or franchisees may be in doubt as to the meaning or intent of the law. This authority may also prevent lawsuits if issues, disputes or doubts may be resolved by the Commissioner's opinion.

The Commissioner may also enjoin acts or practices which appear to him to violate any provision of the law.⁹⁸ Section 31401(a) gives the Commissioner the statutory authorization to conduct public or private investigations within or outside the state in order to determine if any person has violated, or may violate, the law.⁹⁹

⁹⁴ CAL. CORP. CODE § 31211.

⁹⁵ CAL. CORP. CODE § 31115(d).

⁹⁶ CAL. CORP. CODE § 25500, *et seq.*

⁹⁷ Section 4 of the bill gives the Commissioner the power to adopt rules and regulations necessary to carry out the provisions of the Franchise Investment Law prior to the effective date of the law. This section is to allow the Commissioner to hold hearings and to promulgate rules so that they may take effect January 1, 1971. Without this section, the Commissioner would be powerless to adopt rules and regulations until the effective date of the law. CAL. CORP. CODE § 31502, which is part of the enacted chapter, gives the Commissioner the power to make, amend and rescind rules while the Franchise Investment Law is in effect.

⁹⁸ CAL. CORP. CODE § 31400. Upon a proper showing in the superior court, the Commissioner, acting on behalf of the people of the State of California, may obtain a permanent or preliminary injunction, restraining order or writ of mandate against any person violating, or who may violate, any provision of, or rule under, the Franchise Investment Law.

⁹⁹ CAL. CORP. CODE § 31401(a). The law empowers the Commissioner to administer oaths, subpoena witnesses, compel their attendance, take evidence and require the production of any documents and records he deems necessary to the investigation. If a person refuses to obey a subpoena, then the Commissioner may go to the superior court and obtain an order requiring the person to appear or to produce documentary evidence. Failure to obey such a court order may result in an action for contempt of court.

No person will be excused from testifying on the grounds that it may tend to incriminate him, but no person may be prosecuted as a result of testimony he is com-

The Commissioner is additionally given the authority to issue a desist and refrain order if a franchise is offered for sale without first being registered unless it is exempt from registration.¹⁰⁰ In the case of franchises exempt from registration, the Commissioner may still issue a desist and refrain order if the franchisor is not complying with the law.¹⁰¹ These various sections giving the Commissioner the authority to issue desist and refrain orders are essential for they provide the Commissioner with the necessary tools to enforce the law.

Administration

The Committee intended that the regulation of franchises under the Franchise Investment Law should be financially self-supporting. Accordingly, fees are charged for the original filing, for the yearly renewal of applications, and for the filing of an amendment to an application.¹⁰² These fees are established by the legislature and are not subject to administrative revision.

All applications, reports and other papers and documents (such as advertisements and contracts) filed with the Commissioner, are matters of public record. The Commissioner, however, may withhold any information he deems necessary to protect investors, or deems not to be in the public interest.¹⁰³

CONCLUSION

The California Franchise Investment Law, which undoubtedly will serve as a model for the rest of the nation, represents years of cooperative effort among the Department of Corporations, the Attorney General's office, the State Senate Insurance and Financial Institutions Committee, and the members of the California Legislature. During the course of the bill's movement through the legislative process there was substantial support by franchisees and franchisor organizations.¹⁰⁴ The

pelled to give, if he validly claims his privilege against self-incrimination (such person is not immune from prosecution for perjury or contempt of court committed while testifying).

¹⁰⁰ CAL. CORP. CODE § 31402.

¹⁰¹ CAL. CORP. CODE § 31403.

¹⁰² CAL. CORP. CODE § 31500.

The Legislative Analyst estimates that the cost of administration of the Franchise Investment Law would entail a one-time added workload which could be absorbed by the Department of Corporations without extra staff or cost. The Analyst estimates that the initial registration fee revenue to the General Fund will be approximately \$800,000 (based on the registration of 4,000 franchises at \$200 each). The annual renewal fees are estimated to be \$200,000 annually. Income from amendment fees would, of course, be unknown and may vary substantially from year to year. Analyst's letter July 21, 1970.

¹⁰³ CAL. CORP. CODE § 31504(a).

¹⁰⁴ The only opposition during the course of legislative hearings on S.B. 647

bill passed the Senate Insurance and Financial Institutions Committee, the Senate Finance Committee, the Assembly Commerce and Public Utilities Committee, and the Assembly Ways and Means Committee unanimously. It passed the Senate and Assembly with all but two votes.¹⁰⁵

The modified disclosure approach to franchise regulation taken by California is a sound, tough, reasonable and realistic approach for solving the problems which have plagued the franchising industry in the last several years. The law will serve to clarify and strengthen franchisor-franchisee relationships; it aims to protect franchise investors from deceitful and misleading practices of dishonest franchisors; it will prevent "suede shoe" operators from bilking innocent investors, and it will benefit the public interest and the franchising industry—an industry which has been, is, and will continue to be a significant part of the economic growth of our country.

came from a San Mateo County franchisor in the Senate Finance Committee and the Assembly Commerce and Public Utilities Committee. He was subsequently accused by the Federal Trade Commission of selling credit card franchises through "false, misleading and deceptive tactics." He was not seen in Sacramento after the FTC issued their accusation.

¹⁰⁵ The bill passed the Senate on June 11, 1970; the Assembly on August 17, 1970; and the Senate concurred in Assembly amendments on August 19, 1970.

APPENDIX

FRANCHISE INVESTMENT LAW

31001. It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship.

31003. "Advertisement" means any written or printed communication by means of recorded telephone messages or spoken on radio, television, or similar communications media, published in connection with an offer or sale of a franchise.

31016. "Publish" means publicly to issue or circulate by newspaper, mail, radio or television, or otherwise to disseminate to the public.

31018. (a) "Sale" or "sell" includes every contract or agreement of sale of, contract to sell, or disposition of, a franchise or interest in a franchise for value. (b) "Offer" or "offer to sell" includes every attempt to offer to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value. The terms defined in this section do not include the renewal or extension or an existing franchise where there is no interruption in the operation of the franchised business by the franchisee.

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PART 2. REGULATION OF THE SALE OF FRANCHISES

Chapter 1. Exemptions

31101. There shall be exempted from the provisions of Chapter 2 (commencing with Section 31110) of this part the offer and sale of a franchise if the franchisor:

(a) Has a net worth on a consolidated basis, according to its most recent audited financial statement, of not less than five million dollars (\$5,000,000); or the franchisor has a net worth, according to its most recent audited financial statement, of not less than one million dollars (\$1,000,000) and is at least 80 percent owned by a corporation which has a net worth on a consolidated basis, according to its most recent audited financial statement, of not less than five million dollars (\$5,000,000); and

(b) Has had at least 25 franchisees conducting business at all times during the five-year period immediately preceding the offer or sale; or has conducted business which is the subject of the franchise continuously for not less than five years preceding the offer or sale; or if any corporation which owns at least 80 percent of the franchisor has had at least 25 franchises conducting business at all times during the five-year period immediately preceding the offer or sale; or such corporation has conducted business which is the subject of the franchise continuously for not less than five years preceding the offer or sale; and

(c) Exempted franchisors must disclose in writing to each prospective franchisee, at least 48 hours prior to the execution by the prospective franchisee of any binding franchise or other agreement, or at least 48 hours prior to the receipt of any consideration, the following information:

(1) The name of the franchisor, the name under which the franchisor is doing or intends to do business, and the name of any parent or affiliated company that will engage in business transactions with franchisees.

(2) The franchisor's principal business address and the name and address of its agent in the State of California authorized to receive service of process.

(3) The business form of the franchisor, whether corporate, partnership, or otherwise.

(4) The business experience of the franchisor, including the length of time the franchisor (i) has conducted a business of the type to be operated by the franchisees, (ii) has granted franchises for such business, and (iii) has granted franchises in other lines of business.

(5) A copy of the typical franchise contract or agreement proposed for use or in use in this state.

(6) A statement of the franchise fee charged, the proposed application of the proceeds of such fee by the franchisor, and the formula by which the amount of the fee is determined if the fee is not the same in all cases.

(7) A statement describing any payments or fees other than franchise fees that the franchisee or subfranchisor is required to pay to the franchisor, including royalties and payments or fees which the franchisor collects in whole or in part on behalf of a third party or parties.

(8) A statement of the conditions under which the franchise agreement may be terminated or renewal refused, or repurchased at the option of the franchisor.

(9) A statement as to whether by the terms of the franchise agreement or by other device or practice, the franchisee or subfranchisor is required to purchase from the franchisor or his designee services, supplies, products, fixtures or other goods relating to the establishment or operation of the franchise business, together with a description thereof.

(10) A statement as to whether, by the terms of the franchise agreement or other device or practice, the franchisee is limited in the goods or services offered by him to his customers.

(11) A statement of the terms and conditions of any financing arrangements when offered directly or indirectly by the franchisor or his agent or affiliate.

(12) A statement of any past or present practice or of any intent of the franchisor to sell, assign, or discount to a third party any note, contract, or other obligation of the franchisee or subfranchisor in whole or in part.

(13) If any statement of estimated or projected franchisee earnings is used, a statement of such estimation or projection and the data upon which it is based.

(14) A statement as to whether franchisees or subfranchisors receive an exclusive area or territory.
