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Franchisor's Liability for Acts of Franchisees: A Risk Administration Perspective

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FRANCHISOR'S LIABILITY FOR ACTS OF FANCHISEES: A RISK ADMINISTRATION PERSPECTIVE*

INTRODUCTION

The system of products and services distribution[1] known as franchising[2] has enjoyed a phenomenal growth in popularity[3] during the past two decades.[4] The

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1. Franchising is not an industry; rather, it is a unique form of business organization. Franchises, unlike industries which are related by product or service type, are used to market a great variety of unrelated products and services. Fast-food, mufflers and dance instruction are only a few of the unrelated products which have been marketed by franchising techniques. *See* PRACTICING LAW INSTITUTE, BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE 13-17 (J. McCord & I. Cohen ed. 1968) [hereinafter cited as BUSINESS AND LEGAL PROBLEMS].

2. Franchising has been defined by the U.S. Department of Commerce as: "a form of marketing or distribution in which a parent company customarily grants an individual or company the right, or privilege, to do business in a prescribed manner over a certain period of time in a specified place. The parent company is termed the franchisor; the receiver of the privilege, the franchisee; and the right, or privilege, the franchise." U.S. DEPARTMENT OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE U.S. 837 (1979). Various state statutes dealing with franchising have offered more detailed definitions. *See, e.g.,* CONN. GEN. STAT. §42-133(e) (1975); MICH. COMP. LAWS §445.1502(3) (Supp. 1979); NEB. REV. STAT. §87-402(1) (Supp. 1979). The legal significance of the term is imprecise, for as one commentator notes, franchising law "is a modern melange of legal disciplines which includes trademark licensing, antitrust, contracts, securities, taxation, corporations, real estate, financing, and insurance. It is syncretic in nature, and it sorely lacks internal consistency." 1 GILSON, TRADEMARK PROTECTION AND PRACTICE 6-3 (1974 & Supp. 1979).

3. Total sales from franchising are expected to reach $437 billion by 1983. This represents an annual growth rate of 10% since 1973. *See* U.S. DEPARTMENT OF COMMERCE INDUSTRY AND TRADE ADMINISTRATION, U.S. INDUSTRIAL OUTLOOK 1979 500 (1979). One of the principal advantages of franchising is its ability to create and expand a network of product distribution outlets with far less investment capital required of the franchisor. Franchisors recognize that "what is unique to franchising is that the retailer of the products and services, as *owner* of the distribution outlet, *is a source of capital for financing* this 'voluntary' chain — an essential feature of which is the 'division' of the capital investment burden. Both franchisor and franchisee, however, pay less for the advantages of a voluntary chain marketing system than either would pay if he were to integrate 'on his own.'" BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 19. *See generally* G. GLICKMAN, FRANCHISING (1969); R. HANCOCK & E. LEWIS, THE FRANCHISE SYSTEM OF DISTRIBUTION (1963).

4. Franchising in its modern form did not become legally feasible until the courts became receptive to the practice of trademark licensing during the middle 1940s. *See* GILSON, *supra* note 2, at 6-2. Prior to that time, business arrangements similar to franchising had been used successfully by the automobile and soft drink industries to market their respective products. The period of explosive growth for franchising, however, began shortly after the end of World War II. *See* H. BROWN, FRANCHISING — REALITIES AND REMEDIES 1 (1973); J. FELS, FRANCHISING AND THE LAW: AN OVERVIEW FOR CORPORATE COUNSEL AND MANAGEMENT 1 (1976).

franchise relationship consists of two parties. The franchisor expends his resources to develop a product[5] and marketing technique.[6] He then registers a trademark to identify the system and its products,[7] and he licenses the trademark to the use of numerous second parties. These individuals, known as franchisees, distribute the product to the ultimate consumer or user.[8] The typical franchise agreement embodies a quid pro quo between franchisor and franchisee. In exchange for use of the franchisor's trademark, proven techniques, superior business experience and other considerations,[9] the franchisee obligates himself to pay an initial fee,[10] and to remit a percentage of gross weekly or monthly receipts to the franchisor.[11] The parties will often stipulate that their relationship is not that of partners, joint adventurers, or employer and employee.[12] Rather, the franchisee is characterized as an independent business-

5. *See* J. FELS, *supra* note 4, at 4.

6. Some authorities have suggested that franchising systems fall into three categories. The first is the franchising retail outlet, in which the franchisor sells both his trademark and method of doing business to the franchisee on a continuing basis. This may or may not include sales of incidental products such as packaging material, equipment and advertising. The Burger King or Mister Donut franchise is an example. Another category is the franchised distributor, who merely sells products for the franchisor under the latter's trademark. Automobile and food products manufacturers have long employed this type of franchising. The third category is the franchised processor, who employs a licensed trademark in connection with manufacturing or assembling a product according to specifications supplied by the franchisor. The soft drink industry popularized this variety of franchising. *See* Covey, *Franchising and the Antitrust Laws: Panacea or Problem?*, 42 NOTRE DAME LAW, 605 607 (1967).

7. The trademark is literally the foundation stone of the franchising system and has been recognized by the courts as such. *See* Susser v. Carvel Corp., 206 F. Supp. 636, 640 (S.D.N.Y.), *aff'd*, 332 F.2d 505 (2d Cir. 1962). *See generally* Gilson, *Trademarks: Sine Qua Non of Franchising*, 52 CHI. B. REC. 228 (1971).

8. The franchisee thus may employ his own initiative in generating sales and making profits. This is a second key aspect of franchising, the proposition that through a franchise the person of little previous commercial experience may realize the dream of owning his own business. R. HANCOCK & F. LEWIS, *supra* note 3, at 14.

9. The franchisor typically supplies the franchisee with technical and managerial training, aids in site selection, and spends considerable sums in direct advertising to create a national image from which the franchisee directly benefits. *See* Burger King of Florida, Inc. v. Brewer, 244 F. Supp. 293, 295 (W.D. Tenn. 1965).

10. The initial franchise fee provides the capitalization upon which the franchisor establishes the system. The fee requirements vary considerably according to the type of product franchised and the franchisor's financial designs for the systems; however, $5,000 to $50,000 is the usual range. See H. BROWN, *supra* note 4, at 20-21 (criticizes selection of dollar amount of franchise fee in usual case as arbitrary and unfair).

11. *See, e.g.*, Drexel v. Union Prescription Centers, Inc., 582 F.2d 781 (3d Cir. 1978) (franchisee agreed to pay franchisor an amount equal to 4½% of gross receipts within 20 days after end of each month, based on gross receipts for the preceding month); Porter v. Arthur Murray, Inc., 249 Cal. App. 2d 410, 416, 57 Cal. Rptr. 554, 558 (1967) (franchisee agreed to report weekly gross receipts to franchisor and remit a certain percentage); Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 615, 56 Cal. Rptr. 728, 732 (1967) (franchisor required payment of amount equal to 5% of gross weekly receipts). The phrasing of such provisions in terms of percentage of gross receipts, rather than of gross profits, tends to substantially reduce the franchisor's risk. In essence, the franchisor receives his royalties up front, before the franchisee can begin to consider his own profits.

12. *See, e.g.*, Sapp v. City of Tallahassee, 348 So. 2d 363, 366 (Fla. 1st D.C.A. 1977) (franchise agreement provided that the parties were completely separate entities, neither partners,

man,[13] who operates his own enterprise, invests his own resources and receives the major portion of resulting profits.[14]

The nature of the franchise relationship suggests that the franchisor must maintain some degree of control over the business activities of franchisees, if only as a matter of commercial practicality.[15] More specific, however, is the requirement imposed by the Lanham Trademarks Act[16] that the franchisor exercise some control over the nature and quality of goods sold by the franchisee under the licensed trademark.[17] Failure to do so might result in a judicial determination of trademark abandonment,[18] a loss which could lead to dis-

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joint adventurers nor agents). *Cf.* J. FELS, *supra* note 4, at 54 (advising the franchisor always to disclaim agency expressly).

13. Increasingly, state legislatures have recognized the franchisee's independent interest in his business by enacting statutes designed to regulate the franchise relationship. Most seek to impose a requirement of good faith dealing upon the franchisor by provisions against arbitrary termination or other coercion of franchisees. Some apply only to petroleum products franchises. *See* ARIZ. REV. STAT. ANN. §§44-1551, 44-1554 (Supp. 1979) (prohibiting cancellation of franchise "without good cause"); CAL. [Business & Professional] CODE §§20999-20999.3 (West Supp. 1980) (prohibting termination, cancellation or failure to renew any existing franchise without good cause). Others apply to automobile dealerships alone. *See* COLO. REV. STAT. §12-6-120 (1973) (cancellation of franchise wthout just cause a violation of the act). Still others are not limited to any particular type of franchised outlet. *See* CONN. GEN. ANN. §§42-133e to 42-133n (West) (Supp. 1980); DEL. CODE ANN. tit. 6, §2551-2556 (1974); IND. STAT. ANN. §§23-2-2.7 (Burns) (Supp. 1979); MD. ANN. CODE art. 56 §§345-366 (Supp. 1979); MICH. COMP. LAWS §§445.1501 to 445.1545 (Supp. 1979); N.D. CENT. CODE §§51-19.01 to 51-19.17 (Supp. 1979); N.J. STAT. ANN. §§56:10-1 to 56:10-15 (Supp. 1980); S.C. CODE §§56-15-10 to 56-15-130 (1976); S.D. COMPILED LAWS ANN. §§37-5A-1 to 37-5A-80 (Supp. 1978); VA. CODE §§13.1-557 to 13.1-574 (1978). The federal government has been involved in the regulation of motor vehicle franchises since passage of the Automobile Dealers Day in Court Act, 15 U.S.C. §§1221-1225 (1976).

14. In many cases the franchisee's dream of owning his own profitable business is a cruel deception. Through devices such as arbitrary termination, constraints upon the franchisee's right to transfer his business, and restrictive covenants not to compete, franchisors may take unfair advantage of franchisees and reap windfall profits. The franchisee may work long hours for what amount to subsistence wages. *See* H. BROWN, *supra* note 4, at 31-49; Brown, *Franchising—A Fiduciary Relationship,* 49 TEX. L. REV. 650, 651-64 (1971).

15. The franchisee may have little business experience and may be totally unfamiliar with the franchisor's production techniques. Thus, the franchisor must train and supervise the franchisee through the use of training manuals, seminars and even direct oversight. *See generally* Evans, *Franchising as a Device For the Organization, Financing, Control and Growth of the Small Business,* 17 CLEV.-MAR. L. REV. 346 (1968). Uniformity and quality of the product marketed are essential to creation of desirable public image and consumer goodwill. In addition, the franchisee may have little credit and, to obtain funds for the construction of the franchise premises, the franchisor may pledge his own credit. *See* J. FELS, *supra* note 4, at 6.

16. Trademark Act of 1946 (as amended), 15 U.S.C. §§1051-1127 (1976).

17. The Lanham Act does not incorporate any particular standard of quality into its requirement of control. The product may be of high, low or indifferent quality within the constraints set by various federal regulatory agencies such as the FDA or Consumer Products Safety Administration. The requirement of the act is only that whatever goods are produced under trademark must be of uniform quality and that public deception concerning their origin be avoided. *See, e.g.,* Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367 (2d Cir. 1959) (unless licensor exercises supervision and control over operations of licensees, public will face increased risk of deception).

18. *See* E.I. duPont de Nemours & Co. v. Celanese Corp. of America, 167 F.2d 484, 488-89.

integration of the franchise system.[19] Increasingly, however, the very controls inserted in franchise agreements to achieve profits and safeguard trademark integrity have subjected franchisors to liability for the torts and contracts of their franchisees.[20] Almost without exception, courts deciding such questions have employed the control test traditionally used to determine the relationship of master and servant,[21] or principal and agent.[22]

The resulting question, then, is not whether the control test will be used, but whether courts have applied it perceptively in their analysis of the franchise relationship. The question which courts must ask is whether, under the facts of a particular case, imputing liability to the franchisor serves generally accepted and socially beneficial objectives of the law of torts and contracts.[23] This note

(C.C.P.A. 1948); Arthur Murray, Inc. v. Horst, 110 F. Supp. 678, 679 (D. Mass. 1953) (naked license without transfer of goodwill, communication of trade secret, or provision for supervisory control of product or service invalid because public deception likely to follow); *cf.* American Broadcasting Co. v. Wahl Co., 121 F.2d 412, 413 (2d Cir. 1941) (license of trademark unconnected with business of licensee, similar to assignment of trademark in gross and transfers no rights).

19. *See* BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 30-31.

20. *See, e.g.*, Kosters v. Seven-Up Co., 595 F.2d 347 (6th Cir. 1979) (tort action — strict products liability); Kuchta v. Allied Builders Corp., 21 Cal. App. 3d 541, 98 Cal. Rptr. 588 (1971) (tort action — fraud); Sheraton Corp. of America v. Kingsford Packing Co., 162 Ind. App. 470, 319 N.E. 2d 852 (1974) (contract action); Duluth Herald & News Tribune v. Plymouth Optical Co., 286 Minn. 495, 176 N.W. 2d 552 (1970) (contract action).

21. *See* RESTATEMENT (SECOND) OF AGENCY §219 (1958). "A master is subject to liability for the torts of his servants committed while acting in the scope of their employment." RESTATEMENT (SECOND) OF AGENCY §220 (1958) defines servant as "a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control." Section 220 sets forth a number of factual matters relevant to determination of a master-servant relationship, first among these being "the extent of control which, by the agreement, the master may exercise over the details of the work." *Id.* Section 220, comment (d) states that "although control or the right to control the physical conduct of the person giving service is important and in many situations is determinative, the control or right to control needed to establish the relation of master and servant may be very attenuated."

22. *See id.* §1. "(1) Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. (2) The one for whom action is to be taken is the principal. (3) The one who is to act is the agent." *Id.* RESTATEMENT (SECOND) OF AGENCY §140 (1958) provides that "the liability of the principal to a third person upon a transaction conducted by an agent, or the transfer of his interests by an agent, may be based upon the fact that: (a) the agent was authorized, (b) the agent was apparently authorized; (c) the agent had a power arising from the agency relation and not dependent upon authority or apparent authority."

23. In the law of torts, commentators have identified four such broad objectives. First, the inherent fairness or moral objective, encompassing the idea that it is inherently right to impose liability upon the guilty and to shield from liability the blameless. Second, the compensation objective, embodying the well-recognized rule of tort law that liability for damages accrues to make the injured party whole. Third, the deterrence objective, that is, to discourage unreasonably dangerous conduct by causing the actor to pay for resulting damages. Finally, the avoidance of unduly overburdening risky but socially advantageous activity. 2 F. HARPER & F. JAMES, THE LAW OF TORTS 752-758 (1956). *See generally* Seavy, *Speculations as to Respondeat Superior* in HARV. LEGAL ESSAYS 433, 447 (1934).

The two basic measures of damages in contract reflect separate objectives. The general examines the development of the control test and its modern application to franchising. The problem of Lanham Act requirements will be analyzed and the note will conclude with suggestions for application of the doctrine known as risk administration as a guide to use of the control test in deciding which party to a franchise relationship should be required to bear a given loss.

THE CONTROL TEST FOR AGENCY: APPLICATION TO THE OIL COMPANY — DISTRIBUTOR RELATIONSHIP

By the beginning of the twentieth century American courts had delineated the rights and obligations of parties in an industrial society.[24] Between principal and agent[25] there was held to exist a consensual,[26] fiduciary[27] relationship, in

measure of damages seeks to place the aggrieved party in the same position he would have occupied had the contract been performed. *See, e.g.*, Popwell v. Abel, 226 So. 2d 418 (Fla. 4th D.C.A. 1969). The restitutionary measure of damages seeks to place both parties in the position they occupied prior to entering the contract. *See, e.g.*, Schwasnik v. Blandin, 65 F.2d 354 (2d Cir. 1933).

24. In the law of torts, the fundamental characteristic was the substitution of the fault principle for the notion of strict liability as the basis of liability for damages to person and property. *See* F. HARPER & F. JAMES, *supra* note 23, at 744. The doctrine of negligence developed from the medieval action of trespass on the case and gained particular acceptance during the industrial revolution of the late nineteenth century as a manifestation of the spirit of laissez-faire individualism. *See* Bohlen, *The Rule in* Fletcher v. Rylands, 59 U. PA. L. REV. 298, 433 (1911). The doctrine of vicarious liability, by which one party might be liable for the acts of another, although the former was without fault, found acceptance in English law by the end of the seventeenth century and was incorporated into American jurisprudence by the early colonists. *See, e.g.*, Jones v. Hurt, 90 Eng. Rep. 1255 (K.B. 1698) (opinion by Holt, C. J.). *Cf.* Holmes, *Agency*, 4 HARV. L. REV. 345, 362 (1891) (suggesting that vicarious liability developed from historical fiction of the identity of master and servant).

25. *See* RESTATEMENT (SECOND) OF AGENCY §1 (1958). *Cf.* W. SEAVY, HANDBOOK OF THE LAW OF AGENCY §3 (1964): "Agency is a consensual, fiduciary relation between two persons, created by law, by which one, the principal, has a right to control the conduct of the agent, and the agent has a power to affect the legal relations of the principal."

26. The parties must indicate by words or conduct an intention that one is to act for the other. The law will imply an agency in the absence of express agreement that such is to be formed: "The relation which the law calls agency does not depend upon the intention of the parties to create it, nor their belief that they have done so. . . . [I]f the agreement results in the factual relation between them to which are attached the legal consequences of an agency, an agency exists although the parties did not call it an agency, and did not intend the consequences of the relation to follow." RESTATEMENT (SECOND) OF AGENCY §1(1) comment (B) (1958). *See also* Bonenberger v. Sears Roebuck & Co., 449 S.W.2d 385, 387 (Mo. App. 1969); Strangi v. United States, 211 F.2d 305, 307-08 n.10 (5th Cir. 1954); Flight Kitchen, Inc. v. Chicago Seven-Up Bottling Co., 22 Ill. App. 3d 558, 562-63, 317 N.E.2d 663, 667 (1974).

27. *See* RESTATEMENT (SECOND) AGENCY §13 (1958): "An agent is a fiduciary with respect to matters within the scope of his agency." W. SEAVY, *supra* note 25, §3, comment c. Benjamin Cardozo, while still a judge of the New York Court of Appeals wrote perhaps the classic statement of the fiduciary principle for the majority in *Meinhard v. Salmon*, 249 N.Y. 458; 164 N.E. 545 (Ct. App. 1928): "Many forms of conduct permissible in a workaday world for those acting at arms length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is the standard of behavior." *Id.* at 464, 164 N.E. at 546. *See also* Grace Lines, Inc. v. Todd Shipyards Corp., 500 F.2d 361, 373 (9th Cir. 1974) (adopting §14 of the second restatement); Hobson v. Eaton, 399 F.2d 781, 784 (6th Cir. 1968) (interpreting Ohio law); Hodges v. Surratt, 366 So. 2d 768, 774 (Fla. 2d D.C.A. 1978); Fisher v. Grady, 131 Fla. 1, 20, 178 So. 852 (1937).

which the principal had a right to control the agent.[28] In the law of torts, the doctrine of respondeat superior[29] subjected the species of principals known as masters[30] to liability to third parties for the negligence of servants[31] acting within the scope of their employment.[32] The master was not liable, however, for the negligence of a species of agents classified as independent contractors.[33] In

28. *See* RESTATEMENT (SECOND) OF AGENCY §14 (1958): "A principal has the right to control the conduct of the agent with respect to matters entrusted to him." W. SEAVY, *supra* note 25, §11: "A person is not an agent for another in doing an act of conducting a transaction unless the other had a right to control and to have it done for his benefit." *Accord,* Kelley v. Southern Pacific Co., 419 U.S. 318, 324 (1974); Economic Research Analysts, Inc. v. Brennan, 232 So. 2d 219, 221 (Fla. 4th D.C.A. 1970); Gross v. Eustis Fruit Co., 160 So. 2d 55, 57 (Fla. 2d D.C.A. 1964).

29. The Latin translates "let the master answer." In tort law it implies the doctrine that a master is liable in certain cases for the acts of his servant and the principal for acts of his agent. BLACK'S LAW DICTIONARY 1475 (Rev. 4th ed. 1968).

30. "Master" is differentiated from the broader term "principal" chiefly upon the basis of the greater degree of control and intimacy existing between the master and his servant. *See* RESTATEMENT (SECOND) OF AGENCY §2 (1958); W. SEAVY, *supra* note 25, §3.

31. The American Law Institute takes the position that masters and servants are special types of principals and agents. The servant, however, occupies a closer relation to the master and usually submits to a greater degree of control by the master. In the latter respect, RESTATEMENT (SECOND) OF AGENCY §218 (1958) takes the position that "[p]rimarily, the servant sells his personal services, submitting to control as to his physical activities and the use of his time." The non-servant agent, on the other hand, "agrees sometimes to render services and sometimes to achieve results, but he does not surrender control over his physical actions." *Id.* §218 (introductory note). The distinction is important primarily because principals typically are liable for the torts of agents under special circumstances. *See id.* §§343-359A. On the other hand, the liability of masters for servants is less limited. *Accord,* W. SEAVY, *supra* note 25, §§93-95 (1964).

The Second Restatement sets forth a number of distinctions to be considered in determining whether a given party is a servant. Among these are: (1) the extent to which another party may control his activities; (2) whether or not the party is engaged in a "distinct occupation or business;" (3) whether, with respect to other parties performing similar activity in the area, the activity is usually performed under an employer's direction, or by an unsupervised specialist; (4) the degree of skill the activity requires; (5) whether the given party or another supplies the tools and workplace for the activity; (6) the length of the employment period; (7) whether the method of payment is by time or by the job; (8) whether the work is part of the employer's regular business; (9) whether the parties intended to be master and servant, and (10) whether the party alleged to be the master is in business for himself. *Id.* §220.

32. *Id.* §219. The restatement sets forth a number of tests designed to determine whether a given course of conduct was within the servant's scope of employment. *Id.* §§228, 229. See also W. SEAVY, *supra* note 25, §87.

33. The Restatement definition of independent contractor relies heavily upon the notion of control as a distinguishing factor. The independent contractor "is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking." *See* RESTATEMENT (SECOND) OF AGENCY §2 (1958). The independent contractor may or may not be an agent. Thus, the restatement fundamentally distinguishes between servants, non-servant agents and independent contractors, primarily upon the basis of the degree of control exercised over their conduct by the master, principal or employer respectively. *See id.* §250. *See generally* Morris, *The Torts of an Independent Contractor,* 29 ILL. L. REV. 339 (1934); Steffen, *Independent Contractor and the Good Life,* 2 U. CHI. L. REV. 501 (1935).

the law of contracts, the courts firmly established that the principal was responsible only for the authorized transactions of his agents,[34] unless the principal ratified an unauthorized transaction[35] or accepted the benefit of it.[36] While in most instances the rules and their application were clear, certain kinds of business relations presented courts with analytical difficulty because they did not fall neatly into the category of master and servant, or principal and agent.[37]

When courts encountered these cases, they turned to certain tests designed to determine which label the relationship was to be given.[38] Early cases concerning the liability of oil companies for the acts of their distributors illustrate the great significance which courts attached to the master's right of control over the alleged servant.[39] The main issue in cases such as *Reynolds v. Skelly Oil*[40] was whether the oil company had retained the right to control the activities of the station operator beyond some intangible threshold at which the parties ceased to face one another as independent contractor-contractee, and became instead master and servant.[41] In *Skelly Oil* and similar cases, the courts examined various

34. RESTATEMENT (SECOND) OF AGENCY §140 (1958) presents three bases upon which liability for the principal may be founded: "The liability of the principal to a third person upon a transaction conducted by an agent, or the transfer of his interests by an agent, may be based upon the fact that: (a) the agent was authorized; (b) the agent was apparently authorized; (c) the agent had a power arising from the agency relation and not dependent upon authority or apparent authority." *See also,* W. SEAVY, *supra* note 25, §§55-56.

35. RESTATEMENT (SECOND) OF AGENCY §143 (1958) (principal ratifying unauthorized contract of agent with knowledge of material facts becomes responsible as though transaction had been authorized).

36. *Id.* §141 (principal may be liable for unauthorized transaction of agent on grounds of estoppel, restitution or negotiability).

37. *See* E. HARPER & F. JAMES, *supra* note 23, at 1403. Among the difficult to categorize forms of business relationships are commissioned salesmen and their related companies, newspaperboys and their publishers, and taxi drivers and their dispatchers.

38. *See* RESTATEMENT (SECOND) OF AGENCY §220 (1958).

39. *See* Comment, *Liability of Oil Company For Its Lessee's Torts,* 1963 ILL. L.F. 915. The petroleum products distributors of the early twentieth century were not true franchisees in that they did not hold a trademark license, the *sine qua non* of the modern franchise network. However, many aspects of the relationship between oil company and station operator closely resembled that of franchisor and franchisee, particularly the controls built into the relationship. Cases involving suits against petroleum distributors and their related oil companies continue to be litigated today. *See, e.g.,* Aweida v. Kientz, 536 P.2d 1138 (Colo. App. 1975); Beckham v. Exxon Corp., 539 S.W. 2d 217 (Tex. Civ. App. 1976); Jackson v. Standard Oil Co. of California, 8 Wash. App. 83, 505 P.2d 139 (1973).

40. 227 Iowa 163, 287 N.W. 823 (1939).

41. *See* Comment, *supra* note 39, at 915. The courts found several factors particularly relevant. The oil company typically retained the right to terminate the lease under which the distributor held his station, a fact which sometimes was persuasive in the direction of a master-servant relation. *Compare* Gulf Refining Co. v. Brown, 93 F.2d 870, 873 (4th Cir. 1938) *and* Humble Oil & Refining Co. v. Martin, 148 Tex. 175, 178, 222 S.W.2d 995, 998 (1949) (both holding oil company liable as master, power of termination cited), *with* Texas Co. v. Mills, 171 Miss. 231, 234, 156 So. 866, 868, (1934) (power of termination held not controlling, oil company not liable as master). Similarly, courts reached conflicting decisions in cases where the oil company required its distributor to maintain his station in neat sanitary condition. *See, e.g.,* Shell Petroleum Corp. v. Linham, 163 So. 839 (Miss. 1935) (holding oil company liable in tort as master); Texas Co. v. Wheat, 140 Tex. 468, 469, 168 S.W.2d 632, 634 (1943)

aspects of control as exhibited in both the express agreements of the parties and their actual dealings. Typically, the initial inquiry focused on the provisions of the lease under which the service station operator held his premises[42] and the contract by which he agreed to purchase his requirements of gasoline and oil.[43] The courts were equally prepared, however, to recognize informal arrangements whereby the oil company might supervise the distributor's daily activities through field agents or sales representatives.[44]

The oil company's actual control or right to control the station operator's activities was not the sole theory upon which injured plaintiffs sought recovery. Occasionally a third party would claim that the oil company held out the operator as an agent[45] by causing its corporate emblem to be displayed around

(oil company not liable as master for distributor's negligence). The obligation to make regular reports, including auditing information was not necessarily dispositive. *See, e.g.*, Gulf Refining Co. v. Wilkinson, 94 Fla. 664, 666, 114 So. 503, 504 (1927) (oil company not liable in tort as master); Humble Oil & Refining Co. v. Martin, 148 Tex. 175, 177, 222 S.W.2d 995, 998 (1949) (oil company liable in tort as master). Nor was a requirement that the lessee submit to regular inspections by field representatives of the company completely controlling. This element of control was insufficient, in *Skelly*, to hold the oil company liable as a master, because it did not appear that the representative ever compelled the distributor to follow his advice. *See* Reynolds v. Skelly Oil Co., 227 Iowa 163, 169, 287 N.W. 823, 826 (1939). In Brenner v. Socony-Vacuum Oil Co., 236 Mo. App. 524, 528-29, 158 S.W.2d 171, 173-74 (1942), however, the court reached a contrary result when it determined that the field agent of the oil company held a broad power to direct service station activities.

42. 227 Iowa at 166-67, 287 N.W. at 824-25. *See also* Becker v. Aschen, 344 Mo. 1107, 131 S.W.2d 533 (1939); Brenner v. Socony-Vacuum Oil, 236 Mo. App. 524, 158 S.W.2d 171 (1942). The lease before the Texas court in Texas Co. v. Wheat, 140 Tex. 468, 471, 168 S.W.2d 632, 634 (1943), provided for a year to year term, terminable at the end of each year upon ten days notice from either party.

43. 227 Iowa at 168-69, 287 N.W. at 826. *See also* Cooper v. Graham, 231 S.C. 404, 406, 98 S.E.2d 843, 845 (1957); Texas Co. v. Wheat, 140 Tex. 468, 168 S.W.2d 632, 634 (1943) (lessee permitted some discretion in purchasing petroleum products from companies other than lessor); Gulf Refining Co. v. Rogers, 57 S.W.2d 183 (Tex. App. 1933) (oil company's lessee required to purchase only products bearing the former's trademark).

44. This was especially true where plaintiffs could introduce evidence of supervision by the oil company over daily business activities of the station. *See, e.g.*, Gulf Refining Co. v. Brown, 93 F.2d 870 (4th Cir. 1938); Becker v. Aschen, 344 Mo. 1107, 131 S.W.2d 533 (1939).

45. RESTATEMENT (SECOND) OF AGENCY §8 (1958) provides that "apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." Comment (a) to this section stresses that the principal's objective manifestations to third parties and not his manifestations to the agent, are required to raise an apparent agency. The Restatement also provides that a master is subject to tort liability for injuries resulting from reliance by third parties upon the apparent servant's scope of employment. *Id.* §265(1). Whether the designation is that of principal or master, however, apparent authority entails several distinct elements. There must be an affirmative holding out of one party as an agent or servant by another and reasonable reliance upon the holding out by the injured party. *Id.* §§265(2), 266-267.

The term "agency by estoppel" is also used by courts in a manner synonymous with "apparent agency." *See* 227 Iowa at 171, 287 N.W. at 827. The two terms are not identical, however. RESTATEMENT (SECOND) OF AGENCY §8, comment (d) (1958) notes that apparent authority is a contract doctrine, while estoppel is derived from the tort principle that innocent parties who rely upon representations of others to their detriment are entitled to protection. Strictly speaking, one might receive only compensation for loss under estoppel and not, as under an the premises,[46] or on the uniforms of station employees.[47] In such cases the oil company might be held liable as the master of an apparent servant.[48] There were few recoveries under this theory, however, because of the "common knowledge rule," first enunciated by the *Skelly Oil* court.[49] In essence, the rule stated that no one could reasonably believe that a service station operator was the employee of an oil company. It was deemed common knowledge that the signs and uniform insignias merely announced the sale of petroleum products by an independent businessman.[50] Negativing reliance in this fashion resulted in the virtual impossibility of plaintiffs prevailing on a theory of apparent agency.[51]

The Control Test and Modern Franchising

The service station cases illustrate the basic principles of agency considered by courts in determining the liability of the modern franchisor for acts of the franchisee. Plaintiffs typically frame their actions in terms of actual or apparent agency, or both. The contemporary franchise relationship, however, differs from that of the early manufacturer and distributor in a significant respect. The franchisee markets products under a trademark license,[52] a device which enables

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apparent authority theory, compensation and rights against both principal and agent. Nonetheless, the elements of estoppel and apparent authority are virtually identical: (1) representation or holding out by the alleged principal, (2) reliance upon the representation by the injured party (3) change of position by the third party resulting from the reliance.

46. 227 Iowa at 169-70, 287 N.W. at 826. In *Skelly* the sign consisted only of the company's name, with an arrow pointing toward the station which indicated "tire repairing." *See also* Apple v. Standard Oil, Div. of American Oil, 307 F. Supp. 107, 108-09 (N.D. Cal. 1969); Sherman v. Texas Co., 340 Mass. 606, 608, 165 N.E.2d 916, 917 (1960); Coe v. Esau, 377 P.2d 815, 818, (Okla. 1963).

47. *See, e.g.*, Edwards v. Gulf Oil Corp., 69 Ga. App. 140, 143, 24 S.E.2d 843, 844-45 (1943) (station operator wore uniform bearing company name). *Cf.* Arkansas Fuel Co. v. Scaletta, 200 Ark. 645, 649, 140 S.W.2d 684, 687 (1940); Shaver v. Bell, 74 N.M. 700, 706, 397 P.2d 723, 727-28 (1964) (station operator's acceptance of credit card bearing oil company's name did not raise apparent agency); Cities Service Oil Co. v. Kindt, 200 Okla. 64, 67-68, 190 P.2d 1007, 1011 (1948).

48. Restatement (Second) of Agency §265 (1958).

49. 227 Iowa at 171, 287 N.W. at 827.

50. The *Skelly* court held that Skelly Oil was not estopped to deny the agency of its distributor, any more than automobile manufacturers are estopped to deny the agency of dealers who display Chevrolet and Buick signs above their premises. "[I]t is a matter of common knowledge that these trademark signs are displayed throughout the county by independent dealers." *Id.*

51. *See* Comment, *supra* note 39, at 916 n.12. *See also* Apple v. Standard Oil, Div. of American Oil, 307 F. Supp. 107, 112 (N.D. Cal. 1969) (citing common knowledge rule as basis for refusal to allow recovery on estoppel or apparent authority claims); Sherman v. Texas Co., 340 Mass. 606, 608, 165 N.E.2d 916, 917 (Mass. 1960); Coe v. Esau, 377 P.2d 815, 818 (Okla. 1963); *cf.* Westre v. De Buhr, 825 S.D. 276, 144 N.W.2d 734 (1966).

52. The trademark license is a contract in which the licensor, for a royalty, grants a licensee the right to use the licensor's trademark upon products produced by the licensee. The licensor thus gains the benefit of money income and expanded public recognition of the mark. The licensee in turn gains a known symbol under which to market his products and receives whatever goodwill is attached to the trademark. *See* Sage, *Trade-Mark Licenses and Control*, 43 Trademark Rep. 675 (1953).

him to process and distribute goods in circumstances under which he would otherwise be guilty of trademark infringement.[53] The concept of trademarks is deeply rooted in the common law,[54] and their use as a means of impressing the identity of products upon the public is well-recognized.[55] At common law the function of a trademark was to identify the source of goods to which it was attached.[56] A relatively simple policy underlay this doctrine: if a trademark always identified the goods of a particular seller, society would benefit from the consumer's ability to distinguish similar goods based upon experiences associated with the affixed trademark.[57] For decades this source principle was hostile to the practice of trademark licensing,[58] although the assignment of a trademark was permitted if it occurred as an incident to complete transfer of a business and associated goodwill.[59] With a few notable exceptions,[60] trademark

53. In contrast, a trademark license is unnecessary where the original registrant merely affixes the trademark to the product and sells it to an intermediary who resells the product to the public under the same trademark. The reseller performs no processing or assembly function which might change the nature of the product and result in public confusion concerning its origin. *See* DOLE, TERRITORIAL TRADEMARK RIGHTS AND THE ANTITRUST LAWS 110-111 (1965); TRADEMARK PROTECTION, *supra* note 2, at 6-3, 6-4; *see also* Champion Spark Plug Co. v. Sanders, 331 U.S. 125 (1947); Prestonettes, Inc. v. Coty, 264 U.S. 359 (1924).

54. Although artisans used trademarks upon pewterware and armorcloth as early as the Middle Ages, trademarks were not recognized by the English courts until 1618, and in courts of the United States until 1837. *See generally* SCHECHTER, THE HISTORICAL FOUNDATION OF THE LAW RELATING TO TRADEMARKS (1925).

55. *See* Note, *Developments in the Law: Trademarks and Unfair Competition*, 68 HARV. L. REV. 814, 816 (1955). The law of trademarks is dominated by a tension between the need to prevent consumer deception concerning the source of goods and the need to maintain the means of expression necessary for effective competition.

56. The classical function of a trademark was identification of the good to be marketed. *See* Hanover Star Milling Co. v. Metcalf, 240 U.S. 403, 412 (1916); Elgin National Watch Co. v. Illinois Watch Case Co., 179 U.S. 665, 673 (1901); Canal Co. v. Clark, 80 U.S. (13 Wall.) 311, 322 (1871); 3 R. CALLMAN, THE LAW OF UNFAIR COMPETITION AND TRADEMARKS §65 (3d ed. 1967). The trademark serves not only to protect the public from deception, but grants to the entrepreneur certain rights to the goodwill associated with his business. *See* Note, *Trademark Licensing: The Problem of Adequate Control*, 1968 DUKE L.J. 875, 876-77 & n.7.

57. R. CALLMAN, *supra* note 56, §65. *See also* Columbia Mill Co. v. Alcorn, 150 U.S. 460 (1893). A trademark "must be designed, as its primary object and purpose, to indicate the owner or producer of the commodity, and to distinguish it from like articles manufactured by others." *Id.* at 463.

58. *See, e.g.*, American Broadcasting Co. v. Wahl Co., 121 F.2d 412, 413 (2d Cir. 1941); Affiliated Enterprises, Inc. v. Gantz, 86 F.2d 597, 599 (10th Cir. 1936); Everett O. Fisk & Co. v. Fisk Teachers' Agency, Inc., 3 F.2d 7, 8 (8th Cir. 1924); Macmahan Pharmacal Co. v. Denver Chem. Mfg. Co., 113 F. 468, 474-75 (8th Cir. 1901).

59. Provision for assignment under such circumstances was included in the Trademark Act of 1905, ch. 592, §10, 33 Stat. 724 (repealed 1946). This was a codification of the common law view that the trademark was a representation of the goodwill of the business; thus, it was permissible to transfer the trademark along with sale of the business. The danger of public confusion was obviated by the fact that the source of the goods remained unchanged. *See* Hanover Star Milling Co. v. Metcalf, 240 U.S. 403, 413-14 (1916). On the other hand, the transfer of the trademark apart from the business itself stripped the trademark of it relationship to the goods. Consequently, courts frequently invalidated the transfer of such "trademarks in gross." *See, e.g.*, United Drug Co. v. Theodore Rectanus Co., 248 U.S. 90, 97 (1918); Kidd v. Johnson, 100 U.S. 617, 620 (1880); Independent Baking Powder Co. v. Boorman, 175 F. 448,

licensing did not become popular until the end of the 1940s when legislative[61] and judicial attitudes shifted away from the source principle to the quality control, or guaranty theory of trademarks.[62]

451 (D.N.J.) (1910); Spiegel v. Zuckerman, 175 F. 978, 984 (S.D.N.Y. 1910). The 1905 Act purported to confer procedural rights only, particularly the right of access to the federal courts for redress of trademark infringement. The common law continued to govern substantive rights. *See* 2 H. NIMS, THE LAW OF UNFAIR COMPETITION AND TRADEMARKS §223 (4th ed. 1947).

60. Courts proved willing to uphold trademark licensing contracts where the trademark owner maintained a certain degree of control over the licensee, although no transfer of business interest took place. *See* Note, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 YALE L.J. 1171, 1185 (1963). The Coca-Cola Company achieved remarkable success through trademark licensing to franchised dealers, who processed raw materials supplied by Coca-Cola according to Coca-Cola's standards. Perhaps implicit in these cases was the assumption by courts that there was little danger of public deception because the licensor both supplied an essential raw material and exercised supervisory rights over the finished product. *See, e.g.*, Coca-Cola Co. v. Bennett, 238 F. 513, 516 (8th Cir. 1916), *rev'g*, 225 F. 429 (D. Kan. 1915) (Coca-Cola licensed two franchisees who licensed subfranchisees, court assumed propriety of licensing agreement where franchisor supplied syrup base and instructions for processing to subfranchisees); Coca-Cola Co. v. Gay-Ola Co., 200 F. 720, 726 (6th Cir. 1912), *cert. denied*, 229 U.S. 613 (1913) (sustaining licensing arrangement between Coca-Cola and franchisees). *But see* Coca-Cola Bottling Co. v. Coca-Cola Co., 269 F. 796, 806-08 (D. Del. 1920) (transfer of the bottling business and goodwill along with transfer of trademark between Coca-Cola and local bottler held to be a trademark assignment).

The courts also upheld trademark licenses in other situations where it appeared the licensor was in a position to maintain control over the quality of the product and preclude public deception. *See, e.g.*, Smith v. Dental Products Co., 140 F.2d 140, 149 (7th Cir. 1944) (dentist held not to have abandoned trademarks by licensing, court noted degree of control which licensor continued to reserve over production and sale of equipment); Vermont Maple Syrup Co. v. F.N. Johnson Maple Syrup Co., 272 F. 478, 480 (D. Conn. 1921) (licensor owned stock in licensee's business, court emphasized right of licensor to terminate license at will as earmark of control); Adam v. Folger, 120 F. 260, 260-61 (7th Cir. 1903) (license upheld where patentee of water heater licensed use of both patent and trademark under contract which reserved right to cancel if unauthorized changes made in product). Despite these instances in which trademark licensing was permitted, it remained difficult to register a trademark under the 1905 Act. In *Ex parte* United States Steel Corp., 23 U.S.P.Q. 145 (Comm'r 1934) the Commissioner of Patents ruled that the requirement of use necessary to register a trademark could not be met through use by licensees. Because ownership rights in a trademark arise only upon its use, not mere registration alone, United States Steel was denied trademark registration where it did not make use of the trademark, but relied upon use of the trademark by subsidiary corporations. *Id.* at 147-48. This created the anomalous situation in which the trademark licensor could conceivably receive protection for its mark in an infringement action but could not avail itself of the procedural advantages of registration because it was not the owner of the mark. See Note, *supra* note 56, at 887.

61. The Lanham Act of 1946, 15 U.S.C. §§1051-1127 (1976) embodies the guaranty theory of trademarks through its liberalized provisions for trademark licensing. *Id.* §§5, 45. See note 62 *infra*.

62. Judicial attitudes toward trademark licensing began to move toward the guaranty concept in the 1950s. *See, e.g.*, Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367-68 (2d Cir. 1959); E.I. DuPont de Nemours & Co. v. Celanese Corp. of America, 167 F.2d 484, 488 (C.C.P.A. 1948); Joseph Bancroft & Sons Co. v. Shelley Knitting Mills, Inc., 175 F. Supp. 107, 110 (E.D. Pa. 1958), *rev'd*, 268 F.2d 569 (3d Cir. 1959). *See also* Woodward, *Some Observations on Legitimate Control of the Nature and Quality of the Goods*, 49 TRADEMARK REP. 609 (1959). The guaranty theory maintains that public confusion will not result from broad

The Lanham Trademarks Act

The Lanham Trademarks Act[63] of 1946 was adopted as a comprehensive statute simplifying and liberalizing trademark registration procedures.[64] While it leaves unchanged the common law of unfair competition, of which trademark infringement is a part, the Act provides certain advantages not available at common law.[65] Based upon Congress' commerce power,[66] the Act permits an action for trademark infringement to be brought in federal court.[67] It subjects the infringer to possible treble damages[68] and makes registration prima facie

licensing of trademarks so long as the licensor maintains control over the licensee's product. The actual source of the goods is not as important as the fact that the consumer may still enjoy a sense of security in associating goods under trademark with a certain constant level of quality.

63. 15 U.S.C. §§1051-1127 (1976) (originally enacted as Act of July 5, 1946, ch. 540, 60 Stat. 427), *as amended,* Oct. 9, 1962, Pub. L. 87-772, §1, 76 Stat. 769; Jan. 2, 1975, Pub. L. 93-596, §1, 88 Stat. 1949. The movement to pass such legislation had begun in 1938 with H.R. 9041, 75th Cong., 3d Sess. (1935), which stated that use of a registered trademark by subsidiary companies to the registrant should affect neither the validity of the mark nor its registration. *See Hearings on H.R. 9041 Before the Subcomm. on Trademarks of the House Comm. on Patents,* 75th Cong., 3d Sess. 65 (1938). The bill was passed by the House in 1939 but failed in the Senate. *See* 86 CONG. REC. 8990-8993 (1940). Passage of a compromise bill was delayed for several years because of the inability of House and Senate to agree on an identical bill. *See Hearings on H.R. 102, 5461, and S.895 Before the Subcomm. on Trademarks of the House Comm. on Patents,* 77th Cong., 1st Sess. (1941); *Hearings on H.R. 82 Before a Subcomm. of the Senate Comm. on Patents,* 78th Cong., 2d Sess. 63-152 (1944). However, the Lanham Act finally became law in 1946. *See* 92 CONG. REC. 7522, 7525 (1946); S. REP. 1333, 79th Cong., 2d Sess. (1946). *See generally* Shinderman, *Trade-Mark Licensing — A Sage of Fantasy and Fact,* 14 LAW & CONTEMP. PROB. 248 (1949).

64. *See* S. REP. 1333, 79th Cong., 2d Sess. (1946). The report observed that the many amendments of the 1905 Act had scattered statutes concerning trademarks throughout the Code creating a "confused situation." An avowed purpose of the legislation was to "put all existing statutes in a single piece of legislation." While the report did not list the expansion of trademark licensing as an explicit objective, it did recognize that one function of the bill was modernization of the trademark statutes so that they will conform to legitimate present-day business practice. *Id.*

65. The law of trademarks is part of the broader tort doctrine of unfair competition long established at common law. *See, e.g.,* American Foods, Inc. v. Golden Flake, Inc., 312 F.2d 619, 620 (5th Cir. 1963); Safeway Stores, Inc. v. Safeway Properties, Inc., 307 F.2d 495, 497 n.1 (2d Cir. 1962). As a condition precedent to registration, under the Lanham Act, the applicant must establish his common law right to the mark through its continuous use in trade. *See, e.g.,* Casual Corner Assoc., Inc. v. Casual Stores of Nevada, Inc., 493 F.2d 709, 712 (9th Cir. 1974). Once that right has been established, however, the trademark may be registered with the United States Patent Office. *See* 15 U.S.C. §1057 (1976). The registrant is thereafter entitled to both the benefits of the common law action of unfair competition and the federal cause of action created by the Lanham Act, 15 U.S.C. §1114 (1976). The penalties of §1114 apply to any person who, without consent of the registrant, uses the trademark in a manner "likely to cause confusion, or to cause mistake, or to deceive." *Id.,* §1114(1)(b).

66. U.S. CONST. art. I, §8. The Lanham Act is framed explicitly in terms of trademarks upon goods which have moved in commerce. *See, e.g.,* 15 U.S.C. §1051 (1976).

67. 15 U.S.C. §1121 (1976) (providing original jurisdiction of the federal district courts over matters arising under the Lanham Act without regard to diversity of citizenship among the parties).

68. *Id.* §117. Subject to the provisions of §1111 and §1114, the plaintiff may be entitled to recover, in addition to treble damages, the defendant's profits and costs of the action.

evidence of the registrant's right to employ the trademark in commerce.[69] Finally, the registration serves as nationwide constructive notice of a claim of ownership[70] and renders the right to the mark incontestable after five years.[71] The great importance of the Lanham Act to franchising lies in its recognition of trademark licensing through the "related companies"[72] doctrine of sections 5[73] and 45.[74]

But cf., Deering, Milliken & Co. v. Gilbert, 269 F.2d 191, 194-95 (2d Cir. 1959) (treble damages permitted although based upon defendant's profits rather than plaintiff's actual damages).

69. 15 U.S.C. §1057(b) (1976). Under the 1905 Act registration was only prima facie evidence of ownership, that the registrant was the first user of the mark. *See* Act of Feb. 20, 1905, ch. 592, §16, 33 Stat. 724 (repealed 1946). Under the Lanham Act, however, registration establishes a rebuttable presumption of the mark's validity and the registrant's exclusive right of use, shifting the burden of going forward with the evidence in both Patent Office proceedings and infringements suits. *See* Note, *supra* note 55, at 823.

70. 15 U.S.C. §1072 (1976). Section 1072 prevents the infringer from defending against a Lanham Act infringement action on the grounds of the common law defenses of innocence, good faith or lack of knowledge. *See, e.g.*, Value House v. Phillips Mercantile Co., 523 F.2d 424 (10th Cir. 1975); John R. Thompson Co. v. Holloway, 366 F.2d 108 (5th Cir. 1966); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358 (2d Cir. 1959). Additionally, if an action challenging the registered trademark is filed against the registrant, whether in the patent office or the federal courts, the fact that the plaintiff had constructive knowledge of the registration may result in a successful defense based upon the equitable doctrines of laches or estoppel. *See, e.g.*, Polaroid Corp. v. Polaroid Elecs. Corp., 182 F. Supp. 350, 356 (E.D. N.Y. 1960), *aff'd*, 287 F.2d 492 (2d Cir.), *cert. denied*, 368 U.S. 820 (1961); Star Watch Case Co. v. Mido G. Schaeren & Co., S.A., 139 U.S.P.Q. 18, 19-20 (T.T.A.B. 1963), *aff'd*, 347 F.2d 894, 896 (C.C.P.A. 1965).

71. 15 U.S.C. §1064 (1976). Section 1064 implies that if a mark has been registered for five years a petition challenging the registration may not be based upon grounds that the mark is descriptive, geographic or a proper name. Prior to the Lanham Act, a registrant was subject to the risk of losing his registration at any time, for any reason for which registration could have been refused initially. *See* Note, *supra* note 55, at 829. 15 U.S.C. §1065 (1976) recognizes the incontestability of the registrant's right to use the trademark after five years, subject to certain exceptions enumerated in §1064. Finally, 15 U.S.C. §1115(b) (1976) provides that under most circumstances where the right to use has become incontestable, the registrant's right of exclusive use also becomes incontestable. Among the exceptions to this section are that the incontestable right to use was obtained by fraud, or that the mark has been used to violate the antitrust laws, or has been abandoned. *But see* Williamson, *Trademarks Registered Under the Lanham Act Are Not "Incontestable,"* 37 TRADE-MARK REP. 404 (1947 (arguing that scope of the exceptions set up under §§1064, 1065 and 1115 render the incontestability advantage illusory).

72. There is evidence to support the conclusion that Congress adopted the related companies approach, liberalizing trademark licensing in response to the view of the courts that use of a trademark by a licensee could not establish the licensor's rights for trademark registration purposes. *See Hearings on H.R. 9041 Before the Subcomm. on Trade-Marks of the House Comm. on Patents*, 75th Cong., 2d Sess. 65 (1938). The then-head of the A.B.A. committee on trademarks improvement referred to the decision in *Ex parte United States Steel*, 23 U.S.P.Q. 145 (Comm'r 1934) as an example of the type of cases to be overruled by the related companies provision. *Id.* at 136.

73. 15 U.S.C. §1055 (1976).

74. 15 U.S.C. §1127 (1976). The drafters of the Lanham Act seem to have been aware of the previous history of trademark licensing and the anomalous condition created by the decision in *United States Steel*. However, little formal presentation of cases was made and the

The related companies doctrine reflects the acceptance by Congress of the guaranty theory of trademarks.[75] As defined in section 45, a related company is an entity which controls, or is controlled[76] by, the registrant regarding the nature and quality of goods to be marketed under the trademark.[77] Section 5 permits trademark use by such a related company[78] if public deception will not result.[79] Failure to exercise sufficient control over the licensee's goods, however, might constitute an abandonment of the trademark[80] which would forfeit the registration.[81] The Act does not define control, the extent to which the

"guaranty theory" was never specifically mentioned. *See Hearings on H.R. 4744 Before the Subcomm. on Trade-Marks of the House Comm. on Patents,* 76th Cong., 1st Sess. (1939).

76. 15 U.S.C. §1127 provides: "The term 'related company' means any person who legitimately controls or is controlled by the registrant or applicant for registration in respect to the nature and quality of the goods or services in connection with which the mark is used." For purposes of the Lanham Act, §1127 also makes clear that a person is either a juristic or a natural person.

77. Section 1127 requires control of both the nature and quality of the goods. The distinction is not accidental; the licensor must specify both the products and services to be supplied and their quality to receive the protections of the Act. *See* Wehringer, *Trademark Licenses, Control Provided, Control Exercised,* 47 TRADEMARK REP. 287, 298-99 (1957).

78. 15 U.S.C. §1055 (1976) provides: "Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public." Section 1055 raises the question whether a licensor who relies upon the activities of a licensee to satisfy the use requirements prerequisite to registration risks losing ownership of the mark to the *licensee.* Nothing in §1055 excludes licensee first use of the mark. *See* GILSON, *supra* note 2, at 6-5. The spirit and legislative history of the Act, see notes 60, 63, 72, *supra,* appear to oppose such a result, as well as several decisions of the federal courts and patent office. *See* Turner v. HMH Publishing Co., 380 F.2d 224, 229 (5th Cir. 1967) (§5 of the Lanham Act contemplates fulfillment of use requirement through activities of controlled licensees; licensee's first use not an issue); Warner Bros. v. Road Runner Car Wash, Inc., 189 U.S.P.Q. 430, 431-432 (T.T.A.B. 1976) (licensee held to have no independent rights in trademark through licensed use, rights inure to licensor); Mr. Rooter Corp. v. Morris, 188 U.S.P.Q. 392, 394 (E.D. La. 1975) (following *Turner*).

79. 15 U.S.C. §1055 (1976). *Cf.* Reynolds, *Contemporary Problems in Trademark Licensing—Related Company Concepts,* 49 TRADEMARK REP. 1141, 1145-46 (1959) (questioning extent to which United States Patent Office may compel related company applicants to make full public disclosure of their relationship to the licensee).

80. 15 U.S.C. §1127 provides that a trademark is to be deemed "abandoned": "9a) When its use has been discontinued with intent not to resume. Intent not to resume may be inferred from circumstances. Nonuse for two consecutive years shall be prima facie abandonment. (b) When any course of conduct of the registrant, including acts of omission as well as commission, causes the mark to lose its significance as an indication of origin." Furthermore, 15 U.S.C. §1064(c) makes abandonment grounds for cancellation of registration. Uncontrolled licensing of a trademark may constitute an act of omission or commission signifying abandonment. *See* Sterling Drug, Inc. v. Lincoln Laboratories, Inc., 322 F.2d 968, 972 (7th Cir. 1963); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367-68 (2d Cir. 1958). The true test of abandonment is not the actual intent to abandon the mark, which arguably would never be present, but whether the registrant has been so lax in policing the quality of goods to which the mark is affixed that it has lost its significance to the public. *See* Everett O. Fisk & Co. v. Fisk Teachers' Agency, 3 F.2d 7, 9 (8th Cir. 1924).

81. Cancellation by reason of abandonment is not within the general five year incontestability provisions of 15 U.S.C. §1064. See note 71 *supra.*

licensor must exercise it, or the standard under which its exercise by the licensor should be reviewed by courts.[82] Decisions have made clear, however, that the Act requires actual control, rather than mere paper controls as they appear in the license agreement.[83]

The Lanham Act and Agency Principles

The requirements of the Lanham Act have led franchisors[84] and a few commentators[85] to suggest that the use of traditional agency control analysis to determine the vicarious liability of franchisors is inequitable. The argument is that the franchisor is placed in a dilemma: whether to exercise control sufficient for Lanham Act purposes at the risk of vicarious liability, or to eschew controls and risk a judicial determination of trademark abandonment.[86] The alleged dilemma is unconvincing for two reasons.[87] First, it ignores the extreme aversion which the federal courts have long displayed toward abandonment claims against registered trademarks.[88] Because abandonment works a forfeiture upon the trademark owner, the party invoking the doctrine, whether offensively[89] or defensively[90] bears a strict burden of proof.[91] Second, and more im-

82. The Act seeks to impose only a general imperative of quality control. *Cf.* National Lampoon, Inc. v. American Broadcasting Cos., 376 F. Supp. 733, 750 (S.D.N.Y. 1974) (characterizing plaintiff's magazine as "trash," but nonetheless recognizing its consistent "product quality"), *aff'd*, 497 F.2d 1343 (2d Cir. 1974).

83. *See* Professional Golfers Ass'n of America v. Bankers Life & Cas. Co., 514 F.2d 665, 668-69 (5th Cir. 1975) (trademark license inferred from main agreement between parties); Land O'Lakes Creameries, Inc. v. Oconomowoc Canning Co., 330 F.2d 667, 670 (7th Cir. 1964) (oral license held sufficient controls); National Lampoon, Inc. v. American Broadcasting Cos., 376 F. Supp. 733, 737 (S.D.N.Y.) (controls need not be specified in formal agreement, but mere paper controls insufficient), *aff'd*, 497 F.2d 1343 (2d Cir. 1974); Burger King of Florida, Inc. v. Brewer, 244 F. Supp. 293, 298 (W.D. Tenn. 1965) (no requirement that specific agreement be present or that royalties be paid for use of trademark under license).

84. *See, e.g.*, Beck v. Arthur Murray, Inc., 245 Cal. App. 2d 976, 981, 54 Cal. Rptr. 328, 331 (1966) (rejecting use of Lanham Act control requirement of defense); Porter v. Arthur Murray, Inc., 249 Cal. App. 2d 410, 420, 57 Cal. Rptr. 554, 561 (1967) (rejecting Lanham Act defense); Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 615-16, 56 Cal. Rptr. 728, 732 (1967). *Cf.* Drexel v. Union Prescription Centers, Inc., 582 F.2d 781, 786 n.5 (3d Cir. 1978) (court notes possible relevance of Lanham Act not put in issue by either party).

85. *See* BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 100-04; Comment, *The Franchisor As "Seller" Under Strict Liability in Tort—Kosters v. Seven-Up Co.*, 28 DE PAUL L. REV. 1105, 1116 (1979).

86. See notes 80 and 81 *supra*.

87. Although 15 U.S.C. §1127 raises a presumption of abandonment from two consecutive years of non-use, the presumption may easily be rebutted by a showing of special circumstances negativing intent to abandon. *See, e.g.*, American Lava Corp. v. Multronics, Inc., 461 F.2d 836, 840 (C.C.P.A. 1972).

88. *See, e.g.*, American Foods, Inc. v. Golden Flake, Inc., 312 F.2d 619, 624-25 (5th Cir. 1963); E.I. du Pont de Nemours & Co. v. Celanese Corp. of America, 167 F.2d 484, 489 (C.C.P.A. 1948); Tisch Hotels, Inc., v. Atlanta Americana Motor Hotel Corp., 254 F. Supp. 743, 750 (N.D. Ga. 1966).

89. *See, e.g.*, Sutton Cosmetics (P.R.), Inc. v. Lander Co., 170 U.S.P.Q. 461 (S.D. N.Y. 1971) (injunctive action); La Maur, Inc. v. Block, 176 U.S.P.Q. 218 (T.T.A.B. 1972) (application for trademark registration).

90. *See, e.g.*, Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena, 293 F. Supp. 892, 917 (S.D.N.Y.

portant, the argument assumes that every control device created by franchisors and inserted in franchise agreements serves the cause of trademark protection. In fact, the controls in the typical modern franchise agreement extend far beyond those necessary for trademark protection.

The traditional control test for vicarious liability is not unfair to franchisors because, as the court in *Oberlin v. Marlin American Corp.*[92] observed, the Lanham Act does not create a federal law of agency.[93] In *Oberlin*, a subfranchisee sought to hold a franchisor liable for the fraud of a distributing franchisee.[94] The plaintiff argued that the Lanham Act's imposition on the franchisor of a duty to supervise the distributing franchisee's activities created the relationship of principal and agent between the two parties.[95] The court rejected this contention, holding that the duty of a licensor to control product quality for purposes of trademark protection did not compel a finding of franchisor liability under state common law agency principles.[96]

The *Oberlin* court's interpretation of the Lanham Act is consistent with the view of a majority of federal courts finding even de minimis[97] controls sufficient to defend a trademark license against an abandonment challenge.[98] While

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1968), *modified on other grounds and aff'd*, 433 F.2d 686 (2d Cir. 1970), *cert. denied*, 403 U.S. 905 (1971).

91. *Id.*

92. 596 F.2d 1322 (7th Cir. 1979).

93. The *Oberlin* court envisioned a quite narrow purpose for the duty of control imposed by 15 U.S.C. §1055. "The purpose of the Lanham Act, however, is to ensure the integrity of registered trademarks, not to create a federal law of agency." 596 F.2d at 1327.

94. *Id.* at 1324-25. Melabs of California, the co-defendant franchisor, had entered into a fairly common type of franchising agreement under which Marlin American undertook to distribute Melabs' attache telephones. Melabs licensed Marlin American the exclusive rights to market the phones in all but a few states, through the sale of subfranchises to numerous individuals. The plaintiff's husband purchased one of the franchises for $28,000 but learned subsequently that the phones could not be marketed, as Indiana Bell Telephone had no numbers available for them. Upon her husband's death the plaintiff sued upon theories of fraud, breach of contract and conspiracy between Melabs, Marlin and SCM Corp., the entity which had purchased all of Melabs' assets. The plaintiff appealed from directed verdict against her on the question of agency between Melabs and Marlin American. *Id.*

95. The court examined both the controls present in the franchise agreement and the plaintiff's evidence of *de facto* control between Melabs and Marlin American. The latter obligated itself to use best efforts in developing a marketing program for the phones. *Id.* at 1324. Melabs reserved the right to approve all contract forms and to establish the "terms, conditions and prices" to be presented to subfranchisees. There was a provision for assignment of all distributorships established by Marlin American in the event of its bankruptcy. Further, the evidence raised some inference that Melabs exercised approval rights over use of the trademark in advertising materials. *Id.* at 1326.

96. *Id.* at 1327. The court also rejected the plaintiff's theory of agency by estoppel, citing lack of reasonable reliance. *Id.* at n.5.

97. In Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977) (opinion by Goldberg, J.) the court rejected Diversified Packaging's defensive theory of trademark abandonment based upon an alleged lack of controls exercised by Kentucky Fried over its licensees in 47 states. The court observed that "[r]etention of a trademark requires only minimal quality control," although it did not express any opinion concerning the minimal type of controls which would suffice. *Id.* at 387.

98. Judicial examination into the exact nature of sufficient controls is unusual. This reluctance on the part of courts to examine control over Lanham Act related companies

courts have been quick to uphold licensing agreements containing extensive control provisions,[99] many licenses imposing very little control upon licensees have withstood attack.[100] Although the United States Patent Office requires a stricter showing of control as a prerequisite to registration,[101] the modern franchise agreement contains controls in excess of those required either to register or protect an established trademark.[102] The courts have clearly held that the

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typifies cases in which control has been an issue since passage of the Lanham Act. *See* Note, *Trademark Licensing: The Problem of Adequate Control*, 1968 DUKE L.J. 875, 898 (suggests that where courts have struck down licensing arrangements based upon minimal controls, the rationale has been absence of actual, rather than paper, controls between the parties).

Where courts have struck down trademark license agreements in recent cases, the facts have generally reflected a virtually complete absence of control. *See, e.g.*, Haymaker Sports, Inc. v. Turian, 581 F.2d 257, 261-62 (C.C.P.A. 1978); Sheila's Shine Prods., Inc. v. Sheila Shine, Inc., 486 F.2d 114, 124-25 (5th Cir. 1973); Cartier, Inc. v. Three Sheaves Co., 465 F. Supp. 123, 129 (S.D.N.Y. 1979). *Cf.* Robinson v. Plastics Research & Dev. Corp., 264 F. Supp. 852 (W.D. Ark. 1967) (court found abandonment because convinced no quality control retained by licensor; notes that even if control had been retained by parole agreement it would have been unenforceable).

99. *See, e.g.*, Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368, 387 (5th Cir. 1977); Turner v. HMH Publishing Co., 380 F.2d 224, 229 (5th Cir.), *cert. denied*, 389 U.S. 1006 (1967); Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 409 (5th Cir. 1962); Huntington National Mattress Co. v. Celanese Corp. of America, 201 F. Supp. 938, 944-45 (D. Md. 1962) (dictum). *Cf.* E.I. du Pont de Nemours & Co. v. Celanese Corp. of America, 167 F.2d 484, 486-89 (C.C.P.A. 1948) (decided under 1905 Trademarks Act, opinion appears influenced by passage of Lanham Act, two years earlier).

100. *See* Land O'Lakes Creameries, Inc. v. Oconomowoc Canning Co., 221 F. Supp. 576, 581 (E.D. Wisc. 1963), *aff'd*, 330 F.2d 667 (7th Cir. 1964) (refusing to cancel licensing arrangement where *licensee* exercised control over sources of trademarked goods and no showing made that quality of trademarked goods had diminished in almost 40 years); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 368-69 (2d Cir. 1959) (sole evidence of control was the occasional inspections of untrained salesmen); Huber Baking Co. v. Stroehman Bros. Co., 252 F.2d 945, 956-58 (2d Cir.), *cert. denied*, 358 U.S. 829 (1958) (ambiguous licensing contract); Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena, 293 F. Supp. 892, 918 (S.D.N.Y. 1968) (requirement satisfied if licensor has made reasonable inspection and no showing made that any of the goods below some quality standard), *aff'd and modified on damages*, 433 F.2d 686 (2d Cir. 1970); Union Tank Car Co. v. Lindsay Soft Water Corp., 257 F. Supp. 510, 513, 516 (D. Neb. 1966) (some licensees continued use after cancellation; license with others oral). *Cf.* Distillerie Flli Ramazotti v. Banfi Prods. Corp., 151 U.S.P.Q. 551 (Sup. Ct. N.Y. 1966) (license upheld where appeared that licensee sent samples of product to licensor on isolated occasions).

101. *See Ex Parte* Pure Oil Co., 99 U.S.P.Q. 19 (Comm'r 1953). The Commissioner of Patents made clear that "control must be something more than 'paper control,' or 'gentlemen's agreements,' and when others are permitted to use the mark, the Patent Office files should clearly reflect facts which justify a finding that such use inures to the benefit of the applicant." *Id.* at 20. Decisions of the Patent Office, however, have not specifically delineated the nature and extent of controls required. *See, e.g.*, *In re* Celanese Corp. of America, 136 U.S.P.Q. 86, 88 (T.T.A.B. 1962) (written license containing legitimate continuing controls required); Illini Dairy Queen, Inc. v. McCullough's Dairy Queen, 115 U.S.P.Q. 18, 21 (Comm'r 1957) (licensor must have knowledge of those authorized to use the mark and date they acquired such rights); *Ex Parte* Dan River Mills, Inc., 109 U.S.P.Q. 68 (Comm'r 1956) (mere resale agreement insufficient); Baxter Laboratories v. Don Baxter, Inc., 87 U.S.P.Q. 122, 125 (Comm'r 1950) (controls may extend to visual inspection of samples, site inspections at plant where product is manufactured).

102. *See, e.g.*, Drexel v. Union Prescription Centers, Inc., 582 F.2d 781 (3d Cir. 1978). The plaintiff brought a diversity wrongful death action against both franchisee and franchisor

Lanham Act may not be used by franchisors as a defense to liability under the antitrust laws.[103] Similarly, whether very extensive franchisor control over franchisees serves profit or administrative objectives, the requirements of the Lanham Act should not be permitted to shield franchisors from vicarious liability if principles of enterprise responsibility justify such an outcome.

ENTERPRISE THEORY AND FRANCHISING: NEW APPLICATIONS FOR AN ESTABLISHED CONCEPT

The federal circuit court's decision in *Drexel v. Union Prescription Centers*[104] illustrates the application of control analysis to determine the vicarious liability of franchisors for franchisees.[105] The plaintiff brought a diversity wrongful death action[106] against both franchise parties under theories of both actual[107] and apparent agency.[108] Addressing the plaintiff's first theory, the court scrutinized the standard Union Prescription Centers franchise agreement[109] and determined that it exhibited sufficient evidence of the franchisor's

alleging liability on the part of the former under theories of both actual and apparent agency. Addressing the plaintiff's first theory, the court examined in minute detail the standard UPC franchise agreement and determined that sufficient indicia of control or the right of control were present to create a fact question concerning the franchisor's liability. Arguably, various aspects of control retained by UPC went far beyond anything justified by the desire to comply with the Lanham Act. They included the right to designate minimum operating hours for all stores, the styling of employee uniforms and the type of prescription bottle labels to be used. *Id.* at 787-88, 795. Additionally, the working of the franchise agreement itself emphasizes that the desire for trademark protection is merely one factor motivating franchisors to control their franchisees; a more plausible factor is profit. The UPC franchise agreement required the owner to present an appearance like that of any other UPC franchise in order "to maintain . . . national recognition, point of purchase impact and full penetration of promotional opportunities." *Id.* at 795.

103. Timken Roller Bearing Co. v. United States, 341 U.S. 593, 598-99 (1951). The Lanham Act itself, 15 U.S.C. §1115 (1946), makes use of a trademark to violate the antitrust laws a defect capable of rebutting the inference of exclusive right of use otherwise raised by section 1115. *Id.* at (b) (7).

104. 582 F.2d 781 (3d Cir. 1978).

105. *Drexel* specifically concerned vicarious liability for negligence of a franchisee's employee. However, the control analysis employed in cases involving a franchisor's liability on contracts of a franchisee has been virtually identical. *See* Weil v. Arthur Murray, Inc., 67 Misc. 2d 417, 422-23, 324 N.Y.S.2d 381, 387-88 (N.Y. Civ. Ct. 1971); Sheraton Corp. of America v. Kingsford Packing Co., 162 Ind. App. 470, 473-74, 319 N.E.2d 852, 854-57 (1974).

106. The plaintiff's husband was killed when an employee of the franchisee negligently filled a prescription which the decedent had filled previously at the same drugstore without incident. 582 F.2d at 783.

107. *Id.* at 785-90. The court recognized that under Pennsylvania law the question whether the relationship between parties was that of master and servant or independent contractor and contractee depended primarily upon the degree of control or right to control exercised by the alleged master. *Id.* at 785.

108. *Id.* at 790-96. The plaintiff contended that UPC led the public to believe that it was dealing with a "nationally established and uniformly controlled establishment." *Id.* at 790. These representations led the plaintiff's decedent to place his trust in the reputation of the franchise entity of which the franchisor was a part.

109. *Id.* at 786-88. The *Drexel* court observed that there was little evidence that UPC exercised actual control over its franchisee, aside from some testimony by the franchisee that UPC representatives had visited the store, apparently on isolated occasions. *Id.* at 786 n.7.

right to control to present a jury question.[110] Specifically, the court observed a broad franchisor power to impose upon the franchisee virtually any restriction,[111] although there was no evidence this power had actually been exercised.[112]

The *Drexel* court's analysis is a direct descendant of that employed in *Skelly Oil* and similar cases.[113] As with the service station cases, courts have encountered difficulty in categorizing franchise parties along traditional agency lines, and have thus relied heavily upon the control test.[114] A fundamental question, however, is why one business entity should be responsible for the acts of another merely because a right of control exists between them.[115] Enterprise theory was first developed as an attempt to resolve this issue,[116] focusing on whether one business entity has allocated or severed a particular function from itself to another.[117] It has been suggested that courts, when required to categorize parties as principal and agent or contractee and independent contractor, examine the facts of a case for the positioning of four distinct enterprise earmarks.[118] Control over formulation and execution of policy is the first earmark[119] and that most clearly emphasized in the franchising cases. A second

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These visits had concerned labor relations and planning, however, and were unrelated to daily marketing operations. *Id.*

110. *Id.* at 790.

111. *Id.* at 788-89. The court cited the contractual obligations of the franchisee: to do such things as perpetuate an "attractive condition" and "a high degree of cleanliness" about the store. The franchisee was also required to adhere strictly to UPC's "uniformly high standards of service, appearance, quality of equipment and proved methods of operation." *Id.* at 789. While the court could not say that these established a master-servant relationship, they at least created a question to be resolved at trial.

112. See note 109 *supra*.

113. *See, e.g.*, Oberlin v. Marlin American Corp., 596 F.2d 1322 (7th Cir. 1979) (fraud—franchisor control over franchisee insufficient to create jury question of franchisor liability); Kosters v. Seven-Up Co., 595 F.2d 347 (6th Cir. 1979) (products liability—appropriate submission of liability question to jury); Murphy v. Holiday Inns, Inc., 216 Va. 490, 219 S.E.2d 874 (1975) (negligence—franchisor control insufficient to establish jury question); Sapp v. City of Tallahassee, 348 So. 2d 363 (1st DCA), *cert. denied*, 354 So. 2d 985 (Fla. 1977) (negligence—franchisor control sufficient to present jury question); Holland v. Nelson, 5 Cal. App. 3d 308, 85 Cal. Rptr. 117 (1970) (contract—franchisor liable in damages for illegal contract of controlled franchisee).

114. See text accompanying notes 39-51 *supra*. Similar close questions have arisen in connection with the activities of newspaper carriers and other route delivery personnel. *See, e.g.*, Florida Publishing Co. v. Lourcey, 141 Fla. 767, 193 So. 847 (1940) (carrier an independent contractor); Natchez Coca-Cola Bottling Co. v. Watson, 160 Miss. 173, 133 So. 677 (1931) (carrier a servant).

115. *Cf.* Wigmore, *Responsibility for Tortious Acts: Its History (II)*, 7 HARV. L. REV. 383, 404-05 n.2 (1894) (suggesting that master is made liable for servant's acts as a matter of public necessity).

116. *See* Douglas, *Vicarious Liability and Administration of Risk I*, 38 YALE L.J. 584, 594-604 (1929) [hereinafter cited as Douglas I].

117. *Id.* at 595. *Cf.* F. HARPER & F. JAMES, *supra* note 23, at 1401 (suggests that the allocation, or "lopping off" of enterprise function must be in good faith and not belied by actions of the parties in fact).

118. Douglas I, *supra* note 116, at 595.

119. *Id.* Indeed, it might be argued that insofar as franchising is concerned control has

earmark is placement of title to the premises at which the activity was conducted.[120] Ownership by the party whose negligent conduct caused the loss argues in favor of independent contractor status.[121] The third and fourth earmarks, right to profits[122] and risk of loss,[123] reflect the conviction of courts that the true entrepreneur operates in the market place at his own risk, but receives rewards commensurate with his risks.[124] Once the court has identified the distribution of these earmarks, the party having the greatest number is held liable as the entrepreneur.[125]

The difficulty in applying the tests of enterprise liability to the franchise relationship is that the distribution of earmarks may be unclear or in equipoise. The franchisor may exercise extensive control over the quality of the product sold,[126] yet leave broad discretion over daily operations to the franchisee.[127] Franchise agreements vary considerably concerning responsibility for location and construction of the franchised premises.[128] For example, while the franchisor may own the site, leasing it to the franchisee,[129] the franchisor may alternatively provide that the franchisee procure a lease on the site of a pre-

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eclipsed the other factors entirely. Thus, control has risen from the status of one factor in the calculus of enterprise liability to that of an independent test.

120. *Id.* This concept is inherent in RESTATEMENT (SECOND) OF AGENCY §220(e) which sets up as one test of servanthood whether the "instrumentalities, tools and the place of work" are supplied to one party by another. RESTATEMENT (SECOND) OF AGENCY §220(2)(e) (1958).

121. Douglas I, *supra* note 116, at 595. RESTATEMENT (SECOND) OF AGENCY §220, comment (k) (1958) indicates that the fact that a worker supplies his own tools or instrumentalities is "some evidence that he is not a servant," although it is only of evidential value.

122. Douglas I, *supra* note 116, at 595-96. *See also* RESTATEMENT (SECOND) OF AGENCY §220 (1958). The restatement indicates that method of payment, whether by job or by time, is a test of servanthood, with payment by the job cutting in favor of status as independent contractor. As payment by the job implies a right to profits over materials and labor, the profit earmark seems implicit in the subsection. *Cf. id.* comment j (appears to indicate that importance of method of payment lies in its usefulness as index of employer's control over activities contracted for).

123. Douglas I, *supra* note 116, at 595. *Cf.* RESTATEMENT (SECOND) OF AGENCY §220(b) (1958) (establishing as one test for servanthood whether the one employed is engaged in a distinct business or occupation).

124. *Cf.* Farmers Elevator Co. of Reserve v. Pheister, 153 Mont. 152, 156, 455 P.2d 325, 327-28 (Mont. 1969) (question for jury whether agency to be inferred from acts of one business party indicating a willingness to protect profit margin of the other).

125. Douglas I, *supra* note 116, at 596-97. Professor Douglas observed that although the allocation of earmarks was generally clear, such was not invariably the case. He was convinced, however, that the outcome of cases in which the issue was the independent contractor status of a party could be predicted on the basis of a simple plurality distribution of the enterprise earmarks.

126. See text accompanying notes 63-103 *supra*.

127. *See, e.g.*, Beck v. Arthur Murray, 245 Cal. App. 2d 976, 977-78, 54 Cal. Rptr. 328, 329-30 (1966); Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 615-16, 56 Cal. Rptr. 728, 732-33 (1967) (both courts observing division of controls between franchisors and franchisees).

128. *See* H. BROWN, *supra* note 4, at 22. Similar variation appears regarding ownership of the signs, fixtures, furniture and equipment used in operation of the franchised business.

129. *See, e.g.*, Carpa v. Ward Foods, Inc., 536 F.2d 39, 44 (5th Cir. 1976). The franchisee in that case agreed that all furnishings as well would be procured by the franchisor or his agent. *See also* BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 25.

approved location.[130] The earmarks of profit and loss may be equally ambiguous. While the franchisee bears the obvious risk of failure through forfeiture of his franchise fee and accumulated efforts,[131] the franchisor has an undeniable investment in the franchisee's training[132] and the royalties which accrue from each franchisee's continued success.[133]

Given the ambiguity surrounding allocation of the traditional enterprise earmarks among parties to a business franchise, it is hardly surprising that courts have differed concerning the franchisee's status as servant, agent or independent contractor.[134] The usual response, in fact, is to avoid ruling as a matter of law and instead leave the question of agency for the jury.[135] This approach may follow a mechanical enumeration of controls as they appear in the franchise agreement, with little effort to determine the relevance of the controls to the loss which actually occurred.[136] For example, there seems little reason why a franchisor's control over the quality of ice cream mix should condition his liability for negligent repair of the premises by the franchisee.[137] Similarly, a franchisor's control over the fixtures of a drugstore have little relevance to the question of his liability for a carelessly filled prescription.[138] A strictly quantitative examination of controls, as a preliminary to throwing the ultimate decision of agency before the jury, allows a court to avoid the responsibility of construing franchise agreements[139] and arriving at the decision of liability

130. *See, e.g.*, Drexel v. Union Prescription Centers, Inc., 582 F.2d 781, 799-800 (3d Cir. 1978). Furthermore, the franchisor commonly leases from a third party and subleases to the franchisee. H. BROWN, *supra* note 4, at 68.

131. *See, e.g.*, Milsen Co. v. Southland Corp., 454 F.2d 363, 367-68 (7th Cir. 1972). The *Milsen* plaintiffs were confronted with loss of their businesses for refusal to comply with what they considered to be the franchisor's anticompetitive activities. *Id.*

132. J. FELS, *supra* note 4, at 7. *Cf.* Sheraton Corp. v. Kingsford Packing Co., 162 Ind. App. 470, 473-74, 319 N.E.2d 852, 854 (1974) (franchisor obligates self to provide extensive planning, promotion and procurement activities in connection with opening of franchised hotel). The franchisor's interest in an efficient, willing franchisee is particularly obvious where the franchise is of the so-called "turn-key" variety. In this case, the franchisor prepares every aspect of the business for the franchisee's arrival, so that the franchisee steps into a prefabricated business operation. See BROWN, *supra* note 4, at 69, n.40.

133. *See* Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368, 375 (5th Cir. 1977).

134. Very slight differences in pleadings and evidence may change an outcome under the control test, particularly where the issue is whether to grant summary judgment for the franchisor. *Compare* Murphy v. Holiday Inns, Inc., 216 Va. 490, 219 S.E.2d 874 (1975) (summary judgment granted where control over daily activities of franchisee deemed insufficient to establish master-servant relationship) *with* Hayward v. Holiday Inns, Inc., 459 F. Supp. 634 (E.D. Va. 1978) (summary judgment denied, under facts virtually identical to *Murphy* where plaintiff indicated ability to prove controls outside of franchise agreement).

135. *See, e.g.*, Billops v. Magness Constr. Co., 391 A.2d 196 (Del. 1978) (jury question whether franchise agreement established agency); Wood v. Holiday Inns, Inc., 508 F.2d 167 (5th Cir. 1975).

136. *See* Drexel v. Union Prescription Centers, Inc., 582 F.2d 781, 786-88 (1978).

137. *Cf.* Singleton v. International Dairy Queen, 332 A.2d 160, 161 (Del. Super. Ct. 1975) (ice cream mixes subject to franchisor regulation).

138. 582 F.2d at 787.

139. As a general principle it is for the courts to construe contracts as a matter of law. *See* Pentecostal Holiness Church, Inc. v. Mauney, 270 So. 2d 762, 769 (Fla. 4th D.C.A. 1972).

based upon principles of enterprise theory. The decision that a franchisor is to be liable for a franchisee's act, based only on an enumeration of unrelated controls, serves only to encourage arbitrary and conflicting results.

The better alternative is for courts to recognize the function of the control test as an analytical device to determine whether franchise parties effected an actual severance of responsibility for tort or contract liability.[140] The body of principles known as risk administration is useful as a guide in this respect and focuses on two major issues.[141] The first is whether the burden of a loss falls on franchisor or franchisee from the perspective of relative ability to distribute losses. The second concerns the allocation of loss to franchisor or franchisee based on relative ability to prevent losses.

FRANCHISOR LIABILITY FROM A RISK DISTRIBUTION PERSPECTIVE

The law of torts seeks to compensate the injured[142] by shifting the burden of loss to the tortfeasor through the imposition of damages.[143] Before the general use of liability insurance, this principle achieved the compensation objective only imperfectly.[144] The advent of insurance in the latter nineteenth century,[145] however, provided not only the means by which to guarantee the injured victim a recovery,[146] but the ability to distribute accidental losses over a larger portion of society.[147] The insured tortfeasor, then, becomes a conduit for

Thus if a plaintiff sued the franchisor alleging that the franchise contract itself established an agency it would be for the court to decide the issue. On the other hand, if the plaintiff alleged controls outside the agreement or that the contract was ambiguous the facts would have to be found by the jury and summary judgment would be inappropriate. A similar question for the jury would be presented if the plaintiff alleged liability under a claim of apparent authority. *See, e.g.*, Sapp v. City of Tallahassee, 348 So. 2d 363, 367 (Fla. 1st D.C.A. 1977) (possibility of dealings outside the franchise contract); Duluth Herald & News Tribune v. Plymouth Optical Co., 286 Minn. 495, 176 N.W.2d 552 (1970) (apparent authority theory employed against franchisor).

140. See text accompanying notes 115-125 *supra*.

141. Douglas I, *supra* note 116, at 587-88. Professor Douglas first employed the term in analysis of the problem of "frolic and detour" in the context of vicarious liability of the master where the negligent servant deviates beyond the scope of his employment. He recognized four distinct principles within the rubric of risk administration: avoidance, prevention, shifting, and distribution of losses arising from the servant's negligent torts.

142. *See* W. PROSSER, LAW OF TORTS 143-44 (4th ed. 1971). J. SALMOND, LAW OF TORTS 545 (16th ed. 1973).

143. *Cf.* F. HARPER & F. JAMES, *supra* note 23, at 761-62 (1956) (tort liability viewed as shifting a loss from person suffering it to one causing it).

144. The uninsured tortfeasor, against whom judgment cannot be executed, remains a source of conflict between the fault principle and the compensation objective of tort law.

145. *See* Douglas I, *supra* note 116, at 591.

146. *See* F. HARPER & F. JAMES, *supra* note 23, at 763-64.

147. *Id.* at 763. The mere shifting of a loss produces little societal benefit, outside of possibly assuaging some cause of moral outrage against the negligent tortfeasor. On the other hand "if a certain type of loss is the more or less inevitable by-product of a desirable but dangerous form of activity it may well be just to distribute such losses among all the beneficiaries of the activity though it would be unjust to visit them severally upon those individuals who had happened to be the faultless instruments causing them." *Id.* Although this principle applies most clearly where social insurance legislation has instituted a system of

the compensation of the injured.[148] The costs occasioned by the injury fall upon the insurer, who in turn increases premiums among policyholders facing similar risks by an amount sufficient to cover his out-of-pocket payments and to maintain a certain profit margin.[149]

Society realizes a number of gains from the consequent spreading of losses beyond the tortfeasor and victim. The victim benefits from the guaranteed payment by the insurer.[150] The tortfeasor benefits from substitution of the predictable costs of insurance for the risk of a ruinous judgment.[151] This system ameliorates the economic hardship which would be worked by casting the burden of compensation upon a single individual by distributing the loss in small portions over many persons.[152]

The capacity to spread losses beyond the tortfeasor to consumers and other capital holders has been a primary justification for enterprise liability. Directly related to this proposition is the thesis that the loss-spreading aspect of enterprise liability causes an efficient allocation of societal resources through the price system.[153] This theory assumes that consumers generally exercise purchasing power in their own best interests,[154] but correctly perceive these interests only when products reflect their total cost to manufacture and distribute.[155] When prices fail to incorporate the expense of paying losses, or of insuring against losses which occur in producing goods and services, a misallocation of resources occurs to the extent consumers demand products which would not have been desired at a loss-adjusted price.[156] Insofar as risk distribution ability

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liability without fault, such as workers' compensation, it may also be applied where mandatory or widespread use of insurance is the rule.

148. *Id.*

149. *See generally* Kulp, *The Rate-Making Process in Property and Casualty Insurance — Goals, Technics and Limits,* 15 LAW & CONTEMP. PROB. 493 (1950); Morris, *Enterprise Liability and the Actuarial Process — The Insignificance of Foresight,* 70 YALE L.J. 554, 560-83 (1961).

150. *See generally* Corstvet, *The Uncompensated Accident and its Consequences,* 3 LAW & CONTEMP. PROB. 466 (1936).

151. *See* F. HARPER & F. JAMES, *supra* note 23, at 763 n.7 (1956). This factor, in turn, removes a detriment to engaging in dangerous, but societally beneficial conduct.

152. This proposition is a variant of the theory of diminishing marginal utility of money. Because the first dollar of a person's income is most valuable, and each dollar thereafter less so, greater economic disutility results from depriving a single person of a thousand dollars than from depriving a thousand persons of a dollar each. Diminishing marginal utility no longer enjoys the vogue among economists that it did once; studies have indicated that even a small loss may effect a discomfiting perception of hardship if it causes a change in living style relative to some previous standard. *See* Friedman & Savage, *The Utility Analysis of Choices Involving Risk,* 56 J. POL. ECON. 279 (1948).

153. Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts,* 70 YALE L.J. 499, 502 (1961).

154. *Id.* at 502. Professor Calabresi suggested that assumption was in the nature of a "fundamental ethical postulate." In his words, "by and large people know what is best for themselves. If people want television sets society should produce television sets; if they want licorice drops, then licorice drops should be made." *Id.*

155. *Id.*

156. *Id.* at 503. A similar result would follow if an excise tax on food were applied to subsidize production of concrete. Other factors equal, the price of concrete would decline, stimulating demand for greater quantities of the product.

is concerned, then, vicarious liability arises not from the master's fault,[157] but because he, rather than the servant, is capable of secondary loss-spreading through insurance, and of causing the price of products to reflect their costs in terms of human life and injury.[158]

In the franchise setting, it might initially appear that holding the franchisor liable for the franchisee's contracts or negligence would always effectuate the broadest spreading of losses.[159] The chain department stores situation is an attractive analogy. A large-scale merchandiser with hundreds of retail outlets is in a position to purchase insurance for the entire chain at a relatively advantageous rate.[160] The costs of insuring against accidents which occur with a certain degree of frequency may be calculated and distributed over the prices charged for merchandise in all stores.[161] If an employee of one store negligently injures a customer, the insurer compensates the victim and increases the chain's premiums by an amount derived from the level of risk which the insurer associates with the chain.[162]

Holding the franchisor liable for the negligence of a franchisee by analogy to the risk spreading capabilities of a chain merchandiser, however, ignores the business realities of franchising. Typically, the franchisee procures his own insurance[163] and, indeed, may be required in the franchise agreement to name the franchisor as an insured.[164] The insurer, in turn, presents the franchisee

157. An analogy to the theory of workers' compensation is appropriate. Such a social insurance system requires liability without fault, an assurance that the amount theoretically due will be paid and wide distribution of resulting payments for injuries. *See* F. HARPER & F. JAMES, *supra* note 23, at 763-64. The idea that tort recovery punishes the morally reprehensible tortfeasor gives way to the compensation principle almost entirely.

158. Calabresi, *supra* note 153, at 505.

159. The temptation to view the franchisor as a deep pocket is strong, particularly where very large tort recoveries are at stake. The fact that the franchisor operates at a more general level of business sophistication than the franchisee, however, does not compel a conclusion that the former is the superior loss-spreader. J. FELS, *supra* note 4, at 48; BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 102-03.

160. Because the number of outlets in the chain is large, the insuror may obtain a fairly accurate forecast of the kinds of tort risks facing stores by geographical region. *See* Morris, *supra* note 149, at 566. The corporate office is thus in a position to negotiate relatively lower insurance rates based upon the greater accuracy with which the insuror may predict the probability of paying for losses. This in turn causes the price of goods sold to more accurately reflect their true cost with a minimum of distortion attributable to high-cost insurance. *See* Calabresi, *supra* note 153, at 506.

161. Critics of the theory of risk distribution base their attacks, in part, upon the credibility of this assumption. Among competitive firms, such as department stores or fast-food restaurants, it is uncertain to what extent prices can be substantially raised without decreasing sales. *See* Morris, *supra* note 149, at 585. However, to the extent that firms within an industry appear to face similar long-run risks, insurance costs for all firms within a market would be relatively the same. Perhaps the idea of risk distribution should be accepted with the caveat that sweeping economic generalizations are sometimes difficult to justify.

162. *Id.* at 569-74, 585 (discussing procedure by which product liability rates are determined by the insuror).

163. *See* Drexel v. Union Prescription Centers, Inc., 582 F.2d 781, 803 (3d Cir. 1978); BUSINESS AND LEGAL PROBLEMS, *supra* note 1, at 89. The UPC franchise agreement specified that the franchisee was responsible for maintaining both general liability coverage and pharmacist's professional liability insurance in specified amount. 582 F.2d at 803.

164. *Id.* The Union Prescription Center agreement specified that, irrespective of the

with a premium based upon its experience with a number of similar businesses in the same area.[165] The franchisee is thus placed in the primary position to effect secondary loss-spreading through insurance.[166] The question remains, however, whether a franchisor could distribute losses if a court did impose liability.

The burden of loss should shift to the franchisor only if he is in a position to defray the cost of paying or insuring against it, and further, if by doing so he causes the price of goods marketed by the system to reflect their risk allocated value.[167] These requirements will effect both the broadest possible spreading of losses and an efficient allocation of society's resources.[168] Conceivably, the franchisor could accomplish these objectives in either of two ways.

First, the franchisor could require all franchisees to raise prices by an amount sufficient to offset the franchisor's increased risks.[169] The price increase would benefit the franchisor through his royalty share. A franchisee price increase without some kind of profit participation by the franchisor would be irrelevant for loss distribution purposes, for without the revenue incentive the increase would not be motivated by the franchisor's losses or risk of losses. Thus, the combination of direct control over prices charged by franchisees and a royalty share of profits would make it proper to hold a franchisor liable for losses incurred by a franchisee.[170]

Second, the franchisor could require the franchisee to purchase necessary raw materials and supplies exclusively from the franchisor at an increased price.[171] The higher costs would induce a corresponding increase in franchisee

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company with which the franchisee insured, the franchisor was to be given coverage under the policy. *Id.*

165. *See* Morris, *supra* note 149, at 564-65.

166. See notes 157-161 *supra*.

167. A question arises concerning the propriety of charging the franchisor with liability for the contracts of a franchisee, risks which are by nature uninsurable. In such cases, the franchisor can make provision for losses by becoming a self-insuror, setting up a reserve against contractual claims. Further, contract losses tend to be relatively small in relation to tort losses, so the liability fund would not require great amounts of capital to be tied up against uncertain risks. *See* Note, *Liability of the Franchisor for Acts of the Franchisee*, 41 So. CAL. L. REV. 143, 156 (1967).

168. *Id.* at 155.

169. *See* Douglas, *Vicarious Liability and Administration of Risk II*, 38 YALE L.J. 720, 728-29 (1929) [hereinafter cited as Douglas II]. Professor Douglas directed his analysis toward the determination whether a given party should be held liable for the affairs of a partnership; however, it does no violence to his reasoning to employ it in connection with franchising. The focus, whether a party sought to be held liable is in a position to distribute losses, transcends any particular type of business organization.

170. *Id.* at 728. Other forms of control frequently considered by courts are thus irrelevant to the problem of risk distribution by the franchisor. Thus, the strongest case for holding the franchisor liable occurs where the latter received substantial royalties from a franchisee, the size of which were within the franchisor's direct power to control through manipulation of the prices charged by the franchisee.

171. Such requirements commonly occur in franchising, particularly where the franchisee must do extensive processing to produce the finished product. *See, e.g.*, Smith v. Denny's Restaurants, Inc., 62 F.R.D. 459 (N.D. Cal. 1974); *In re* 7-Eleven Franchise Anti-trust Litigation, 1974-2 CCH TRADE CASES ¶75,429 (N.D. Cal. 1974).

prices, which again would reflect the franchisor's loss or risk of loss. Therefore, a second type of control relevant to the question of franchisor liability from a loss distribution perspective is control by the former over the franchisee's costs.[172] Significant control in this respect would argue strongly for holding the franchisor liable where the franchisee injures a third party or breaches a contract. The franchisor's power of control in both ways has been limited by the antitrust laws, which must therefore be examined to determine whether a franchisor possesses any significant loss-spreading capacity.[173]

Control Over Franchisee Prices — Resale Price Maintenance Agreements

The most direct means by which a franchisor might control the prices of franchisees is also the most obvious violation of the Sherman Act.[174] An agreement between franchisor and franchisee under which the latter agrees to observe prices set by the former constitutes a resale price maintenance agreemen,[175] long recognized by the courts as a per se violation of section 1 of the Sherman Act.[176] The policy behind this severe view is to encourage freedom among retailers to set prices in response to local competitive pressures, thereby

172. *Cf.* Doulglas II, *supra* note 169, at 729 (suggesting that control over costs of partnership relevant to determination of whether one is a partner).

173. *See generally* L. SULLIVAN, ANTITRUST 399-411, 423-31 (1977); D. THOMPSON, FRANCHISE OPERATIONS AND ANTITRUST (1971).

174. 15 U.S.C. §§1-7 (1976). Section 1 renders illegal "[e]very contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several States, or with foreign nation. . . ."

175. *See, e.g.*, Dr. Miles Medical Co. v. John D. Parte & Sons Co., 220 U.S. 373 (1911). Thus, a clause inserted in a franchise trademark licensing agreement requiring that the franchisee abide by price announcements would constitute a contract in restraint of trade for purposes of Section 1.

176. Because virtually every agreement concerning commercial relations restrains trade to some extent, the Supreme Court has read into the Sherman Act a "rule of reason." Adopted from the common law concept of "restraint of trade" which was in effect at the time the Sherman Act was enacted, the rule states that the Act proscribes only agreements which adversely affect the public interest by unduly restraining competition either inherently or because of their evident purpose. *See, e.g.*, United States v. American Tobacco Co., 221 U.S. 106, 179-80 (1910). The rule of reason requires that a court confronted with an antitrust case determine the facts peculiar to the particular firm involved, to determine whether a particular agreement or combination at issue was intended to serve good business purposes, or to monopolize. If the former is found to be the case, the standard to be applied is whether the adverse effect upon competition in the marketplace is more than trivial. *See* L. SULLIVAN, *supra* note 173, at 171-82.

On the other hand, certain forms of trade restraints have been held unreasonable per se. For example, agreements which exercise a deleterious effect upon commerce, and are without redeeming social value are conclusively presumed to be illegal. Thus, where a court finds price-fixing activity, no further inquiry is made concerning the effect of the practice upon the market or the intention of the parties. *See* United States v. McKesson & Robbins, 351 U.S. 305, 309-10 (1956). The determination of per se unreasonableness further eliminates the need for complex and prolonged economic investigation of the history of the enterprise alleged to have violated the Sherman Act. *See* Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958).

rendering prices less rigid than would be the case if manufacturers alone fixed prices.[177]

The abhorrence of price maintenance agreements exhibited by antitrust law does not mean that a manufacturer of goods is wholly powerless to influence the prices of a retailer, or a franchisor to influence the prices of a franchisee. In *United States v. Colgate*,[178] the United States Supreme Court held that the Sherman Act did not prevent a seller of goods from announcing to a retailer the prices at which the goods were to be sold and refusing to deal if the price was not observed.[179] As long as the seller exercised his choice unilaterally, and not in concert with buyers[180] or other sellers,[181] the refusal to deal would not constitute an antitrust violation even if its practical effect were to impose a resale price maintenance agreement.[182]

Pragmatically, however, the strict construction of the *Colgate* doctrine employed by courts since its inception renders it virtually useless as a means for franchisors to fix the prices of franchisees by way of loss distribution.[183] Although the franchisor may suggest a price at which products should be sold, it may not coerce the franchisee by threats of termination,[184] nor may it engage in arrangements with other franchisees to police or monitor compliance with the suggested price.[185] Further, the franchisor who enters competition with the franchisee in order to enforce a suggested price,[186] or who even makes known

177. *See* Sullivan, *supra* note 173, at 387-88. Further, more efficient dealers might achieve cost efficiencies which would permit them to sell at lower prices than their less efficient counterparts.

178. 250 U.S. 300 (1919).

179. *Id.* at 307.

180. *See* Albrecht v. The Herald Co., 390 U.S. 145 (1968) (Sherman Act violated where publisher entered agreement with competitor of plaintiff to coerce plaintiff into abiding by suggested price for newspapers).

181. *See* United States v. Parke, Davis & Co., 362 U.S. 29 (1960) (Sherman Act violated where manufacturer combined with wholesalers to coerce retailers in obeying suggested retail price).

182. A similar result would occur if the manufacturer chose simply to "integrate forward" by converting all retailers from independent dealers into outlets of a wholly-owned chain. *See, e.g.*, Loren Specialty Mfg. Co. v. Clark Mfg. Co., 241 F. Supp. 493 (N.D. Ill.), *aff'd*, 360 F.2d 913 (7th Cir. 1965), *cert. denied*, 385 U.S. 957 (1966).

183. Much of the litigation in which the issue arises involves franchise terminations. The dealer may allege that his franchise was terminated because of failure to comply with an illegal resale price maintenance provision. *See* L. SULLIVAN, *supra* note 173, at 394-95.

184. *Cf.* Simpson v. Union Oil Co. of Cal., 377 U.S. 13, 20-23 (1964) (Sherman Act violated where oil company refused to renew leases of dealers who refused to obey suggested resale prices); United States v. Toyota Motor Sales U.S.A., Inc., 1975-1 CCH TRADE CASES ¶65,695 (N.D. Cal. 1975) (consent decree enjoining franchisor from enforcing suggested resale price by threat of termination); The Magnavox Co., 78 F.T.C. 1183 (1971) (similar consent decree). *But see* Davison v. Crown Cent. Petroleum Corp., 1977-1 CCH TRADE CASES ¶61,277 (D. Md. 1976) (mere allegation that field representative of franchisor recommended termination insufficient to establish coercion); Chock Full O'Nuts, Inc., 83 F.T.C. 575 (1973) (insufficient evidence of coercion where no evidence that franchisor enforced resale price provisions in several franchisee contracts).

185. *Cf.* FTC v. Beech-Nut Packing Co., 257 U.S. 441, 448 (1922) (manufacturers and wholesalers).

186. *Cf.* Albrecht v. The Herald Co., 390 U.S. 145 (1965) (publisher — independent distributor).

the fact that termination is likely to follow price-cutting, has violated the Sherman Act.[187] Thus, it appears highly unlikely that the franchisor could directly influence franchisee prices in order to cover the costs of insuring or paying losses without hazarding the risk of Sherman Act liability.

Control Over Franchise Costs — Tying Agreements

Although the Sherman Act's proscription of resale price maintenance prevents the franchisor from exercising direct control over prices charged by the franchisee to the public, it precludes only direct price loss-spreading. The franchisor might instead opt to increase prices for materials and services to the franchisee, who would in turn raise prices to retain profit margins and effect an eventual secondary spreading of losses. This, however, is also rendered impractical by the antitrust laws.

Sales of goods and services to franchisees by franchisors is a quite common practice, but the franchisor must carefully avoid restrictions against the practice known as tying imposed by courts under section 1 of the Sherman Act[188] and section 3 of the Clayton Act.[189] A tie-in agreement occurs when one party contracts to sell a product which another party wishes to buy, but only on the condition that the latter purchase an additional, unwanted product as well. The first product is known as the tying product, the second as the tied product.[190] In addition to the requirement of two distinct products, a tie-in becomes illegal for Sherman Act purposes if three other elements coalesce: the seller refuses to sell one product apart from the other;[191] the seller exercises sufficient economic power over the tying product to restrain free competition in the market for the tied product;[192] and the arrangement affects interstate commerce substantially in the market for the tied product.[193] An agreement may be illegal under section 3 of the Clayton Act if it incorporates both the two-product and refusal to deal requirements and either of the latter two elements.[194]

187. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365, 375-76 (1967) (*Colgate* doctrine could not be invoked where franchisor led franchisees to understand that failure to follow suggested prices would lead to termination); Canadian American Oil Co. v. Union Oil Co. of Cal., 1978-1 CCH TRADE CASES ¶61,910 (9th Cir. 1978) (allegation stated antitrust violation where dealers made aware that termination would follow failure to observe suggested minimum price).

188. See note 174 *supra*.

189. 15 U.S.C. §§12-27 (1976).

190. *See* United States v. Loew's, Inc., 371 U.S. 38 (1962); IBM Corp. v. United States, 298 U.S. 131 (1936); Kugler v. AAMCO Automatic Transmissions, Inc., 460 F.2d 1214 (8th Cir. 1972). In cases involving franchise tie-ins, the tying product is usually the trademark while the tied product may be equipment or supplies. *See, e.g.*, Siegal v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir.), *cert. denied*, 405 U.S. 955 (1971).

191. *See, e.g.*, Carpa, Inc. v. Ward Foods, Inc., 536 F.2d 39, 47 (5th Cir. 1976) (seafood products tied to trademark of restaurant franchise).

192. *See, e.g.*, Ungar v. Dunkin Donuts of America, Inc., 531 F.2d 1211, 1222 (3d Cir. 1976), *cert. denied*, 429 U.S. 823 (1976); Warriner Hermetics, Inc. v. Copeland Refrigeration Corp., 463 F.2d 1002, 1012 (5th Cir.), *cert. denied*, 409 U.S. 1086 (1972).

193. *See, e.g.*, Susser v. Carvel Corp., 332 F.2d 505, 512 (2d Cir. 1964) (Sherman Act); Siegal v. Chicken Delight, Inc., 448 F.2d 43, 52 (9th Cir.), *cert. denied*, 405 U.S. 955 (1971).

194. *See* Crawford Transport Co. v. Chrysler Corp., 338 F.2d 934, 936 (6th Cir. 1964).

Tie-ins, which may be shown either from the franchise agreement[195] or from evidence of the relations of the parties,[196] were once common in franchising systems. For example, a fast-food franchisor might condition use of its trademark upon continuing purchases by the franchisee of cooking equipment, foodstuffs and paper goods.[197] In such fashion the franchisor could guarantee a market for its own products at whatever prices it chose to deal. Such an agreement, however, has been identified as an illegal tie-in if the franchisor refuses to permit the franchisee to purchase its requirements from suppliers other than the franchisor.[198] While the franchisor is entitled to protect the quality of the product ultimately sold under trademark, he must do so through means least restrictive to competition.[199] Typically, quality control may be achieved by requiring all products and supplies obtained from other sellers to meet explicit standards.[200]

The Fifth Circuit's decision in *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*[201] illustrates the type of arrangement held by courts not to impose a tie-in. The franchisor sued a manufacturer of paper goods on a charge of trademark infringement. The defendant counterclaimed that the franchise agreement, which required franchisees to purchase trademarked paper and plastic goods only from the franchisor or "approved suppliers," constituted an illegal tie of the supplies to the trademark.[202] In rejecting the tie-in allegation, the circuit court noted a distinction between coercing franchisees to purchase exclusively from the franchisor and requiring them to purchase only from sources requiring pre-approval for quality control purposes.[203]

The "approved sources" doctrine seriously weakens the ability of franchisors to distribute losses over the prices of products sold to franchisees. Because the franchisor is only one supplier among many others competing for the franchisee's business it faces the demand curve of firms in pure competition.[204] Consequently, the franchisor has little power to raise prices above that charged by other sellers in the market unless it accepts a serious loss of competitive position and a decline in sales.[205] Yet this is exactly what a franchisor must do if required to include in its prices the expense of insuring or paying losses incurred by franchisees. Alternatively, the franchisor might choose simply to

195. *See, e.g.*, Susser v. Carvel, 332 F.2d 505 (2d Cir. 1964) (franchise agreement).

196. *See, e.g.*, Lessig v. Tidewater Oil Co., 327 F.2d 459 (9th Cir.), *cert. denied*, 377 U.S. 993 (1964).

197. *Cf.* Siegal v. Chicken Delight, 448 F.2d 43, 47 (9th Cir.), *cert. denied*, 405 U.S. 955 (1971) (trademark tied to chicken frying equipment, packaging and mixes).

198. *See, e.g.*, Carpa, Inc. v. Ward Foods, Inc., 536 F.2d 39 (5th Cir. 1976).

199. *See* Standard Oil Co. v. United States, 337 U.S. 293, 314 (1949).

200. *Id.* at 296.

201. 549 F.2d 368 (5th Cir. 1977).

202. *Id.* at 374.

203. The court observed that a party seeking to prove a tie must establish a franchisor practice of coercing franchisees into purchasing supplies only from the franchisor. *Id.* at 380. *See also* Response of Carolina, Inc. v. Leasco Response, Inc., 537 F.2d 1307, 1326-31 (5th Cir. 1976).

204. *Cf.* Calabresi, *supra* note 153, at 519-24 (added costs result in decreased output and higher prices).

205. *Id.* at 521-22.

absorb the cost, with the result that prices for goods sold ultimately by franchisees would be held artificially low.

Cumulative Influence of the Antitrust Laws Upon Loss Distribution Capacity of the Franchisor

The antitrust proscriptions against tying and resale price maintenance combine to destroy franchisor control over the prices and costs of franchisees within a system.[206] In effect, the franchisor is cut off from spreading to consumers the cost of risks associated with vicarious liability. In the parlance of enterprise theory, this amounts to a severance of the capacity to distribute losses from the franchisor and an allocation of the function to the franchisee.[207] The latter sets his prices in much the same fashion as a sole proprietor. Price is determined by numerous costs, one of which is an insurance premium based upon the insurer's experience in dealing with enterprises of similar risk, size and location.[208] Should the premium rise because the franchisee is careless, the franchisee is best capable of adjusting his prices to reflect the true cost of his products. Further, because all franchisees in similar industries will experience roughly similar exposure to risk, none will be placed in a marked competitive disadvantage because of equal loss-spreading requirements.[209] In contrast, if a loss is thrown upon the franchisor he may elect either to raise prices to the franchisee, placing himself in a poor competitive position against producers who are not exposed to similar risks, or simply absorb the loss. The former alternative is inequitable and the latter prevents loss-spreading and efficient resource allocation through the price mechanism. From a loss-distribution perspective, then, courts should use their powers of construction to hold as a matter of law that the franchisor is not liable for the franchisee's actions on principles of vicarious liability.

Franchisor Liability From A Risk Prevention Perspective

Enterprise theory assumes that the independent contractor is a better preventer of losses[210] then the contractee.[211] This follows from the allocation of

206. See text accompanying notes 173-202 *supra*.

207. See notes 116-125 and accompanying text, *supra*.

208. Morris, *supra* note 149.

209. Those which do manage to reduce accidents and minimize losses will achieve a lower price and resulting competitive advantage over other franchised firms. *See* Calabresi, *supra* note 203, at 523.

210. One of the recognized objectives of the law of torts has been the prevention of accidents and deterrence of unreasonably dangerous conduct. *See* F. HARPER & F. JAMES, *supra* note 23, at 771. Insofar as contractual liability is concerned, it may be stated that the doctrine of a principal's liability for an agent's authorized contracts is at least partially derived from the idea that the principal controls the agent's conduct, and is thus in a position to prevent engagements which he has no intention of honoring. *Cf.* RESTATEMENT (SECOND) OF AGENCY §144 (1958) (introductory Note).

211. Douglas I, *supra* note 116, at 601. Professor Douglas justified the independent contractor's sole liability for torts primarily upon grounds of his superior ability as a loss preventor.

control over the daily activities of a function which occurs between contractee and independent contractor.[212] The building contractor, for example, is better able than his employer to understand the hazards of his trade and to employ the degree of care necessary to forestall accidents.[213]

In analyzing the business franchise, it may again be difficult initially to determine which party, franchisor or franchisee, was in the superior position to prevent a particular loss. Although the franchisor may exercise inspection rights under the franchise agreement, these may extend only to relatively narrow concerns, such as quality control or bookkeeping accuracy. The franchisee, on the other hand, is the party closest to the consuming public. He is typically in a better position to choose careful employees or to fire careless ones.[214] Further, the likelihood that the franchisee will insure substitutes the insurer for the franchisor as a cautionary influence on the franchisee. Insurers, in order to minimize their exposure to claims, not only choose their risks with caution, but also use their experience to counsel businesspersons in preventing accidents.[215] The insurer, rather than the franchisor, will best understand the possibility of accidents and the probability of their occurrence in relation to small firms such as the typical franchisee.[216] The franchisor, on the other hand, is not primarily concerned with accidents, having allocated both the insuring function and control over employees to the franchisee.

Recognizing the superiority of the franchisee and his insurer in the risk prevention function, courts should grant summary judgment to the franchisor on the question of liability for the franchisee's acts unless the plaintiff alleges special franchisor controls that bear a preventive relationship to the loss or accident which occurred. *Singleton v. International Dairy Queen*[217] illustrates a situation in which summary judgment was inappropriate from a loss prevention perspective. The plaintiff was a minor injured by broken glass from a defective entry door to a franchised restaurant.[218] When joined as a defendant with the franchisee, the franchisor defended on grounds that the former was an independent contractor. Despite a provision in the franchise contract renouncing franchisor control over the franchisee's daily business activities, the court denied the franchisor's motion for summary judgment. The denial was ap-

212. *Id.* at 602.

213. *Id.* When the independent contractor agrees to take on a particular function, the contractee is relieved of the task and its attendant anxieties, for a consideration. The allocation of risk prevention responsibility is evinced by delegation of control over daily activities from one party to the other. *Id.* at 601.

214. *See* Drexel v. Union Prescription Centers, Inc., 582 F.2d 781, 801 (3d Cir. 1978). The owner obligated himself only to use best efforts in seeking out unionized labor. *But see* Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 615, 56 Cal. Rptr. 728, 732 (1962). The franchisor in *Nichols* reserved the right to control the employment of all employees of the dance studio, whether or not their function included dancing instruction. The franchisor was held liable on the contract with its franchisee. *See also* Harper & Kime, *The Duty to Control the Conduct of Another*, 43 YALE L.J. 886 (1934).

215. *See* F. HARPER & F. JAMES, *supra* note 23, at 773.

216. *See* Morris, *supra* note 149, at 565.

217. 332 A.2d 160 (Del. Super. Ct. 1975).

218. *Id.* at 161. The plaintiff had pushed against the door's cross-bar, causing the glass to crack and fall outward.

propriate if the court arrived at its decision because the franchisee alluded, in deposition, to the franchisor's control over the restaurant's daily operations.[219]

The denial was incorrect, however, if the court was persuaded by a lengthy enumeration of franchisor controls which bore little relation to the defective door which injured the child. Such elements as control over the size of servings, assignment of the franchise and pre-approval of suppliers bear scant relation to the ability of the franchisee to prevent risks and, on motion for summary judgment, should be ignored.[220]

The field of products liability is an exception to the principle that courts should presume the superior risk preventive capabilities of the franchisee, as the decision of the federal circuit court in *Kosters v. Seven-Up*[221] illustrates. The plaintiff was injured when a soft drink bottle slipped from its carton and exploded upon impact with the floor.[222] The allegedly defective carton had been produced for the franchisee by an approved supplier, according to type, style, size and design specifications imposed by the franchisor.[223] Upholding the franchisor's liability under the principle of strict liability for breach of implied warranty,[224] the court took notice of the franchisor's superior position to prevent hazards to consumers arising from defective product design.[225] In particular, the court observed, the franchisor was uniquely capable of appreciating the dangers likely to result if an unsafe product design was approved.[226]

219. *Id.* at 161-63. The franchisor had retained a right not only of quality control over the product, but the conditions of manufacture or sale of it. Further, the franchisee testified that the franchisor had exercised some control over daily operations. However, other facts raised a question as to whether the franchisor had any significant opportunity to prevent the injury which occurred. The door had been installed by an independent contractor when the franchisee remodeled the premises. The remodeling plans had been supplied by the franchisor, but adapted by the franchisee's personal architect. Thus, the extent to which Dairy Queen had any real opportunity to prevent the loss which occurred is unclear.

220. *Id.* at 161-62.

221. 595 F.2d 347 (6th Cir. 1979).

222. *Id.* at 349-50.

223. Olinkraft, Inc. had produced the carton for the franchisee Brooks Bottling Co. according to standards set by Seven-Up, the franchisor. The franchise agreement specifically provided that cartons had to conform to the "type, . . . and design" approved by Seven-Up. The franchisor argued, unsuccessfully, that its standards went only to the display of the trademark upon the carton and not to design of the carton itself. *Id.* at 350.

224. *Id.* at 351-53. The RESTATEMENT (SECOND) OF TORTS §402A (1965) subjects a seller of products to liability to the ultimate user or consumer if the seller normally engages in the business of selling the product and the product "is expected to and does reach the user or consumer without substantial change in the condition in which it is sold." Thus, liability of the franchisor in *Kosters* turned first upon the issue of whether the trademark licensor was a "seller" for purposes of section 402A, and second, whether the franchisor had violated section 402A where it produced no product. The court found against the franchisor on both issues. See also Kasel v. Remington Arms Co., Inc., 24 Cal. App. 3d 711, 101 Cal. Rptr. 314 (1972) (trademark licensor held strictly liable in tort for injuries caused by shell defectively manufactured by licensee); City of Hartford v. Associated Constr. Co., 34 Conn. Supp. 204, 384 A.2d 390 (Super. Ct. 1978) (trademark licensor held strictly liable for property damage caused by defective compound produced and applied by trademark licensee).

225. 595 F.2d at 352.

226. The court noted, however, that Seven-Up was not liable as an insurer of the carton's safety merely because it occupied a position as franchisor. *Id.* at 355.

CONCLUSION

The principles employed by courts in analyzing the modern business franchise are derived from the law of agency and their application proceeds in a manner quite similar to early decisions involving the relationship of oil company and distributor. Courts confronted with the question of a franchisor's liability for a franchisee's actions have relied heavily upon the traditional agency control test as an analytical device.[227] Use of the control test, however, is complicated in two ways. First, the Lanham Trademarks Act requires that the franchisor exercise some control over the franchisee or risk loss of his trademark registration.[228] These requirements are minimal, however, and the Lanham Act should not be allowed to shield franchisors from liability if other considerations require it. Second, from an enterprise theory perspective, the traditional earmarks employed by courts in fixing responsibility for injury to third parties are not clearly allocated between franchisor and franchisee.[229]

Risk administration principles are useful in determining which types of control are relevant to the decision of enterprise liability. From a loss distribution perspective, liability clearly should accrue to the franchisee, as he is in the best position to make the prices of his products reflect their true cost to produce and market.[230] From a risk prevention perspective, the franchisee appears similarly better suited, except where the plaintiff's cause of action alleges products liability or special facts raising the question whether the franchisor might better have prevented a given loss.[231] Barring these exceptions, summary judgment on the question of the franchisor's liability is appropriate.

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227. *See also* J. FELS, *supra* note 4, at 47-55.
228. See text accompanying notes 64-83 *supra*.
229. See text accompanying notes 126-134 *supra*.
230. See text accompanying notes 205-209 *supra*.
231. See text accompanying notes 210-215 *supra*.