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The Legal Aspects of the Franchise Relationship

Richard J. Hunter, Jr. [α] & Héctor R. Lozada [σ]

Abstract- In Part II of our study, the authors deal with the myriad of legal issues that pervade the franchise relationship. Of particular interest are the differences between the sale of a franchise and the sale of a security; an analysis of the elements of the critical Franchise Disclosure Document (FDD); a detailed look at the franchise contract; some "special protections" available to automobile dealers and petroleum dealers in the United States; and the relationship between franchising and U.S. antitrust law (which provides a fertile area of litigation between franchisors and franchisees). The purpose of Part II is to inform the franchisee about the issues that will require professional attention by a competent and well-versed franchise contract advisor and legal expert.

Keywords: security; franchise disclosure document; antitrust; franchise contract; negotiation and drafting.

I. An Introduction to Franchising and the Law

There are many legal issues that are relevant to the franchise relationship. In fact, *the legal aspects of franchising* contain many critical pitfalls for both the franchisor and the franchisee that will require careful attention. It is therefore important that both parties to the relationship understand the legal implications inherent in the relationship and, in some cases, seek out competent legal counsel to help navigate the "legal waters" of franchising.

a) Is the Sale of A Franchise the Sale of a Security?

One important issue revolves around whether the franchise contract is the sale of a security under applicable federal law. The implications of this question are staggering. If the sale of a franchise were considered as a security, a whole rash of fraud-specific provisions of relevant securities' laws would be applicable to this relationship.

It is well settled under American law that a franchise agreement is a contract and does not amount to a security under applicable federal or state securities laws. What is the rationale for this distinction? The *Securities Act of 1933* (1933) has defined a security as any "note, stock, treasury stock, bond, debenture, evidence of indebtedness, or participation in any profit-sharing agreement...." *The Securities Exchange Act of 1934* (1934) regulates the secondary distribution of securities through national stock exchanges, national securities associations, brokers, and dealers and covers proxy solicitations, regulates tender offers, and limits actions which are found to be "insider trading" (Hunter & Loviscek, 1997). The 1934 Act generally was passed into law in order to eliminate fraud and "manipulative conduct" with respect to the sale or purchase of securities through the enactment of Section 10b of the Act *and Rule 10b-5,* promulgated by the Securities Exchange Commission (Utset, 2013).

b) The text of Rule 10b-5 is as follows:

> *"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange: (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."*

Professor Heyman (2013) notes that although the Securities Exchange Commission or SEC may not bring actions on behalf of an individual investor, several of the anti-fraud provisions of the Securities Act will allow an individual investor to bring civil actions against an issuer, an underwriter, and other offering participants on the basis of false or misleading statements. Professor Heyman (2013) further notes specifically that Section 11 of the Act imposes liability on issuers and underwriters for registration statements that contain "an untrue statement of a material fact or omit to state a material fact required . . . to make the statements contained therein not misleading." Section 12(a)(2) creates a liability for "any person" (presumably, the franchisor) who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission of fact. Section 17(a) is a catchall provision, which imposes liability for fraudulent sales of securities. However, franchises are generally not considered to be a security under applicable securities laws, and thus the *antifraud provisions* of Section 10b and Rule 10b-5 are not applicable, because the distributor/franchisee invests their own efforts in the franchise and does not expect to obtain benefits "solely from the efforts of others." In other words, the passive investment component generally associated with certain types of securities is not present in the typical franchising arrangement. This is referred to as the *"Howey principle,"* from *SEC v. Howey* (1946).

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II. Franchising and the Federal Trade Commission (FTC)

The Federal Trade Commission (FTC) is the chief administrative agency of the federal government designed to discourage "unfair methods of competition" and "unfair or deceptive acts or practices." The FTC promulgated a regulation in 1979 concerning franchise disclosure in order to assure that the "bargaining power" between franchisors and franchisees would be more evenly balanced. The FTC itself and enforcement procedures and regulations enacted pursuant to federal antitrust law have attempted to do away with some of the more egregious abuses previously associated with the sale of franchises. If a violation is detected, the FTC may order the defendant to *cease and desist* (the administrative law equivalent of an injunction) from certain acts or practices, or may compel the affirmative disclosure of information previously omitted. In certain cases, the FTC may also seek civil penalties or permit a consumer to seek individual redress through filing a damage suit (Westenberg, 2011).

The FTC in the United States is especially concerned about advertising that it regards as either "deceptive" or "unfair." In order to combat these practices, the *FTC Franchise Rule requires* a franchisor to provide a prospective franchisee with a disclosure document (initially called the Uniform Franchise Offering Circular or UFOC, it has now been renamed as the *Franchise Disclosure Document or FDD)*[1] which gives detailed information about the "franchise offering" and includes a copy of all documents the franchisee will be required to sign, including the actual franchise agreement or contract.

Federal law requires that the franchisee must receive the FDD "on or before a first personal meeting with a representative of the franchisor." The franchisee is required to execute an on-the-record "Acknowledgment of Receipt," usually found in Item 23 of the FDD. The franchisor cannot require the franchisee to deposit any monies (either as an escrow or a returnable deposit) unless the franchisee is in possession of the FDD for at least ten business days. In addition, the franchisee must have the final and complete franchise agreement at least five business days before the franchisee is required to sign it or to provide any monies. (The five-day rule can run within the ten-day rule in the case of a contracted negotiation period). In addition, individual states require the franchisor to register its franchise offering with a state agency and obtain "approval" prior to selling franchises in that state or to a resident of that state. (For example, California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Certain states, such as Illinois and Minnesota, have even more stringent requirements for the franchisor. This in turn affords better protection for the prospective franchisee). If the franchisee is a resident of one of these states, a separate state-specific page will be provided on the federal FDD. Note, however, that approval by a state does not mean that the state believes the franchise is a good investment or that the franchisee will be successful. It's still up to the franchisee to investigate! The approval is more of technical requirement prior to a franchise offering.

[1] The amended *Franchise Disclosure Rule* states what must be disclosed. It is published in the Code of Federal Regulations, Volume 16, Part 436 (16 CFR § 436) and in the Federal Register at Volume 72, No. 61, pp. 15544- 15575. The *Franchise Rule Compliance Guide,* which is designed to assist franchisors in complying with the amended Rule, is available at www.ftc.gov/bcp/edu/pubs/business/-franchise/bus70.pdf.

III. What Information is Found in the FDD?

The purpose of the FDD is to provide prospective franchisees with information about the franchisor, the franchise system, and the agreements they will be required to sign so that a prospective franchisee may make an informed business decision.

a) The Disclosure Document (FDD)

The following is a description of the important provisions of the FDD:

- Item 1 : Provides the names of the franchisor and any parent corporation, predecessor corporation, and affiliates. This section provides a description of the franchisor and its business history.
- Item 2 : Business experience. This section provides biographical and professional information about the franchisor and its officers, directors, and most important executives or employees. Since the reputation and good will of the franchisor are critical elements in forming the relationship between the parties, this information may be critical in gaining an insight into reasons why the franchise may or may not be successful.
- Item 3 : Litigation. This section provides current and past criminal and civil litigation history for the franchisor and the "key" members of its management team.
- Item 4 : Bankruptcy. This section provides information about the franchisor itself and any key management personnel who have filed or who have proceeded through a bankruptcy proceeding.
- Item 5 : Initial fees. This section provides information about the initial franchise fees and the factors that determine the amount of the fees.
- Item 6 : Other fees. This item provides a description of all other recurring fees or payments that must be made. In *Part I* of this study, fees such as

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advertising fees and accounting fees were discussed in great detail. (Hunter & Lozada, 2013.)

- Item 7 : Initial investment. This item is presented in table format and includes all the expected expenses required of the franchisee in order to establish the franchise as a part of the franchise system. These expenses are justified as part of the "Quality Control" function of operating a franchise.
- Item 8 : Restriction on sources of products and services. This section includes any restrictions or requirements that the franchisor has established regarding the source of products or services. This section, dealing with product sourcing and "tie-ins," is often the main source of significant litigation as franchisees may claim that the franchisor is violating their individual rights to contract for supplies and services by requiring purchases from the franchisor—often at inflated prices.
- Item 9 : Franchisee's obligations. This item provides a reference table that indicates where in the franchise agreement franchisees can find the obligations to which the parties have agreed.
- Item 10 : Financing. This item describes the terms and conditions of any financing arrangements offered by the franchisor so that the franchisee can make an intelligent decision about how to finance its franchise obligations—either through the franchisor or an independent source of funding.
- Item 11 : Franchisor's Assistance, Advertising, Computer Systems and Training. This section describes the services that the franchisor will provide to the franchisee. This section likewise relates to the *"Quality Control"* obligation of the franchisor, which is at the core of the franchise relationship.
- Item 12 : Territory. This section provides the description of any exclusive territory and whether franchise territories can be modified. This is important because the franchisee should know in which areas his or her rights will be protected from competition by another franchise unit owned, operated, or licensed by the franchisor.
- Item 13 : Trademarks. This section provides information about the franchisor's trademarks, service marks, and trade names that provide the main method of identification of the franchisee with the franchisor's business operation.
- Item 14 : Patents, copyrights and proprietary information. This section provides information about how the patents and copyrights owned by the franchisor may be used by the franchisee. At issue will be the use of the "confidential information" of the franchisor by the franchisee that may be contained in the franchisor's "operations manual."
- Item 15 : Obligation to participate in the actual operation of the franchise business. This section describes the obligation of the franchisee to participate in the actual operation of the business. In most franchise contracts, there is a firm requirement that the franchisee become an active participant in the day-to-day franchise operations.
- Item 16 : Restrictions on what the franchisee may sell. This section deals with any restrictions on the goods and services that the franchisee may offer its customers. A franchisor may attempt to restrict sales of ancillary goods and services on the premises of the franchise operation pursuant to its "Quality Control" obligations.
- Item 17 : Renewal, termination, transfer, and dispute resolution. This section will inform the franchisee when and under what circumstances the franchise can be renewed or terminated and what are the rights and restrictions when a franchisee has a disagreement with your franchisor. (In most cases, the franchise contract will require mediation or arbitration of any franchise disagreement rather than permitting a franchise to press their claim in a more normal legal proceeding).
- Item 18 : Public Figures. If the franchisor uses public figures (celebrities, sports personalities, or other public persons) as endorsers or franchise-spokespersons, the amount the person is paid is revealed in this section.
- Item 19 : Financial Performance Representations. Here the franchisor is permitted, but not required, to provide information on individual unit financial performance so the franchisee may make an intelligent decision about the real prospects for profit in the individual franchise.
- Item 20 : Outlets and Franchisee Information. This section provides locations and contact information of existing franchises so that a prospective franchise might be able to contact franchisors to discuss "real world" business or professional concerns.
- Item 21 : Financial statements. Audited financial statements for the past three years are included in this section. It would thus be critical for a prospective franchisee who does not have a "working knowledge" of accounting to take these statements to their own professionals so as to analyze the facts or representations made in the financial statements. (Recall that in many cases, the franchisee will lack significant business experience and might have great difficulty in reading or interpreting financial statements, among other important franchise documents).
- Item 22 : Contracts. This item provides a list of all the agreements that the franchisee will be required

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to sign—the most important of which is the franchise agreement itself.

- Item 23 : Receipts. This is a technical "acknowledgment requirement." Prospective franchisees are required to sign a receipt that they received the FDD.

IV. Other "Unique" Protections for the Franchisee

In one important industry, the sale of automobiles, a special statute, the *Automobile Dealers' Franchise Act* (ADFA), also known as *"The Automobile Dealer's Day in Court Act"* (1988), allows a terminated dealer to bring an action in federal court asking for the retention of the franchise if the dealer can prove that the franchisor has either conducted the termination in "bad faith" or has acted with coercion. This statute is important because it contradicts the common law rule formerly held in such cases which was built around a variation of the so-called "business judgment rule." Under the *business judgment rule,* as interpreted under the ADFA, a franchisor may still be able to terminate the franchisee, but only if the decision is based upon:

- financial ability (including failure to meet reasonable sales quotas, or to maintain or meet appropriate investment levels);
- business experience—or lack thereof (including the failure to observe quality standards as enunciated in the franchise handbook);
- "substantial" violations of the franchise contract; or
- moral character, as it relates to the important intangible element termed "good will" or other indicia of misconduct.

The federal *Petroleum Marketing Practices Act* (1996) likewise protects motor fuel distributors and dealers from "arbitrary" terminations *(Union Oil Co. of California v. O'Riley,* 1991). Other types of business have sought and received similar protections.[2]

V. Why it is Important to Hire a Knowledgeable Franchise Attorney and Accountant?

Especially during the initial ten-day period under the FDD, the prospective franchisee should completely and carefully review all of the relevant documents. A franchise agreement is generally a very complex, lengthy, and imposing legal document, which becomes the basis for the legal relationship between the parties. Retaining an experienced franchise attorney is the most critical thing a prospective franchisee can do in protecting him/herself at this point. The franchise attorney will be able to assist the franchisee in understanding the franchisor/franchisee relationship, and the parties' rights and obligations under the franchise agreement. However, unlike other contracting situations, a franchise attorney will have limited ability to "negotiate" the deal on behalf of the franchisee. Most franchise offerings, particularly in the established franchise systems, are offered virtually on a "take it or leave it" basis, and contain many "boilerplate" provisions. The following are some of the unique legal issues that a qualified, competent franchise attorney needs to understand and be prepared to discuss with the parties to the franchise relationship:

- Advertising obligations
- General obligations of the franchisee
- Arbitration or mediation
- Obligations of the franchisor
- Attorneys' fees provision
- Payments to the franchisor
- Contingencies terminating the contract
- Post-termination obligations
- Covenants Not To Compete
- Renovation of the premises
- Default provisions
- Reporting requirements
- *Force Majeure*
- Sales restrictions
- Term and renewal rights
- Jurisdiction and venue (for dispute resolution)
- Trademarks
- Liquidated damages
- Transfer by the franchisee to family member(s) or third parties
- Location of the franchise
- Transfer (sale) by the franchisor

VI. The Franchise Contract

a) Overview: Setting Up the Franchise Relationship: Evaluating a Franchise

Buying, and then operating, a franchise can either be a "dream come true" or a real "nightmare"! Success or failure, to a large extent, will depend on the *relationship developed between the franchisor and the franchisee.* These are some of the most important questions that relate to the franchise contract itself which must be addressed *before* the parties enter into the franchise contract:

- Is the *length* of the initial term (usually ten years) sufficient to make the franchise financially viable? A prospective franchisee must determine the total

[2]These industry-specific statutes relate to automobile dealerships, alcoholic beverages, farm equipment, petroleum, and office products, among other industries (Emerson & Benoliel, 2012/2013).

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capital initially required, continuing fees owed to the franchisor, other costs (accounting, payroll, advertising, etc.), and rental costs and compare these costs to the expected or projected revenue. How do these expenses "match up" against any "earnings claims" found in Item 19 of the FDD?

- Will the franchisee have any right under the contract to *renew* the initial agreement on reasonable terms and conditions? This may include signing the then-existing franchise agreement, which may be substantially changed from the original agreement, especially with regard to the fee structure.
- If relevant (under a distributorship arrangement), what are the franchisee's rights to an adequate and reliable *supply of goods* at "competitive prices" and under reasonable terms and conditions?
- What are the franchisor's responsibilities regarding the protection of its *intellectual property* (trademarks, service marks, patents or copyrighted materials)? What happens to these marks if the franchisor ceases its business operations?
- Will the franchisee have the *right to sell* the business to a "third party" at a "fair market price" at the end of the relationship without the imposition of unreasonable conditions or demands by the franchisor?
- Should the franchisee wish to cease doing business, decide to retire, or becomes disabled or die, will the franchisee or his/her estate have the *right to transfer* or "assign" the franchise contract to a relative/spouse on reasonable terms?
- What are the requirements or prohibitions on the right of the franchisor to arbitrarily or unreasonably *terminate* the franchise, or to take over (as opposed to "acquire" on reasonable terms) the franchise?
- If relevant, what is the *relationship* between the franchise and its business premises? Is the franchisee the owner of the property or a lessee? Is the franchisee a sub-tenant of the franchisor?
- What are the rights of the franchisor (as either the primary tenant or landlord) in relation to the franchise premises?
- Will the franchise be required to *arbitrate* any disputes with the franchisor or will the franchisee be permitted to litigate these issues? (Adapted from Lewis, 2013).

b) A Franchisee's Checklist for Negotiation and Drafting

Without referencing any specific franchise contract, a general discussion of several standard provisions of a franchise contract is in order. We have raised these issues in the form of questions that must be addressed directly in the negotiations between a prospective franchisee (with the help of a competent franchise attorney and in some cases, a well-versed accountant familiar with franchising) and the franchisor:

i. *General Provisions*

a. *Description* of the parties; financial arrangements; experience of the franchisor; mandatory disclosure provisions;

b. *Nature* of the franchise; issues relating to service marks, trade marks, or trade names. (The franchisee may be asked to sign an agreement by which the franchisee agrees not to challenge the ownership or validity of the mark during the term of the agreement or afterwards). Will the franchisee be able to use the "trade name" after termination?

c. *Territory:* Will the franchisee be granted an area within which the franchisee is licensed to do business? What are the criteria upon which the location is selected? What is the primary area of the franchisee's responsibility? Can dealers compete "cross territory"?

d. *Representations* of the franchisor: assistance offered by the franchisor. Have there been any projected earnings?

e. *Legal requirements and representations:* Is there adequate time to consult counsel? Is there a period within which the franchisee can withdraw from a contract without any penalty?

ii. *Start-Up Provisions*

a. *Deposit of the fee:* initial franchise fee (usually by a "lump sum.") What is the nature of royalties (usually based upon a % of gross sales)? The initial fee should be stated with specificity as to what is the franchisee going to receive? Will there be advertising fees? Can the franchisor retain some of the fee if the franchisee backs out of the contract?

b. What sort of *legal entity* will the franchisee be? (corporation, partnership, etc.) Will *personal guarantees* be required of the franchisee? Can a franchise later be assigned to a corporation that the franchisee creates for this purpose?

c. What is the franchise *name*? Upon termination, can the franchisee continue to use the franchise name? Will there be a "reasonable period of time" to effect any change? Can the franchisee transform the name into one that is not "confusingly similar"? Can the franchisee use the designation "formerly known as....."?

d. *Land and building:* Must the building bear a distinctive design? Is there a requirement of any specific construction? Are there any location questions? Should the contract be made contingent upon finding a suitable building at a reasonable rental or upon the execution of a

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satisfactory mortgage? Can the franchisee be required to enter into a "turn key" operation or is a "turn key" operation even offered by the franchisor?

e. *Equipment:* What specific equipment requirements are found in the franchise contract? What equipment must be purchased or installed? Will these arrangements potentially violate antitrust provisions?

f. *Training:* reasons; nature and extent. What amount of training does the initial fee cover? Is additional training for franchisee or for other employees? If so, who will be required to pay for this additional training?

g. *Transmission of standards* (called "quality control"). This is a core responsibility of the franchisor. The ability to continue to charge the franchise fee may be contingent upon whether or not the franchisor has maintained "quality control." Likewise, the Trade Mark may be lost because of a lack of quality control and may be transformed into what has been termed as a "naked license."

iii. *Opening of the Business*

a. *Purchasing requirements:* What is the extent of initial stocking? What is the ability of the franchisor to require purchases of supplies?

b. Guidance of the franchisor in *book keeping and accounting:* Will the franchisor provide advertising assistance?

c. *Sales and other promotions:* mandatory nature? The use of the phrase "at participating locations."

d. *"Primary are of responsibility":* Can the franchisee open "satellite" or secondary locations? Can the franchisor compete directly in the same territory with a franchisee?

e. *Sales quotas:* Are there any mandatory sales required?

f. Royalty payments: At what point are the royalty payments to commence? Is there a "grace period" for payment?

g. *Confidentiality:* especially regarding the Operations Manual.

iv. *Termination of the Franchise*

a. *Grounds* for termination: the concepts of "good faith" termination; "covenant of fair dealings";

b. *Obligations* of the parties upon termination;

c. Resolution of disputes.

VII. Franchising and Antitrust

The implications of antitrust (sometimes internationally called "antimonopoly" law) law are especially relevant in the area of franchising. For the first 114 years of U.S. history, business had a fairly free hand in the field of commerce. The courts and the government took a "hands off" attitude ("laissez-faire") towards business (Barkoff, 2013). In the United States, the tide began to turn in the late 1800s as the public tired of the irresponsible behavior of some of the "captains of industry," derisively termed "robber barons." The press began to call for reforms and for public protection from abuses of "big business." The assault on unfettered big business, inspired by "muckrakers," had begun. Government regulation of business was to become a major factor in the management of commercial affairs. Many of the regulations that affect business today in the United States and in many nations around the world, and many of the government interventions that confront the modern businessperson, can be traced back to the cornerstone of business regulation. (Hunter, Shannon, O'Sullivan-Gavin & Blodgett, 2011.) The law that changed American business so dramatically was the *Sherman Antitrust Act* (1890). This important statute, and all of the subsequent legislation in this field, is predicated on increasing competition and encouraging competitive behavior.

Competition is seen as desirable for the following reasons:

- It promotes efficiency in resource allocation;
- It provides for meaningful consumer choice;
- It assures the avoidance of concentration of political power; and
- It assures basic "fairness" in economic behavior (Lande, 2013).

Flaim (2012, p. 160) stated the purposes in this way:

> "Antitrust law—or competition law—is generally concerned with promoting and maintaining competition through the regulation of exclusionary business conduct. Competition is said to enhance the efficiency of the marketplace and benefit society as a whole. Without competition, cartels of firms, or single firms known as monopolists, are able to extract rents from consumers by restricting the output of goods or services and raising prices to supracompetitive levels. Monopolistic behavior results in economic waste to society, or "deadweight loss," as wealth is transferred from consumers to monopolists."

a) The Sherman Antitrust Act (1890)

Section 1 of the Sherman Antitrust Act (Sherman Act) is perhaps the most important legislative enactment that deals in the evaluation of potential restraints on trade. Restraints are considered as either *horizontal,* that is, where two or more competitors engage in conduct that is a restraint on trade; or *vertical,* that is, a restraint that may occur within a "marketing chain," such as between the manufacturer (franchisor), wholesaler (e.g., sub-franchisor), and the franchisee.

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Section 1of the Sherman Act reads: *Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal."*

Almost immediately, however, courts began to interpret this section narrowly (otherwise nearly every contract could be viewed as a restraint of trade... for example, a customer who contracts to buy some item from *seller A* normally will not buy the same type of item from a competitor of *seller A*) and developed the "rule of reason" as a means of applying the provisions of Section 1.

Thus, as a general rule, only those contracts or combinations that *unreasonably restrain trade* are prohibited. The first major case in the United States on point was *Standard Oil v. United States* (1911), in which Standard Oil had attempted to gain control of oil pipelines, engaged in regional price cutting to suppress competition, set up "bogus" independents to give the impression of competition, and engaged in industrial espionage. While the Supreme Court recognized the existence of the "rule of reason defense," in this case, the Court ruled specifically that Standard Oil's conduct did not fall within the rule and was, in fact, unreasonable and illegal.

Courts in the United States will examine the following factors in applying a rule of reason analysis in any particular case:

- The pro-competitive and anti-competitive effects of any challenged restraint on trade;
- The competitive structure of the industry;
- The firm's market share and economic power;
- The history and duration of the restraint; and
- "Other relevant factors" (Cheeseman, 2012, p. 719).

In contrast, it is recognized that there is conduct that is so lacking in social value that it is seen as an "automatic" violation of Section 1. Such conduct is termed as a *per se* violation of Section 1. If a firm is accused of a *per se* violation, and the government can meet its prima facie burden of proof, the defendant is not permitted to defend its conduct on the ground that it is reasonable, and it will be guilty of violating Section 1 of the Sherman Act.

Professor Jesse Markham (2012, p. 593) has stated:

> "Courts resolve antitrust cases by applying various modes of analysis. These modes range across a spectrum from so-called "full blown" rule of reason analysis at one end to per se condemnation at the other. Per se rules condemn limited categories of conduct by applying a conclusive presumption of net anticompetitive effects, while rule of reason analysis requires a court to engage in case-specific evaluation of evidence bearing on actual or predictable competitive effects. Although the per se rules have obvious advantages of clarity, administrability, and predictability, the sorts of conduct falling under these rules have been narrowed in recent years as courts have become more wary of condemning legitimate competitive conduct. For example, although vertical price restraints and certain vertical non-price restraints were per se illegal for roughly 100 years, recent cases have established that all vertical price and non-price restraints are to be evaluated based upon some degree of analysis of the defendant's market power or ability to affect market competition, as well as a contextual review of the competitive effects of the challenged conduct."

There are three generally recognized *per se* violations under Section 1 of the Sherman Act that are relevant to the franchise relationship.

The first is *horizontal price fixing* or agreements on price among competitors. The United States Supreme Court framed the issue as follows: *"Any combination or agreement between competitors, formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal per se" (U.S. v. Socony-Vacuum Oil Co.,* 1940).

In the area of franchising, price fixing may include the franchisor setting minimum prices (resale price maintenance or vertical price fixing), as where a party at one level of distribution enters into an agreement with a party at another level to adhere to a price schedule that either sets (determines) prices or stabilizes prices);[3] setting maximum prices, even where there is a *freedom* to charge less than the maximum;[4] the use of franchise-wide "list prices;" and today, the use of minimum fee schedules by certain professional societies, formerly exempted under the "learned professions" exception for professions such as lawyers, architects, accountants, and real estate brokers[5] *(Goldfarb v. Virginia State Bar (attorney), 1975; Arizona v. Maricopa County Medical Society (physician),* 1982). A possible violation might stem from pricing *suggestions* where such actions become "active

[3] In *Dr. Miles Medical Co. v. John D. Park & Sons, Co.* (1911), the United States Supreme Court held that setting minimum resale prices is a *per se* violation of Section 1 of the Sherman Act as an "unreasonable restraint of trade."

[4] However, the U.S. Supreme Court's recent ruling in this area may have changed the equation for this type of restraint. In *State Oil Co. v. Khan* (1997), the Supreme Court held that setting of maximum resale prices would be examined under a rule of reason analysis in order to determine whether or not setting maximum resale prices violates section 1 of the Sherman Act. The Supreme Court concluded that there was "insufficient economic justification for *per se* invalidation of vertical maximum price fixing" (Cheeseman, 2013, p. 723).

[5] Professor Bruce Hunter noted: "The inherent anticompetitive potential of all price-fixing schemes requires their invalidation regardless of any procompetitive justifications" (Hunter, 1983, p. 260).

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exhortation," or where the exchange of information regarding prices may take place at required meetings, conventions, or sales promotions arranged by the franchisor at which there is mandatory attendance required of franchisees.

It is also important to note that certain businesses are subject to government-regulated prices, as highly *regulated* industries. Such industries as airlines, railroads, shipping companies (common carriers), stock exchanges, insurance companies, and banks) may be permitted, in fact, to "fix" prices without violating antitrust law if a government agency has determined that the rates fixed are in the "public interest" (Cheeseman, 2012, p. 735, notes 24-27).

Sometimes, a franchisor (especially in a distributorship arrangement) will attempt to determine or "fix" the price of an item through a procedure known as a *consignment sale.* In order for a court to determine that a "true consignment" sale has taken place, the following factors will be considered:

- The distributor (franchisor) must retain *title* to the goods;
- The distributor (franchisor) must retain *ownership;*
- The distributor (franchisor) must retain *risk of loss;*
- The distributor (franchisor) must permit the franchisee the *right to return* unsold goods.

In the area of franchising, consignment sales (also called "sale or return" contracts) have been attacked on the basis of a violation of any of the elements of the rule and generally have been held to be nothing more than price fixing (*Cont'l T.V., Inc. v. GTE Sylvania, 1977; United States v. Arnold, Schwinn & Co.,* 1963) (However, in the case of certain new car sales, the ability of the consignor to "set" or "fix" the price was attacked because, in fact, there was *"virtually no chance that there would be any unsold goods."*). In any event, the ability of the franchisor/consignor to fix the price of goods has been severely called into question.

Finally, in the area of price fixing, it is doubtful that competitors will overtly conspire or agree to fix prices, although there were a few examples from American history in which competitors did just that! Sometimes an agreement or conspiracy that violates Section 1 can only be proved by *circumstantial evidence.* At this point, the emphasis shifts to the concept of an *agreement* based upon the conduct of the parties. This is undertaken under a doctrine called *"conscious parallelism"* (*cf., Interstate Circuit v. U.S.,* 1939). In this case, the Supreme Court stressed the existence of three elements:

- *Knowledge* of competitor pricing;
- *Motivation* (usually to undercut competition in order to keep prices high);
- *Substantial unanimity* (usually within a rather narrow 2-5% range).

In *Theater Enterprises v. Paramount Film Distributor Corp.* (1954), the Supreme Court noted that "The crucial question is whether the respondent's conduct stemmed from an independent decision; or from an agreement tacit or express."

Conscious parallelism is a difficult and intriguing problem because of a recognized concept in marketing termed "price leadership" which may be a significant aspect of competition among franchises offering similar products or services.

The second per se is *horizontal market division* or agreements among competitors as to who can sell in which region (allocations of markets). This violation may occur where an agreement exists among businesses performing similar services or dealing in similar products, whereby the available market is divided up and each given a share (*U.S. v. Topco Associates, Inc.,* 1972). In the United States, some heavily "regulated industries" have been granted rights to in fact divide markets if the relevant regulatory agency has determined that this practice would "benefit the public." One such industry is the airline industry in which regulations have allowed certain U.S. airlines to dominate certain markets (e.g., United/Continental in Denver or Chicago; Delta in Dallas or Atlanta; USAir in Pittsburgh and Charlotte; and United/Continental in Newark).

A third per se violation involves a *group boycotts or refusals to deal*—essentially practices or agreements among competitors not to sell to a particular buyer or not to buy from a particular seller. An individual has discretion to choose with whom he or she wishes to deal. Such a practice is generally protected under the *business judgment rule.* (As you may remember, the considerations or elements of the rule are business experience, financial ability, and moral character—especially as it relates to the element of "good will.") Thus, the United States Supreme Court has held that a firm may *unilaterally* choose not to deal with another party without being in violation of Section 1 of the Sherman Act because is "no concerted action with others" (Cheeseman, 2013, p. 723). The rule relating to a "unilateral refusal to deal" was announced in *United States v. Colgate & Co.* (1919) and is often referred to as the *Colgate Doctrine.*

However, when a group of competitors agrees not to deal with (often sell to) a person outside the group at all or only on certain terms, there may be an unlawful boycott, constituting a combination in restraint of trade.

i. *Section 2 of the Sherman Act*

Section 2 is the important antimonopoly provision of the Sherman Act. It reads:

"Every person who shall monopolize, or attempt to monopolize, or combine or conspire with

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any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor."

In determining what is or is not an improper or illegal monopoly, courts generally look at two aspects: the *relevant market and the percentage share of dominance* in that market. The relevant *product or service market* generally includes any substitute products or services that are *reasonably inter changeable* with the products or services offered by the defendant. A relevant *geographic market* is generally defined as the area in which the defendant and its competitors sell their products or services. The geographic market may be national, regional, state-wide, or local, depending on the circumstances of each case. Professor Cheeseman (2013, pp. 724-725) notes that "The Courts generally apply the following guidelines: Market share of above 70 percent is monopoly power; market share under 20% is not monopoly power. Otherwise, courts generally prefer to examine the facts and circumstances of each case before making a determination about monopoly power."[6]

Some monopolies are deemed as "natural"; that is, they have been created by producing superior products or through a long-standing domination of the market (e.g., Yoo, 2012). In *American Football League v. National Football League* (1963), the Fourth Circuit stated: "When one has acquired a natural monopoly by means which are neither exclusionary, unfair, nor predatory,[7] he is not disempowered to defend his position fairly." Likewise in *Union Leader Corp. v. Newspapers of New England, Inc.* (1960), the First Circuit stated: "A natural monopoly market does not of itself impose restrictions on one who actively, but fairly, competes for it, any more than it does on one who passively acquires it."

Other industries may have been granted monopoly status by the government and are called "regulated monopolies." These are such as power companies, utilities, water companies, and until recently, American cable companies.

b) Other Important Antitrust Statutes Relevant to Franchising

i. *The Clayton Act*

The Clayton Act of 1914 was the second most important piece of legislation enacted to encourage competition. The aspects of the Clayton Act relevant to franchising may be summarized as follows:

- Section 3 prohibits sales on the condition that the buyer will not deal with competitors of the seller. Three types of contracts fall within the scrutiny of Section 3: "tie-in" sales, exclusive dealing arrangements (found especially in distributorships), and requirement contracts.

Perhaps the most important portion of the Clayton Act deals with the area of price discrimination, an important aspect of franchising: Section 2 of the Clayton Act (as amended by the Robinson-Patman Act of 1936).

Under Section 2 as amended, it is unlawful for any person engaged in commerce to discriminate in price between different purchasers of like grade, quantity, and quality (*e.g., Hartley & Parker, Inc. v. Florida Beverage Corp.,* 1962), where the effect may be "to substantially lessen competition in any line of commerce, or tend to create a monopoly (by, for example, forcing one party out of business), or to injure, destroy or prevent competition (through such indirect actions as dummy brokerage fees and promotional "kickbacks").

The major defense to a charge of price discrimination is that the seller is "meeting" but not "beating" the price being offered by a competitor. The defendant can also defend by showing that a lower price is being offered because of obsolescence, seasonal variations, damage to goods sold, changing conditions, perishable goods being sold, that the goods are of different grade or quality, or real "quantity discounts" which are available to *all* buyers.

The major case in the United States concerning the defense of "meeting- not beating- the competition" was *Standard Oil of Indiana v. FTC* (1951).

- Section 4 allows treble damage suits by private individuals for violations of either the Sherman or Clayton Act, although the U.S. Department of Justice and its specialists in the Antitrust Division are primarily responsible for enforcing the Sherman Act.
- Section 6 exempts labor unions, certain agricultural organizations (Agricultural Cooperative Associations), farmer and fisherman organizations, export organizations, baseball (and not other professional sports) under *Federal Baseball Club v. National League* (1922) *(see, e.g., Community Communications Co., Inc. v. City of Boulder* (1982), certain "regulated industries" (Cheeseman, 2013, p. 731) and other small businesses.
- Section 7 is a very important section because it deals with the area of acquisitions and mergers. *Mergers* may be of three general types: *horizontal* (between competitors), *vertical* (between different

[6] In *Greyhound Computer Corporation v. International Business Machines* (1977), IBM's market share of the leasing market for computers was 82.5 percent.

[7] Predatory pricing has been defined as pricing below average or marginal cost with the intention to drive out competition (*William Inglis & Sons Baking Company v. ITT Continental Baking Company, Inc.* 1982).

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levels within the marketing chain), or *conglomerate* (between essentially different or unrelated businesses) (see *R.C. Bigelow, Inc. v. Unilever, N.V.,* 1989). Mergers may be banned when the effect would be to "substantially lessen competition or tend to create a monopoly." A merger might occur when a company acquires the stock or assets of another firm. These types of mergers involve the application of the *Cellar-Kefauver Act of 1950.* There was again a period of "merger mania" in the United States in the 1980s which resulted in a variety of new words—and new business practices and concepts being introduced into the law such as targets, "poison pills," "junk bonds," "insider trading," "Pac-man defenses"—and which may have ushered in the S&L "scandal" in the 1980s. In the United States, a defense that has been accepted is the *"failing company doctrine,"* showing that without the merger, (1) there is no other reasonable alternative for the failing company, (2) no other purchaser is available, and (3) the assets of the failing company would completely disappear from the market if the otherwise anticompetitive merger were not allowed to proceed. There is also the *"small company defense,"* where courts have permitted two or more small companies to merge without incurring Section 7 liability so that they might be able to compete with a large company. Many of these defenses are especially relevant in the franchise relationship.

In 1976, pursuant to the passage of the *Hart-Scott-Rodino Antitrust Improvement Act* (1976), certain firms are required to notify the Federal Trade Commission and the Department of Justice of any proposed merger so as to give these bodies time to investigate and potentially challenge a merger that is potentially anticompetitive. If the merger falls within the parameters of the Act, the parties must file the notification form and wait thirty days. If within the thirty day period the government files suit to block the proposed merger, that suit is entitled to "expedited treatment" in the courts.

- Section 8 prohibits so-called "interlocking directorates" under certain circumstances (MacLeod, 1984). That is, no individual may sit on the boards of directors of two or more competing companies if either of the firms has capital and surplus (cash) in excess of $1 million and if a merger between them would violate any antitrust law. This section has been largely ignored by the Department of Justice.

ii. *The Federal Trade Commission Act of 1914*

Section 5 of the FTC Act prohibits "unfair methods of competition" and "unfair and deceptive trade practices." The Act also created the Federal Trade Commission (FTC) to enforce antitrust laws, especially the Clayton Act. The Federal Trade Commission Act is especially relevant in the area of franchising, where advertising plays such a critical role in differentiating between franchise operations and models and products or services.

A violation of the FTC Act can be found without any overt proof of any deception (similar to conscious parallelism). A mere showing that there is a "fair prospect" that the public will be deceived is sufficient to establish that the conduct is unfair and deceptive. The FTC Act is also involved in stemming so-called "bait and switch" advertising which involves advertising a product at an especially low or enticing price to get a customer into a store (the "bait") and then talking the customer into buying a more expensive model or service (the "switch") because the advertised model is sold out or has some alleged defect.

The FTC may order a respondent to "cease and desist" from certain acts or practices determined to be unfair or deceptive (similar to an injunction issued by a court), or may compel the affirmative disclosure of information previously omitted from an advertisement. The order may extend to products or services other than the products or services covered by the original advertisement which drew the wrath of the FTC. In certain cases (depending on whether the action was determined to be deliberate or unintentional, whether the violator has a prior history of similar conduct, etc.) the FTC may seek civil penalties or consumer redress (recalls, forced repurchases, etc.) The FTC may fine a violator up to $5,000 per violation- *with each day constituting a separate violation.*

Warner-Lambert Corporation v. Federal Trade Commission (1977) shows that the FTC may opt for corrective advertising as an appropriate remedy. Corrective advertising is business advertising that admits *in some way* that a product lacks some characteristic or performance feature it "appears" to have and is in order when the FTC believes that it is necessary to correct a false impression created by the respondent's prior advertisements.

At one time, so-called "resale price maintenance" agreements were legal under the *Miller-Tydings Act* of 1937 under which a retailer (franchisee) would agree to charge a single, uniform price so as to assure that the article would be "fair traded." These arrangements are no longer valid. Several important U.S. businesses rose to prominence under the special protection of "fair trade" legislation (like Tupperware and Corning Ware which were "fair traded" all over America).

iii. *Antitrust Remedies*

The penalties for a violation of an antitrust statute are myriad (Cavanagh, 2005). Several sections of the Sherman Act are punishable by fines (up to $1 million for a corporation and $100,000 for an individual) or up to three years in jail or both. If a corporation violates any of the penal provisions of antitrust laws, an

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individual director, officer, or agent of the corporation may be held liable (generally, Lande and Davis, 2011).

Federal Courts in the United States may also issue orders to:

- *Restrain* particular acts or practices;
- Compel *divestiture* of a subsidiary;
- *Divide* a company's assets, even to the extent of creating a competing entity;
- Compel a company to *license a patent* with a reasonable royalty, or on a royalty-free basis (*U.S. v. Glaxo Group, Ltd.,* 1973);
- *Cancel contracts* entered into in violation of any antitrust law;
- *Disgorge illegal profits or impress a constructive trust* on parties.

Private parties today may file suit under the Sherman, Clayton, and Robinson-Patman Acts and seek treble damages (e.g., *Brunswick Corporation v. Pueblo Bowl-O-Mat, Inc.,* 1977). In the case of the Sherman Act, a successful plaintiff may also receive reasonable attorney's fees.

a. Rule of Reason Considerations: The Major Standard in Franchising

The "rule of reason" continues to be the basis of most judicial decisions in the area of franchising. A "rule of reason" analysis permits the courts to ask three important questions:

- What is the effect of the alleged restraint on competition?
- Would the restraint actually promote competition? (Has anyone actually been harmed?)
- Was the restraint reasonable and necessary to serve a legitimate competitive purpose?

The rule of reason is generally applied in the following circumstances:

Exclusive dealing contract (the essence of a distributorship arrangement): wherein one party requires the other party to deal with that party alone. For example, the seller tells the buyer that unless the buyer only buys from the seller, and not from a competitor of the seller, he will no longer deal with the buyer. Not all such arrangements are illegal; in fact, most are legal and permissible. Only those arrangements which in fact close off competition or where their effect "may be to substantially lessen competition or tend to create a monopoly..." will be branded illegal. Writes Danielle Paschal (2001, pp. 256-257):

> "Exclusive dealing agreements frequently have procompetitive benefits not only for parties to the agreement but also for consumers. Exclusive dealing encourages manufacturers to invest in their distributors by providing training and capital investments. Without these agreements, distributors have an incentive to free-ride by using investments made by one manufacturer to sell products made by competing manufacturers. In addition to deterring free-riding, exclusive dealing agreements reduce transaction costs between suppliers and distributors because long-term contracts allow parties to avoid the expenses of entering into agreements for each transaction. These contracts give manufacturers the ability to control the quality of their products. Exclusive dealing also fosters trust between parties by protecting trade secrets and trademarks."

Requirements contracts (a contract in which the quantity is measured by the requirements of the buyer): like an exclusive dealing contract, a requirements contract obligates the buyer to purchase all of its requirements from a seller. Again, the rule of reason is used to evaluate such contracts, provided that the underlying contract is legal (Clayton Act, 1914, Section 3).

Customer and territory restrictions (to whom products/services can be sold or where products/-services can be sold): Originally, territorial and customer restrictions were considered to be *per se* violations by the United States Supreme Court, under a precedent termed the *Schwinn Rule* (*U.S. v. Arnold, Schwinn & Co.,* 1969). Under *Schwinn,* the Court had written: "It is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion and control over it." The *per se* view was set aside, however, as the Supreme Court now applies the rule of reason to such cases.

It is possible, however, for a manufacturer (distributor) to set up a "primary area of responsibility" with sales quotas for its franchisees by and through the contract entered into by the parties. These types of restrictions are important when a franchisor guarantees territories to a franchisee, in a concept termed "franchise market area protection." This is most often accomplished through using a radius (space/area), zip code (postal code) or population base (i.e., one franchise outlet per _____ thousands of persons). In the United States, protected territories originally had a median range of one mile. In many such cases, the franchisor may allow for expansion within an area by allowing the franchisee, if qualified, to purchase the new site on the same terms available elsewhere in the system in a comparable market. This is sometimes termed an option or a right of first refusal.

Tying Arrangements: In a tying arrangement, one party (usually the seller) refuses to sell one product unless the buyer also agrees to purchase or take a second product or service from the seller. Originally, tying arrangements were considered as *per se* violations. However, today, many exceptions or justifications do in fact exist which permit a court to apply a rule of reason analysis.

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Requirements of a typing arrangement include: Two products (one of the products can be the trade mark or the service mark or the franchise contract itself *(Siegel v. Chicken Delight, 1971);*

- "Economic power" on the part of the seller; that is, the typing product/service must be desirable (economic power will be automatically inferred from the existence of a patent);
- There must be an actual tie-in (and not just the "opportunity" to purchase goods/services);
- The fact that commerce is "not insubstantially affected." Thus, even a small effect on commerce will bring a tie-in under close scrutiny;
- "No legal justification is present." That is, the rule of reason will be applied in most cases; and
- Damages which can be shown easily if the tied product can be purchased at a lower cost from a second supplier (see, e.g., *Metrix Warehouse, Inc. v. Mercedes-Benz of North America, Inc.,* 1987).

A franchisor can still offer products or services to a franchisee. An illegal tie-in occurs where there is a *requirement of purchase that cannot be justified* under the rule of reason.

Several "justifications" have been offered under a rule of reason analysis that may be especially relevant in franchising:

- Sophistication regarding specifications for a product;
- Quality control (e.g., *Collins v. Dairy Queen, International, 1996; Tripoli v. Wella Corporation,* 1970);
- Product uniformity;
- The "practically indistinguishable" justification (relevant to franchises such as Hires Root Beer, Orange Julius, Dairy Queen). In essence, there is only *one product*- the product is the franchise or the franchise is the product; or
- The "new business" exception (usually for no more than six months) or "failing business" exception established in general antitrust cases (cf., *U.S. v. Jerrold Electronics,* 1961).

Many franchisors also attempt to circumvent rules by offering so-called "turn-key" operations to franchisees; in essence, full package franchises (land/building/equipment and supplies). A turn-key is not illegal; however, recently in the United States, courts have held that no more than a reasonable amount of supplies may be stocked in a franchise operating under an initial turn-key. At the outside, this may be no more than necessary to operate the franchise for an "initial reasonable period" (3-6 months).

Many successful American franchises now operating internationally began by tying-in a whole variety of products and services to an attractive product or service. The method of doing business outlined in KFC was the standard under which most franchises originally operated: low (or no) franchise fees; percentages of income dedicated to the on-going franchising operation and to advertising; and sales of a whole host of products and services "tied" to the relationship (forks, napkins and paper products, "sporks," menu boards, accounting assistance, etc.) that provide the majority of income to the franchisor.

From this study of the *legal aspects of franchising* it should be apparent that a prospective franchisee must thoroughly understand and become familiar with these critical elements and concepts *before* they enter into a relationship that will determine their future success.

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