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1968

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### Recommended Citation

John Clinton Evans Jr., Franchising as a Device for the Organization, Financing, Control, and Growth of the Small Business, 17 Clev.-Marshall L. Rev. 346 (1968)

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## *Franchising as a Device for the Organization, Financing, Control, and Growth of the Small Business*

*John Clinton Evans, Jr.\**

THE FRANCHISE SYSTEM of distribution<sup>1</sup> of goods and services is playing an increasing role in our economy.<sup>2</sup> Historically the word "franchise" meant freedom from a burdensome restriction.<sup>3</sup> It then evolved to mean a privilege in trading extended by a sovereign.<sup>4</sup> Gradually the term has come to mean a special business privilege extended to a dealer by a large company. One marketing authority<sup>5</sup> distinguishes between the product franchise and the franchise of an entire business entity in terms of the role played by each in our complex marketing system of today. Product franchises are given to a few selected dealers in a community, and the distribution of the product is limited to these outlets alone. The consumer desiring the trade-name product has no choice but to make his purchase through one of these so-called authorized dealers. One retailer may have many product franchises but not, as a rule, of competing products. These product franchises may range from a quite loose agreement with the supplier, to an exclusive grant of a marketing territory. The latter practice has of late come under the scrutiny of the Federal Trade Commission for anti-trust review.<sup>6</sup> Familiar examples of product franchises are high quality furniture, pianos, and automobiles. As a result of the anti-trust activity on the part of the federal government, we have recently witnessed a breaking-down of the exclusiveness of automobile dealerships and now find some dealers handling competing makes of automobiles.<sup>7</sup> The other meaning of franchise, as a method of operating an entire business will concern us here.

In a study prepared by the University of Minnesota for The Small Business Administration,<sup>8</sup> it is stated that franchising in its simplest form involves a company with a product or service which arranges for a group

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<sup>1</sup> Lewis and Hancock, *The Franchise System of Distribution* (1963, University of Minnesota).

<sup>2</sup> *The 1967 Franchise Annual*, Vol. 7, No. 7, National Franchise Reports, 333 North Michigan Ave., Chicago, Illinois 60601; Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 *Duke L. J.* 465 (1967).

<sup>3</sup> Webster's *New Twentieth Century Dictionary of the English Language*, Unabridged; *Elliott v. City of Eugene*, 135 Ore. 108, 294 P. 358 at 360 (1930).

<sup>4</sup> *Black's Law Dictionary* 786 (4th ed. 1951).

<sup>5</sup> Hansen, *Marketing Text Cases and Readings* (Richard D. Irwin, Inc., Homewood, Illinois, 1961).

<sup>6</sup> *Franchising Finds It's An Industry*, *Bus. Week* (June 19, 1965).

<sup>7</sup> *Are Supermarkets For Autos Next?*, *Bus. Week* (May 7, 1966).

<sup>8</sup> Lewis and Hancock, *op. cit. supra* note 1.

of dealers to handle its distribution. The company is known as the franchisor, and the dealers who acquire the right, by contract,<sup>9</sup> to sell the product or service are franchisees. Of the contract involved, The Small Business Administration in its internally-circulated *Counseling Notes*<sup>10</sup> has said:

A franchise contract is a legal agreement to conduct a given business in accordance with prescribed operating methods, financing systems, territorial domains, and commission fees. It holds out the offer of individual ownership while following proven management practices. The holder is given the benefit of the franchisor's experience and help in the choice of location, financing, marketing, record-keeping, and promotional techniques. The business starts out with an established product or service reputation. It is organized and operated with the advantages of "name" and standardization.

*Changing Times*<sup>11</sup> states that a franchise business is owned by an individual and operated by him as part of a national, regional, or local chain of businesses. The franchisor's view is reflected in the statement of Matt Perkins, "The Pancake King,"<sup>12</sup> that the franchise concept allows an individual with limited resources to take advantage of a larger economic unit's more plentiful assets of both capital and knowledge. These definitions point up some of the advantages and disadvantages of franchising to both parties.<sup>13</sup>

### Growth of the Franchising Industry

As we now know it, franchising is a relatively recent development in our economy. While it is true that the automobile industry was committed to the franchise distribution system as early as 1910 or 1911<sup>14</sup> and franchised drug stores<sup>15</sup> and root beer stands appeared generally during this era,<sup>16</sup> the phenomenal growth period has been since World War II.<sup>17</sup> Today, franchising is a large factor in retailing, representing an annual volume of approximately \$70 billion.<sup>18</sup>

The franchising industry includes such diverse activities as the installation of automobile mufflers and the operation of motels. Over two years ago there were at least one-third of a million holders of franchises

<sup>9</sup> Directory Of Franchising Organizations, 1 (Pilot Industries, Inc., 1966).

<sup>10</sup> Kursh, *The Franchise Boom*, 15 (Prentice-Hall, 1967).

<sup>11</sup> *Get a Franchise?*, in, *Changing Times*, *The Kiplinger Magazine*, 7 (May, 1959).

<sup>12</sup> Perkins, *The Franchise Concept* (Perkins Pancake Houses, Cleveland, Ohio, 1965).

<sup>13</sup> Scherer, *Financial Security And Independence Through A Small Business Franchise*, 12 (rev. ed. 1967, Pilot Industries).

<sup>14</sup> Hewitt, *Automobile Franchise Agreements*, 18 (Richard D. Irwin, Inc., Homewood, Illinois, 1956).

<sup>15</sup> Kursh, *op. cit. supra* note 10 at 3.

<sup>16</sup> Editorial, *Modern Franchising Magazine* (1967).

<sup>17</sup> *Franchise Selling Catches On*, *Bus. Week* (Feb. 6, 1960).

<sup>18</sup> Vaughn and Slater, *Franchising Today (1966-1967)* at vii.

conducting business in the United States, and it should be mentioned that franchising has spread throughout the free world.<sup>19</sup> Some fifty consulting firms will sell advice to persons wishing either to extend or obtain franchises.<sup>20</sup> Monthly<sup>21</sup> and bi-monthly<sup>22</sup> trade publications exist and the number of authoritative books in the field is increasing.<sup>23</sup> At least one college has set up a center for the study of franchise distribution,<sup>24</sup> while others publish<sup>25</sup> or do contract work<sup>26</sup> in the field. Throughout the country there are franchise exhibitions featuring displays by franchisors seeking to attract potential investors and small businessmen seeking franchises to personally operate.<sup>27</sup> A trade organization, The International Franchise Association<sup>28</sup> was organized in 1959 to represent the industry and to act as a clearing house for information. The result of all this activity has been the emergence of a Code of Ethics<sup>29</sup> and a good deal of standardization of operations. This self-policing functions, as it does in the legal profession, helps to build public trust. There is, however, an ever-present element in society attempting to prey upon franchising as on other industries.<sup>30</sup> Reputable businessmen are protected by the policing agencies of the federal government<sup>31</sup> acting under the implementing legislation and the commerce power.

### The Many Roles of Franchise Counsel

With the increasing trend of business toward franchising, more attorneys are finding themselves called upon to represent either expanding franchisor companies entering the field or small businessmen seeking franchises.<sup>32</sup> The touchstone of success in this, as in any area of law practice, is a bountiful source of information. Routinely found in this

<sup>19</sup> Vaughn and Slater, *Franchising Today* (1965, Report of the First Management Conference on Franchising Held at Boston College, June 10-12, 1965).

<sup>20</sup> The 1967 Franchise Annual, *op. cit. supra* note 2 at 53.

<sup>21</sup> The National Franchise Reports (333 N. Michigan Ave., Chicago, Illinois 60601).

<sup>22</sup> Modern Franchising, 1085 Walnut St., Des Plaines, Illinois 60016.

<sup>23</sup> The 1967 Franchise Annual, *op. cit. supra* note 2, at 7.

<sup>24</sup> Boston College Center For The Study Of Franchise Distribution, Boston, Mass.

<sup>25</sup> Franchising System For Establishing Independent Retail Outlets, The Bureau Of Business And Economic Research Of Georgia State College, Atlanta, Georgia.

<sup>26</sup> Lewis and Hancock, *op. cit. supra* note 1.

<sup>27</sup> Franchises: Start Your Own Business—Exposition At The New York Coliseum, *New Yorker Magazine* 25 (Feb. 12, 1966).

<sup>28</sup> International Franchise Association (333 N. Michigan Ave., Chicago, Illinois 60601).

<sup>29</sup> *Ibid.*

<sup>30</sup> Surest Shortcut To Being Your Own Boss, 86 *Readers Digest* 213 (June 1965).

<sup>31</sup> Slocum, Franchise Flourish, in, *Wall Street Journal* (Dec. 21, 1960).

<sup>32</sup> Quarterly Legal Bulletin of the International Franchise Assoc. (333 N. Michigan Ave., Chicago, Illinois 60601).

field of business are problems in real property, contracts, taxation and business organization.

Basically, the franchise is a contract;<sup>33</sup> however, no two franchise agreements are alike. Attorneys involved in this field often find checklists invaluable until their experience has increased sufficiently. Both information checklists<sup>34</sup> and contract clause lists<sup>35</sup> have been published. Counsel representing the franchisee should go over the franchise offer agreement clause-by-clause. It is his responsibility to clarify the respective rights and duties of his client and particularly to point out where he may run into trouble. During the early excitement of getting his business underway, the client, like the bridegroom, may be unwary and unprepared for the harder facts of his "marriage," or the possible divorce. One clause found in nearly every agreement is the quota clause which states simply that the franchisor expects the franchisee to do a stipulated amount of business or possibly relinquish the franchise. The alternatives to outright loss are many and varied. In some cases the franchisor may do everything including moving the business to a better location, largely at his own expense, to help it succeed, while in the other extreme case he may simply ignore the franchisee until bankruptcy occurs. As a rule, the parent company does not want any failures which can be prevented by their efforts, since obviously their trademark and reputation suffer the exposure. As a result, there exists a low failure rate for this type of business.<sup>36</sup>

The excellent book by Harry Kursh<sup>37</sup> contains specimen contracts from some well-known franchisors. The Small Business Administration also provides helpful material on request. For the attorney who is becoming more involved in franchising, the trade association (IFA), previously mentioned may be of great help. Many of the companies whose addresses appear in the Franchise Annual,<sup>38</sup> a yearbook listing of active franchisors, will provide specimen contracts.

The most basic aspect of any franchise agreement is that it sets forth a continuing relationship<sup>39</sup> designed for the benefit of both parties. Counsel would do well to ascertain if a client who is seeking a franchise realizes that he is making a compromise of a degree of freedom for a potential profit. He will never be truly free and independent of his fran-

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<sup>33</sup> Henle, *How To Start A Family Business*, in, *McCall's Magazine* (Nov. 1962).

<sup>34</sup> Perry and Schultz, *How To Start, Build And Operate Your Own Franchise Business* (Box 1, Kenilworth, Illinois, 60043).

<sup>35</sup> Kursh, *op. cit. supra* note 10 at 69.

<sup>36</sup> Anreder, *License For Growth*, in, *Barron's Weekly* (Nov. 27, 1961).

<sup>37</sup> Kursh, *op. cit. supra* note 10.

<sup>38</sup> The 1967 Franchise Annual, *op. cit. supra* note 2.

<sup>39</sup> Kursh, *op. cit. supra* note 10 at 15.

chisor. The relationship, though paternalistic, is designed to provide a higher probability of business success with profits for both.<sup>40</sup>

The respective rights of the parties to terminate the franchise agreement must be brought out emphatically.<sup>41</sup> Termination is often tied into the quota requirements. The initial and continuing franchise fees, along with the profit percentage contributions of the franchisee to the franchisor are clearly spelled out in the contract. Indemnity clauses make clear the responsibility of the franchisee as an independent businessman and not as an agent of the franchisor when liability to a customer arises. Franchisors universally insulate themselves, insofar as possible, against third party actions arising from the activities of the franchisee.<sup>42</sup> This is accomplished through contractual provisions and insistence upon insurance coverages. In the contract is also found the methods of paying for the fixtures and specialized equipments often supplied with the help of the franchisor's funds. The real estate is often tied to the franchise so that the surrender of the right to represent the product relinquishes any equity in the property to a new franchisee or to the franchisor as the terms may require. Most companies will allow the franchisee who is unhappy to sell his franchise, but usually on the franchisor's own terms. These terms usually require the first franchisee to find a buyer who meets the same requirements imposed upon him and who is acceptable to the franchisor.

The franchise counsel would do well to understand the problems of both parties regardless of whom he represents. In this regard, franchise practice is much like personal injury wherein the main strength of counsel is forged by investigation. This is the most important role of the attorney. His experience uniquely equips him for checking on credit ratings, bank inquiries, personal and professional references and general reputation. The services of local and national credit bureaus and Better Business Bureaus, and particularly those offered by local banks can be utilized. The annual reports of the public companies may be studied. One successful franchisee personally spent six months investigating before committing his savings and time to his eventual enterprise.<sup>43</sup> He talked with other franchisees of the company in his own and distant territories. He states unequivocally that such an effort should be made if it can be afforded. With today's fast moving economy, however, many franchisees will not want to lose time. This will make the work of counsel even more important.

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<sup>40</sup> The National Franchise Reports, *op. cit. supra* note 21 at 3.

<sup>41</sup> Gellhorn, Limitations On Contract Termination Rights—Franchise Cancellations, 1967 Duke L. J. 465 (1967).

<sup>42</sup> Lewis and Hancock, *op. cit. supra* note 1 at 25.

<sup>43</sup> *Op. cit. supra* note 30 at 212.

An attorney guiding a franchisor company may act as advisor and allow the company to use its personnel to perform the detailed investigation. He can show the franchisor's personnel some of an attorney's techniques for ferreting out needed information. Franchisors universally rate franchisees in terms of diligence, aggressiveness and willingness to expend time and money for success. While these attributes are certainly important, other characteristics such as stability, affability, sobriety and general reputation in the community may be equally important. The attorney may provide another view into these areas. He may inquire whether there are any pending suits, undisclosed liens, or anything hidden in the franchisee's background pertinent to the business success. While these points seem self-evident, the record shows that they are often overlooked in many areas of business and even government. The conscientious attorney must look to the future to protect his clients' interests.

According to one source,<sup>44</sup> the Small Business Administration uses a checklist of typical clauses often found in franchise contracts in evaluating them. The following are adaptations of these covenants. The franchisee may be obligated to:

- Use products specified by the franchisor.
- Carry a prescribed inventory.
- Pay a fee, either fixed or continuing, for the franchise.
- Follow the franchisor's specifications in construction.
- Submit potential employees for the franchisor to approve.
- Adhere to business hours prescribed by the franchisor.
- Use a prescribed accounting system or service.
- Submit his books to the franchisor for inspection.
- Contribute to the franchisor's advertising costs.
- Advertise locally as directed by the franchisor.
- Submit this advertising to the franchisor for approval.
- Use prescribed employee uniforms.
- Obtain the amount and types of insurance specified.
- Conduct the business in accordance with franchisor policies.
- Sell the business under terms set by the franchisor.
- Purchase equipment and fixtures as specified.
- Submit periodic financial statements.
- Bank where and when specified by the franchisor.
- Make withdrawals within limits specified by the franchisor.
- Deal only with franchisor-approved services.
- Charge retail prices as specified by the franchisor.
- Conduct no other business upon the franchise premises.
- Give a covenant not to compete after termination as provided.
- Assume all liability for any claims arising out of the business.
- Lease the business to the franchisor, in return take a sub-lease.

In return, the franchisor must:

- Help select a suitable business location.

<sup>44</sup> Kursh, *op. cit. supra* note 10 at 69.

Refrain from forcing the selection, however.

Train the franchisee and his employees.

Aid in the design, layout, construction and leasing of the site for the business.

Aid the franchisee in the promotion and advertising of his business.

Help in the selection of the merchandise.

Provide continuing informational services.

Allow the franchisee to purchase supplies during times when the company is unable to supply them.

Provide managerial assistance including operating manuals and record books.

Not cause or assist the invasion of the assigned business territory by any company-controlled competitive business.

Not sell certain supplies and equipment to nearby competitors.

Not compel the franchisee to sell any product or service, which was not originally written into the agreement.

Permit the financing of supplies and equipment from approved sources.

Financially assist franchisee requiring such aid through no fault of his own.

Permit franchisee to sell the franchise on the open market, provided the purchaser agrees to sign the same agreement originally signed by the franchisee-seller.

Agree not to force the franchisee out of business upon termination of the franchise except as to the requiring of the removal of all identification with the company.

Not terminate the franchise for failure to meet contract quotas without aiding the franchisee to do so.

Must help to relocate the business when changing conditions cause significant sales losses.

Stand behind any merchandise or equipment supplied.

Not alter the exclusive territory without the franchisee's permission.

Obviously some of the covenants on one side are in conflict with those on the other, and a number are questionable in the light of anti-trust laws as will be seen in our discussion of these. Having considered some of the aspects of the franchised business, we will review the methods of small business financing applicable to this method of doing business.

### **The Financing of Franchises**

The classic remark "banks will not lend money unless you don't need it" is somewhat modified today. Lending institutions still look for collateral but it may take the form of mortgages upon the real estate of a business, or the operating machinery, store fixtures or inventory. Even the Small Business Association will stand behind the major part of an investment for a business when such guarantees are provided.<sup>45</sup> Accord-

<sup>45</sup> Small Business Administration (811 Vermont Ave. N.W., Washington, D. C.).



ing to the figures often quoted for small business failures,<sup>46</sup> franchising may be many times the safest place for the investment in a small business venture. There are numerous reasons for the low risk of franchising, but the best is the stability and financial soundness of the franchisor company which by contract almost guarantees the small franchisee a degree of success. The idea of strength in numbers is nowhere better seen than in this activity. The immense resources and management know-how of the large company serve the small businessman. It is said that there are as many methods of arranging the financing as there are franchises.<sup>47</sup>

Every franchise involves the investment of private capital and time, with the ratio of capital to time varying widely. Some very reliable franchisors<sup>48</sup> have said that they are not really so much concerned with how much money the man can raise as how much of himself he is willing to invest. One highly successful franchisor<sup>49</sup> stated that once his company contacted a man whom they believed had great franchisee potential that they would "reach for him" regardless of the capital he could raise. The experience of many successful franchise operations is reflected in this statement. The difference between a success on a grand scale and a moderately profitable business may well hinge on ambition. The actual cash investment for many franchises is well publicized. One source<sup>50</sup> states that a franchise for a gum vending machine for a cash outlay of something over thirty dollars might represent the lower limit of franchise investment, while at the other extreme \$1.5 million might get one started with a restaurant-motel of a well-known chain. Many of the advertised franchises range between ten and thirty thousand dollars as the franchisee's investment.<sup>51</sup> The actual cost of the enterprise may be a total of ten times these respective amounts. The expected return may be anything from a modest living to several times the investment per annum. The business may be financed by the cash investment of the franchisee, a bank loan or a loan from the franchisor, or possibly a combination of these.<sup>52</sup> Under the recently relaxed rules of the Small Business Association, many franchises now qualify for government guarantees if not outright loans.<sup>53</sup> The principal criteria for regarding the franchises as independent businesses revolve around the showing by the

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<sup>46</sup> Vaughn and Slater, *op. cit. supra* note 18 at 251.

<sup>47</sup> Kursh, *op. cit. supra* note 10.

<sup>48</sup> The Franchise Challenge, in, *Fast Food Magazine* (May, 1964).

<sup>49</sup> Kursh, *op. cit. supra* note 10 at 36.

<sup>50</sup> Clark, You Can Be Your Own Boss, in, *Readers' Digest* 222 (Sept. 1959). *Small Business*, in, *Time* 90 (May 24, 1963).

<sup>51</sup> Kiplinger, *Your Guide To A Higher Income* (1959).

<sup>52</sup> *Packaging Businesses, Taking Advantage of Franchises, Anyone Can Be His Own Boss*, in, *The National Observer* (Sept. 10, 1962).

<sup>53</sup> *The 1967 Franchise Annual*, *op. cit. supra* note 2 at 8.

franchisee that he has the rights to the profits of his operation and that he accepts the risk of losses. Normally the SBA with the affiliated lending institutions will match, dollar-for-dollar, the investment of the franchisee up to a statutory limit with the proper collateral.<sup>54</sup> Of increasing concern to the many regulatory agencies of both state and federal governments monitoring commerce is the matter of control.

### The Control and Growth of Franchise Operations

The story of franchising has many chapters dealing with franchisors and franchisees who went from one successful venture into others multiplying their successes. This increase of profits by reinvestment is one of the great incentives of our system. A contrast to this story, however, is often seen by franchisors when they encounter the individual who, suddenly tasting success for the first time, reacts with utter contentment, his ambitions realized. This attitude of sitting back to enjoy the good fortune is antipathetic to the continued expansion of a franchisor's business. Growth is accomplished by the extra effort. The whole consideration of growth in franchising really comes down to the control of the business, or who is really running the show. As stated earlier, the theory underlying franchising is a mutually-beneficial arrangement where both parties contribute to the total success. The opposite point of view is being increasingly noted in the fact that warnings are being published to the public to be alert for sharp "franchisors" out to exploit the good reputation of the industry. These people, if not concocting outright fraudulent schemes, insist upon such an extreme measure of control that the businessman obtaining their franchise has little real chance for success. The regulatory agencies constantly seek such operators. The accepted best method of spotting a "phony" franchise is by investigation, and particularly by interviewing someone who has held a similar franchise for some time. Failing to find someone with experience in dealing with the franchisor, the potential franchisee would do well to look elsewhere.

While overly stringent control by the franchisor may result in anti-trust action, lax control may also catch the eye of the government when it works against the legally-protected interests of the investor. A good franchise operation requires a degree of uniformity and inspection if the trademark is to be protected and the business reputation preserved. The franchisor's expertise can often rectify a bad situation and head off a business failure.<sup>55</sup> Since a proper balance of control is all important in the success of an individual franchise, it is apparent that the regulatory agencies and the courts have the power to tip the scales either way by

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<sup>54</sup> Kursh, *op. cit. supra* note 10 at 41.

<sup>55</sup> Slocum, *op. cit. supra* note 31.

their interpretations of the limits of this control. This leads us quite naturally into the realm of the legality of the franchise method of distribution.

### Is Franchising Legal?

While the original congressional intent in formulating the anti-trust acts was to prevent a few persons from dominating and subjugating an industry or any sizable portion of it, the actual implementation of this intent, as with the income tax laws, has become incredibly involved. We in the legal profession realize that we no longer may expect to master all of its branches and so we look to experts in specialized areas. Their writing can often clarify the state of the law in a given area. Anti-trust law, insofar as it touches franchising, is rapidly evolving. This evolution is directly tied to the fact that franchising permeates every part of our lives; it now represents about ten per cent of the gross national product in value. More cases are reaching the United States Supreme Court each year.<sup>56</sup> New burgeoning industries are the ones most subject to governmental scrutiny. Evidence of coercion, price discrimination, restraint of trade and tendencies toward monopolies is sought. Franchisors are very much concerned with these problems at their annual meetings<sup>57</sup> and spokesmen representing the government and opposing anti-trust counsel are honored speakers. Articles indicate that everyone in the industry is continually seeking assurance that all is well and the watchdogs have no cause for alarm.<sup>58</sup> As every attorney knows, nothing in the law is ever sure; our complex society is changing rapidly and we must find out the situation as it stands at the moment. It can be said that, at the moment, franchising seems to be under no concerted attacks.<sup>59</sup> One reassuring view expressed by Judge Dawson in the case of *Susser v. Carvel Corp.*<sup>60</sup> is worthy of quoting:

The franchise method of operation has the advantage, from the standpoint of our American system of competitive economy, of enabling groups of individuals with small capital to become entrepreneurs. The franchise business has had a phenomenal growth in the ice cream industry. If our economy had not developed that system of operation, these individuals would have turned out to have been merely employees. The franchise system creates a class of independent businessmen; it provides the public with an opportunity to get a uniform product at numerous points of sale from small independent contractors, rather than employees of a vast chain. The franchise system of operation is therefore good for the economy.

<sup>56</sup> Arbitration News, No. 9 (Amer. Arbit. Assoc., 1967).

<sup>57</sup> Vaughn and Slater, *op. cit. supra* notes 18 and 19.

<sup>58</sup> A Poor Job Of Protecting Competition, in, Bus. Week 76 (July 2, 1949).

<sup>59</sup> High Court Hints A Softer Note, in, Bus. Week 40 (June 17, 1967).

<sup>60</sup> 206 F. Supp. 636 at 640 (S.D.N.Y. 1962), *affd.*, 332 F.2d 505 (2d Cir. 1964).

At first glance the tenets of the anti-trust laws do not seem to apply in relation to franchising. The specter of the power of the federal government pursuing the barons of steel or oil is one thing, but this power turning on the small businessman is something else. As one writer<sup>61</sup> has said, the anti-trust laws and the enforcement policies may be likened to a horse-drawn trolley carrying passengers to a jet airport. There may be something to this analogy, inasmuch as the respective modes of transportation reflect the changes in our economy from the time of the first anti-trust action to the present time. The updating of this legislation still lags the economy considerably.

The second glance may provide a little clarification when it is seen that many of the cases concern the interest of the federal government in curbing overly ambitious franchisors who might let their growth threaten the existence of competition in their fields. The federal government is, in recent years, concerned with the survival of everyone. The view of some agency officials may be reflected by something said several years ago before a Federal Bar Association conference. The Chief of the General Trade Restraints Division of the Federal Trade Commission was quoted as follows:<sup>62</sup>

. . . the very nature of a franchise agreement suggests restraint of trade and although the franchise system is legal, it may be abused when either the suppliers or distributors become dominant and exert coercion.

Supreme Court cases decided during 1967 set forth the view that a franchisor who distributes his products by consignment, instead of outright sale to his franchisees, has not surrendered dominion and that the franchisee is not therefore an independent businessman.<sup>63</sup> It has also been held that franchisors who agreed on retail prices had conspired in contravention of the anti-trust laws.<sup>64</sup>

During 1966 the now famous case of *FTC v. Brown Shoe Co.*<sup>65</sup> dealt directly and thoroughly with a franchise program. Unfair competition was charged and the power of the FTC was reaffirmed by the following quote from the case of *FTC v. Motion Picture Adv. Co., Inc.*:<sup>66</sup>

It is . . . clear that the Federal Trade Commission Act was designed to supplement and bolster the Sherman Act and the Clayton Act . . . to stop in their incipiency acts and practices which, when full blown, would violate those Acts . . . as well as to condemn as "unfair methods of competition" existing violations of them.

<sup>61</sup> Kursh, *op. cit. supra* note 10 at 167, and 168.

<sup>62</sup> Lewis and Hancock, *op. cit. supra* note 1 at 72.

<sup>63</sup> *United States v. Arnold, Schwinn & Co.*, 87 S.Ct. 1856, 388 U.S. 365 (1967).

<sup>64</sup> *United States v. Sealy, Inc.*, 87 S.Ct. 1847, 388 U.S. 350 (1967).

<sup>65</sup> 86 S.Ct. 1501, 384 U.S. 316 (1966).

<sup>66</sup> 344 U.S. 392 at 394-395 (1966).

In the study of the present state of anti-trust laws as they apply to franchising, it is perhaps instructive to review the developments during the past eighteen years since much of franchising has evolved during this period. In 1949 in a monumental case involving Standard Oil Company of California<sup>67</sup> and its contractual arrangements with its 6,000 independent dealers, the U.S. Supreme Court outlawed the so-called requirements contracts when the effect was to "foreclose competitors from a substantial market." Many of the tying arrangements so often seen in franchise agreements, wherein the franchise to sell one product requires the use or sale of another of the franchisor's products, would seem to be precluded by the provisions of the Clayton Act.<sup>68</sup> The *Standard Oil* decision and those that followed it indicate that when a franchise reaches the stage where it begins to threaten the existence of competitors in the field it will be subject to very strict control. Shortly after this decision the General Motors Corporation decided to revise its dealership agreements "in the light of legal trends under the anti-trust laws . . . to anticipate any future legal attacks."<sup>69</sup> It became clear that the period of exclusive-dealing contracts was over, and that perhaps territory restriction clauses would soon be the target of governmental control. No sooner had the Federal Trade Commission been successful with Standard Oil Co. than they tackled a dozen other companies prominent in franchising.<sup>70</sup> In addition to the litigation a number of cease-and-desist orders were issued.<sup>71</sup> These, of course, allowed time for compliance with the Commission orders. The question naturally arising in the mind of an attorney is just what the practical effect of a decision such as the *Standard Oil Co.* case is on the day-to-day activities of such an organization. It has been said that most dealers and wholesalers still found it in their best interests to voluntarily deal exclusively with the franchisor-supplier even absent such contract clauses.<sup>72</sup>

The furor stirred up by the exclusive-dealing decision continued for many years, and the interpretation of Section 3 of the Clayton Act as outlawing exclusive dealing contracts when the effect is to lessen competition or create monopolies, is still under refinement.<sup>73</sup> In 1957 the forty thousand new car dealers in the United States felt threatened by state regulation. At the beginning of that year no less than 18 states had passed laws regulating their franchises.<sup>74</sup> In *White Motor Co. v. United*

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<sup>67</sup> *Standard Oil Company Of California v. United States*, 337 U.S. 293 (1949).

<sup>68</sup> *Exclusive Dealing: Under Fire*, in *Bus. Week* 78 (Aug. 27, 1955).

<sup>69</sup> G. M. Precaution, in, *Bus. Week* 52 (Oct. 1, 1949).

<sup>70</sup> *Exclusive Dealing Draws New Fire*, in, *Bus. Week* (Oct. 15, 1949).

<sup>71</sup> *No Peace For Exclusive Dealing*, in, *Bus. Week* 95 (May 5, 1951).

<sup>72</sup> *Ibid.*

<sup>73</sup> *Exclusive Contracts Ruled Out*, *op. cit. supra* note 66.

<sup>74</sup> *Auto Dealer Franchises In Peril*, in, *Bus. Week* 65 (Mar. 23, 1957).

*States*,<sup>75</sup> the Supreme Court pointed out that not every control imposed by a franchisor on his franchisees is illegal, per se, but each must be tested against the "rules of reason" read into the Sherman Act. In the same case the court held that vertical territorial limitations may have the purpose or effect of stifling competition and therefore may be "too dangerous to sanction."

So as not to paint too gloomy a picture it might be well to quote Judge Perry in the *Schwinn* case<sup>76</sup> which subsequently went on to the U.S. Supreme Court for their decision:

It is unnecessary to discuss the development of franchises in the American business world. It is a fact of business life and by and large its effects are wholesome and it furnishes a means for enterprising individuals and businesses to continue developing our competitive society along with all of the bigness of business.

The franchise counsel who diligently reads the cases concerning anti-trust and franchise operations has done much of his preparation, but an area fraught with great dangers still must be investigated.<sup>77</sup> Many of us remember the subject of "doing business" as a fuzzy area in our Conflict of Laws courses. It is incumbent upon counsel representing a franchisor to very carefully investigate the laws of each state in which his client intends any activities. What constitutes doing business is an extremely varied array of acts.<sup>78</sup> Intrastate business is regulated by the state agencies and these are often authorized to impose extremely harsh penalties. If it is found that qualification or registration is required in order to do business, this may be infinitely less expensive than the possible sanction of not being allowed to do business at all or suffering a crippling fine.

In addition to the possibility of being subject to all of the corporation and securities commissions within a state, the business may be subject to the local tax laws and to service of process within the state. The fact that some states have criminal penalties in addition to civil liabilities for infractions should be considered.<sup>79</sup> In at least Alaska, Colorado, and Connecticut jail sentences may be imposed upon the officers of a corporation. In some other states, for example, Tennessee and Virginia, the stockholders of a corporation may be liable for its contracts.

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<sup>75</sup> 83 S. Ct. 696, 372 U.S. 253 (1963).

<sup>76</sup> *United States v. Arnold, Schwinn & Co.*, 237 F. Supp. 323 at 334-335 (N.D. Ill. 1965), reversed on other grounds 87 S. Ct. 1856 (1967), 388 U.S. 365.

<sup>77</sup> Vaughn and Stater, *op. cit. supra* note 18 at 359.

<sup>78</sup> For a full discussion of this point see, *What Constitutes Doing Business (The Corporation Trust Co., 1965)*.

<sup>79</sup> Vaughn and Slater, *op. cit. supra* note 18 at 359.

### **Conclusion**

The franchise method of distribution has become a major industry in America today and is spreading throughout the world. Its dollar volume of business has reached 1/10 of our gross national product and will, no doubt, go much beyond this. The attorney, no matter what his practice, will come more and more into contact with legal problems of franchising. The governmental regulatory agencies, both state and federal, are increasingly busy with franchise problems. There are no standard rules guiding every aspect of franchising, and the attorney would do well to keep abreast of the developments in order to safeguard his clients and to better serve those whose franchising activities bring them to his door.