St. Mary's Law Journal

Volume 14 | Number 2 Article 3

1-1-1983

Franchising in Texas.

Mark H. Miller

FRANCHISING IN TEXAS

MARK H. MILLER*

---

* B.A. 1974, Austin College; J.D. 1978, St. Mary's University; Shareholder, Gunn, Lee & Jackson, P.C., San Antonio, Texas. The author wishes to express his sincere thanks and appreciation for the research assistance provided by Stephen F. Morris, candidate for J.D. degree, May 1983, St. Mary's University School of Law.

I. FRANCHISE REGULATION

A. *Generally*

As any one with a driver's license may attest, franchising has become a vital part of our economy. Franchised gasoline stations, restaurants, and other outlets line every major thoroughfare. An amazing thirty-one percent of all retail sales in the United States are now made through franchises.[1]

The promise of franchising is partly reflected in the fact that during the current recession, franchised businesses have survived almost twice as often as non-franchised businesses.[2] The nightmare is that many inexperienced franchisors and modern day snake oil salesmen have used the method of franchising to defraud franchisees and investors on a scale never before possible.[3] Franchising is

1. U.S. Dep't of Commerce, *Franchising In The Economy* 1981-83 (1983).

2. U.S. Dep't of Commerce, *Franchising In The Economy* 1979-81 (1980).

3. *See* 43 Fed. Reg. 59,614, 59,627-35 (1978) (FTC entertained about 400 complaints involving about 170 franchisors); H. BROWN, FRANCHISING: REALITIES & REMEDIES §§ 1.01[3], 1.03[4] (rev. ed. 1981); *see also* Annot., 64 A.L.R.3d 6 (1975). The New York Legislature recognized the great potential for abuse when it enacted franchise regulation laws. The policy declaration provides:

> 1. The legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems in New York. New York residents have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor-franchisee relationship, . . . the prior business experience of the franchisor, and other factors relevant to the franchise offered for sale.
>
> 2. It is hereby determined and declared that the offer and sale of franchises, as defined in this article, is a matter affected with a public interest and subject to the

thus a double-edged sword; it benefits the public by making available specialized distribution systems and pooling specialized skills,[4] but also provides a means for massive fraud and unconscionable conduct.[5]

This article is written as an overview for the Texas general practitioner with little or no prior knowledge of "franchise law." An attorney representing either a franchisor or a franchisee must be familiar with both relevant federal and other states' laws for several reasons. Many of the common causes of disaster lie in the federal realm. Additionally, most Texas franchisors ultimately expand into other states. Finally, the jurisprudence of franchising will necessarily follow the economic reality of franchising to Texas. An attorney who is not cognizant of these trends will always be at least one advance sheet behind.

The California Franchise Investment Law, enacted in 1970, was the first comprehensive regulation of franchising.[6] Shortly thereaf-

---

supervision of the state, for the purpose of providing prospective franchisees and potential franchise investors with material details of the franchise offering so that they may participate in the franchise system in a manner that may avoid detriment to the public interest and benefit the commerce and industry of the state. Further, it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled.

N.Y. GEN. BUS. LAW § 680.1-680.2 (McKinney Supp. 1982-1983) (legislative findings and declaration of policy).

4. *See* Cantor, *The Federal and State Regulation of Franchises (Part 1)*, 27B PRAC. LAW. 55, 57-58 (Sept. 1981). Among the advantages are site selection, systematic methods of operation, uniform products, and identifiable trademarks. *Id.* at 57-58.

5. *See, e.g.*, A.B.C. Packard, Inc. v. General Motors Corp., 275 F.2d 63, 67-68 (9th Cir. 1960) (fraud could occur for failure to disclose "termination policy" to distributor); Potter's Photographic Applications Co. v. Ealing Corp., 292 F. Supp. 92, 106 (E.D.N.Y. 1968) (defendant guilty of fraud in terminating distributorship agreement); Headrick v. Mutual Supply Co., 497 P.2d 701, 703 (Colo. Ct. App. 1972) (misrepresentation and fraud by franchisor). In an effort to prevent fraud and unconscionable conduct, attempts were made to regulate franchising by defining it as a "security" under the *Howey* test. S.E.C. v. W.J. Howey, Co., 328 U.S. 293, 298-99 (1946). This approach floundered, however, and is currently out of favor. *See, e.g.*, Martin v. T.V. Tempo, Inc., 628 F.2d 887, 891 (5th Cir. 1980); Crowley v. Montgomery Ward & Co., 570 F.2d 877, 880-81 (10th Cir. 1978); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531, 539 (Tex. Civ. App.—Austin 1970, writ ref'd n.r.e.); *cf.* Wilson v. Lee, 601 S.W.2d 483, 485 (Tex. Civ. App.—Dallas 1980, no writ) (joint venture not a "security" within Securities Act). *But see In re* Fashion Flair, Inc., BUS. FRANCHISE GUIDE (CCH) ¶ 7577 (opinion of Oklahoma Securities Commission, July 3, 1980). If franchisor plans to use the franchise fee to pay for goods or services to be delivered to franchisee or to repay debts, the sale of a franchise could be the sale of a security. *Id.* ¶ 7576; *see also* Stanley v. Commercial Courier Serv., Inc., 411 F. Supp. 818, 823 (D. Or. 1975).

6. *See* CAL. CORP. CODE §§ 31000-31516 (Deering 1979). California's franchise regula-

ter, the Federal Trade Commission (FTC) proposed a trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (Rule 436)."[7] Rule 436 was not promulgated, however, until 1978 and did not become effective until October 21, 1979.[8]

B. *Rule 436*

Rule 436 is applicable to "product franchises,"[9] "package franchises,"[10] and "business opportunity ventures."[11] The elements of a package and product franchise are:

(1) a common identifying business format, such as a trade name

---

tion act treats a franchise as analogous to a security, in part because of a California Attorney General's opinion stating that a franchise sale may be a security under certain circumstances. *See* 49 Op. Att'y Gen. 124 [1961-1971 Transfer Binder] BLUE SKY L. REP. (CCH) ¶ 70,747 (1967). *See generally* Damon, *Franchise Investment Law*, 2 PAC. L.J. 27 (1971).

7. *See* 16 C.F.R. § 436 (1982). The term "rule 436" is used herein rather than "part 436." While clients readily appreciate that they must obey "rules," explaining what a "part" is, is never entirely satisfying to clients who are unfamiliar with the Code of Federal Regulations. Additionally, the regulation is often referred to simply as "the rule."

8. *See* 44 Fed. Reg. 49,966 (1979).

9. The FTC guidelines describe a product franchise as follows:

> A product franchise distributes goods that are produced by the franchisor (or under his control or direction) and which bear the franchisor's trademark. The product franchisor exercises significant control over the franchisee's method of operation or, alternatively, promises to provide a significant degree of assistance in the franchisee's method of operation. The franchisee is required to pay the franchisor for the right to sell the trademarked goods, either by required purchases of equipment, supplies, etc., or by paying an initial fee for the right to sell the goods.

Id. at 49,966.

10. The FTC guidelines describe a package franchise as follows:

> A package franchise adopts the business format established by the franchisor and identified by the franchisor's trademark. The franchisee's method of operation in producing the goods or services sold by him are subject to significant controls instituted by the franchisor or, alternatively, the franchisor promises to render significant assistance to the franchisee in the operation of the business. The franchisee is required to pay money to the franchisor.

Id. at 49,966.

11. These terms are not found within rule 436 itself but within its guidelines. *See id.* at 49,966-68. Although the guidelines are essential to understanding rule 436, they are not published in the Code of Federal Regulations, but may be obtained by writing the Federal Trade Commission, Pennsylvania Avenue & Sixth Street, N.W., Wash., D.C. 20580, (202)523-1753, or found in the August 24, 1979, Federal Register. The term prospective franchisee includes "any person . . . who approaches or is approached by a franchisor . . . for the purpose of discussing the establishment . . . of a franchise relationship involving such a person." 16 C.F.R. § 436.2(e) (1982). A person is "any individual, group, associate, limited or general partnership, corporation, or any other business entity." *Id.* § 436.2(b).

or trademark;[12]

(2) significant control of, or assistance to, the franchisee's method of operation;[13] and

(3) a required payment by the franchisee to the franchisor or an affiliate.[14]

A business opportunity venture exists if:

(1) the franchisee is to sell goods or services supplied by the franchisor, its affiliates, or suppliers specified by the franchisor;[15]

(2) the franchisor directly or indirectly secures retail outlets, accounts, or locations for vending devices or racks for the goods or services;[16] and

(3) a required payment is paid by the franchisee to the franchisor or an affiliate.[17]

These definitions were deliberately made extremely broad.[18] The draftsmen intended to expand the FTC's jurisdiction in this area of perceived abuse to include all business methods remotely similar to franchising.[19] Generally speaking, multiple sales of businesses, each employing a similar business format, is "franchising" and therefore subject to Rule 436.[20]

Rule 436 is applicable in all states. It requires disclosure to potential franchisees, prior to certain specified deadlines, of twenty categories of information about the franchisor and the business to

---

12. *See id.* § 436.2(a)(1)(i)(A)(*1*).

13. *See id.* § 436.2(a)(1)(i)(B)(*1*).

14. *See id.* § 436.2(a)(2).

15. *See id.* § 436.2(a)(1)(ii)(A).

16. *See id.* § 436.2(a)(1)(ii)(B).

17. *See id.* § 436.2(a)(2). A "required payment" is a sum of at least $500.00 paid for the business before or within six months after the franchisee commences operations. *Id.* §§ 436.2(a)(2), (3)(iii). "Inventory payments" comprised of bona fide wholesale prices for reasonable quantities of inventory do not count toward the $500.00 threshhold. *See* F.T.C. Op. Letter 6 (Aug. 9, 1979), *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 6382. Notes subject to certain defenses and payable after the six month period also do not count toward the threshhold amount. *Id.* ¶ 6382. Purely oral agreements are exempt from rule 436. *See* 16 C.F.R. § 436.2(a)(3)(iv) (1982).

18. Rule 436.2(a)(3)-(4) specifically exempts the following relationships even though they may fall within the definition of "franchise": (1) fractional franchise, (2) leased departments, (3) minimal investments, (4) oral agreements, (5) employer-employee and general partner relationships, (6) cooperative associations, (7) testing services, and (8) "single" trademark licenses. *See* 16 C.F.R. § 436.2(a)(3)-(4) (1982). Explanations by the FTC of each exemption can be found at 44 Fed. Reg. 49,968-69 (1979).

19. *See generally* 44 Fed. Reg. 49,966-69 (1979).

20. *See id.* at 49,969.

be sold.[21] These deadlines are the "five day rule,"[22] the "ten day rule,"[23] and the "first personal meeting rule."[24] The most important points concerning rule 436 are that it (1) requires *disclosure* to potential franchisees, *not* registration or filing,[25] and (2) does not provide a private cause of action for persons injured in the course of its violation.[26]

C. *Uniform Franchise Offering Circular*

Since the California Franchise Investment Law was enacted,[27] twenty states have enacted business opportunity laws,[28] and fourteen states have enacted franchise registration laws.[29] Numerous

---

21. 16 C.F.R. § 436.1(a)(1)-(20) (1982).

22. *See id.* § 436.1(g). The five day rule stipulates that the franchisee must receive a copy of the franchise agreement to be executed "at least five business days prior to the date the agreements are to be executed." *Id.* § 436.1(g). A "business day" means any day other than Saturday, Sunday, and certain designated holidays. *Id.* § 436.2(f). The names of these "rules" are used by the author to explain to clients what they may and may not do. In a strict sense the nomenclature is not accurate.

23. *See* 16 C.F.R. § 436.2(g) (1982). Any material change in the disclosures required under the rule must be made at least ten business days prior to executing a franchise agreement or paying consideration in connection with the sale of a franchise. The ten day rule is actually termed the "time for making of disclosures." *Id.* § 436.2(g). "Material change" in a disclosure includes "any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee . . . in the making of a significant decision relating to a named franchise business . . . ." *Id.* § 436.2(n).

24. *See id.* § 436.2(o). Certain disclosures must be made at the "first personal meeting." This is a "face-to-face meeting between a franchisor . . . and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise." *Id.* § 436.2(o).

25. *See id.* § 436.1(a); 44 Fed. Reg. 49,966 (1979).

26. *See* 15 U.S.C.A. § 56(a)(2) (West Supp. 1982); *cf.* Holloway v. Bristol-Myers Corp., 485 F.2d 986, 998 (D.C. Cir. 1973) (no private cause of action under Federal Trade Commission Act); Davies v. Arthur Murray, Inc., 260 N.E.2d 240, 244 (Ill. App. 1970) (Act does not create private cause of action for remedy). *But see* 44 Fed. Reg. 49,966, 49,971 (1979). The FTC guidelines express the "opinion" that "any person injured by a violation of the rule has a private right of action . . . ." *Id.* at 49,971.

27. *See* CAL. CORP. CODE §§ 31000-31516 (Deering 1979). The Act was effective January 1, 1971.

28. The following states have enacted business opportunity laws: Alabama, California, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, Maine, Maryland, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, South Carolina, Texas, Utah, Virginia, and Washington. BUS. FRANCHISE GUIDE (CCH) ¶ 2001.

29. The following states have enacted franchise registration laws: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. *Id.* ¶ 2003. These franchise laws survive the FTC rule's preemptive effect either because they provide more protection to the franchisee or they are not inconsistent with the federal rule. *Id.* ¶ 2003.

other states have enacted laws regulating the franchise relationship.[30]

To reduce conflicts and promote compliance, the Midwest Securities Commissioners Association[31] in 1975 approved a Uniform Franchise Offering Circular (UFOC) to be used by franchisors as their disclosure document.[32] While rule 436 literally pre-empted the UFOC in 1979,[33] the FTC has authorized use of the UFOC instead of the rule 436 disclosure document with certain exceptions.[34] In states that do not specifically require use of the UFOC disclosure document, therefore, a franchisor has a choice of which format to use.[35] The FTC format, however, is shorter and requires less disclosure, particularly for a new franchisor, than the UFOC format.[36] Most registration states, however, require that the UFOC rather than the FTC format be used.[37] Thus, in those states a prior choice of the FTC format will require an entirely new disclosure document.

The strictest standard in either format is the UFOC's famous "Question 19" which requires disclosure of the profitability and financial structure of the franchisor and the record of its franchisees.[38] Franchisors not in operation long enough to develop sales

30. BUS. FRANCHISE GUIDE (CCH) ¶ 3000-4999.

31. The Midwest Securities Commissioners Association was merged with the North American Securities Administrators Association on July 30, 1980.

32. *See* BUS. FRANCHISE GUIDE (CCH) ¶¶ 5700, 5750. The reader should be aware that as of the date of this writing, revisions of the UFOC proposed by the Franchise Committee of the North American Securities Administrators Association are being circulated for public comment. The following items of the UFOC are subject to revision: §§ III-VI, XIX-XXI, and XXIV.

33. *See* 44 Fed. Reg. 49,966, 49,971 (1979).

34. *See* 16 C.F.R. § 436.3 n.2 (1982) (FTC does not prohibit use of other regulatory schemes); 44 Fed. Reg. 49,966, 49,970 (1979) (FTC format not mandatory). Either rule 436 or the UFOC format must be used in its entirety; franchisers are not free to pick and choose between formats. 44 Fed. Reg. 49,966, 49,970 (1979).

35. See BUS. FRANCHISE GUIDE (CCH) ¶ 5827 for a list of which disclosure scheme a particular state requires.

36. *Compare* 16 C.F.R. § 436.3 n.3 (1982) (twenty specific items required by FTC to be disclosed by franchisor) *with* Uniform Franchise Offering Circular (UFOC), *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 5750 (twenty-three specific items to be disclosed, including statement of actual or projected earnings).

37. The following states mandate the use of the UFOC format: California, Hawaii, Illinois, Indiana, Michigan, Minnesota, North Dakota, Oregon, Rhode Island, South Dakota, Washington, and Wisconsin. BUS. FRANCHISE GUIDE (CCH) ¶ 5827.

38. *See* UFOC Question 19, *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 5750. This question provides that all "actual, average, projected or forecasted sales, profits or earnings

and profit histories are prohibited from making any such projections.[39] The UFOC becomes difficult for a new franchisor to use because it is virtually impossible to sell a franchise without making projections.[40]

Either disclosure format smokes out the franchisor by forcing him to make written representations for which he can later be held accountable. Further, a truthful disclosure document provides potential franchisees with the information necessary to make a businesslike decision to purchase. From the franchisee's point of view, the most important disclosures are the performance of prior franchisees and the franchisor's financial health.

Many states require information not found in either the UFOC or FTC formats.[41] The prudent franchisor will attempt to provide the complete information required by all states in a single document to avoid the preparation of a new disclosure document for each state. A limitation of this practice, however, is that many states have conflicting directives, some requiring inclusion of information that other states forbid.[42] In any event a state's specific cover sheet must be used in most states.[43]

The overwhelming advantage of preparing and using the UFOC format is that, with the above exceptions, it may be used in all states. The rule 436 format should not be used, therefore, unless the franchisor's track record will not withstand UFOC scrutiny[44] and the franchisor has been advised of the geographical limitations of the rule 436 format.[45]

---

must be for or based upon a *substantial number* of franchisees in a concurrent equal period of time . . . ." *Id.* Question 19C(2), ¶ 5750 (emphasis added).

39. *See id.* Question 19C(4), ¶ 5750.

40. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES, § 6.07[3] (rev. ed. 1981).

41. *See* BUS. FRANCHISE GUIDE (CCH) ¶ 5827 (itemizes state differences in disclosure).

42. *Compare* UFOC "Body of Offering Circular" Question 3A, *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 5750 (requires disclosure of any civil or criminal actions against persons affiliated with franchisor) *with* CAL. BUS. & PROF. CODE § 461 (Deering 1975) (California prohibits disclosure to state agency of applicant's prior arrests not leading to conviction).

43. *See, e.g.*, CAL. CORP. CODE § 31122 (Deering 1979); ILL. ANN. STAT. ch. 121-½, ¶ 710 § 10 (Smith-Hurd Supp. 1982-1983); IND. CODE ANN. § 23-2-2.5-13 (Burns Supp. 1982).

44. *Compare* UFOC Question 19C(1)-(8) *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 5750 (requires franchisors to disclose actual or projected earnings of a franchise location) *with* 16 C.F.R. § 436.1(20) (1982) (requires disclosures of financial information of franchisor only, not actual or projected earnings of a potential franchise location).

45. Geographical limitations arise because certain states require the use of formats

D. *Registration and Impound Prior to Sale*

To understand state registration requirements it is necessary to understand the plague they are designed to cure. Franchising is an excellent vehicle for the unscrupulous or undercapitalized franchisor to collect thousands of dollars in franchise fees, royalties, and other monies from state citizens, only to later vanish into bankruptcy.[46] The common law is inadequate to deal with this phenomenon as it avoids interfering with relationships until a party cries "foul,"[47] after which wrongs are remedied by an award of damages. In franchising, however, the wrong itself, failure of the franchisor to support his franchisees because of his bankruptcy, prevents recovery.

When a franchisor disappears, defrauded citizens complain loudly and demand that something be done.[48] In response, various forms of franchise regulations have been enacted.[49] To be meaningful, however, regulation requires (1) enforcement of disclosure requirements and (2) enough money to satisfy damage awards. The first concern may be satisfied by examination of the state disclosure document prior to the franchise sale,[50] and the second by either an audit, showing sufficient franchisor financial reserves, or an impound.[51]

Fourteen states have laws requiring registration and possible impound prior to the sale of franchises.[52] Because the penalties for

---

other than the FTC format. *See* 44 Fed. Reg. 49,966, 49,970 (1979); BUS. FRANCHISE GUIDE (CCH) ¶ 5827.

46. *See* Brown, *Franchising: Fraud, Concealment And Full Disclosure*, 33 OHIO ST. L.J. 517, 518-19 (1972).

47. *See* Gerst v. Nixon, 411 S.W.2d 350, 361 (Tex. 1966) (court cannot rule on purely hypothetical case).

48. *See* 43 Fed. Reg. 59,614, 59,627-35 (1978) (FTC entertained about 400 complaints involving abuses by 170 franchisors).

49. *See* CAL. CORP. CODE §§ 31000-31516 (Deering 1979) (Franchise Investment Law effective January 1, 1971); R.I. GEN. LAWS §§ 19-28-1 to 19-28-15 (1982) (Franchise And Distributorship Investment Regulations Act effective July 1, 1973).

50. *See* Brown, *Franchising: Fraud, Concealment And Full Disclosure*, 33 OHIO ST. L.J. 517, 555-70 (1972).

51. *See* CAL. CORP. CODE § 1113 (Deering 1979); BUS. FRANCHISE GUIDE (CCH) ¶ 5827.

52. The following states require registration and possible impound prior to the franchise sale: California, Illinois, Indiana, Maryland, Michigan, Minnesota, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. BUS. FRANCHISE GUIDE (CCH) ¶ 2003. Generally, state law controls advertisements for the sale of franchises if two-thirds of the publication is distributed in that state. This is a separate area requiring com-

selling franchises without registration in these states are Draconian,[53] the franchisor must comply with registration requirements to be successful on a national basis. The franchisor can usually satisfy the disclosure and registration requirements through amendments to his application. Only later does he confront the real dragon—the impound.[54]

The impound is the state's guarantee that its citizens' injuries will be remedied. In theory, the franchisor is impartially evaluated to determine his ability to satisfy obligations to franchisees in a given state.[55] If found unsound, the franchisor is required to place sufficient monies within the state's reach to assure the remedying of any wrongs.

The reality is that the state subjectively determines whether an impound should be imposed. An impound deprives the franchisor of the use of the initial franchise fee until the state concludes he has fulfilled his obligations to his franchisees. This may effectively preclude the franchisor from selling franchises in that state. Some states have exempted larger, well-established franchisors from registration because there is no real need for regulation of a franchisor from whom damages can be collected,[56] and likewise exempted sales to sophisticated investors that do not need protection.[57]

---

pliance. *See* Pitofsky, *Beyond Nader: Consumer Protection And The Regulation Of Advertising*, 90 HARV. L. REV. 661 (1977).

53. *See, e.g.*, CAL. CORP. CODE §§ 31300, 31404 (Deering 1979) (rescission, damages, and criminal prosecution available if act is violated); ILL. ANN. STAT. ch. 121-½, ¶ 718-20 § 18-20 (Smith-Hurd Supp. 1982-1983) (suspend or terminate sale of franchises, civil and criminal prosecution for violating act); MICH. STAT. ANN. § 19.854(38) (Callaghan 1981) ($10,000 fine, seven years criminal punishment, or both, for violating any provision of act). In Nauman v. J's Restaurants Int'l, 316 N.W.2d 523 (Minn. 1982), the franchisor was ordered by the trial court to pay the franchise fee, plaintiff's costs, disbursements, and attorney's fees due to franchisor's failure to register with the state before selling franchises. The supreme court affirmed all damages granted, and reversed for failure to award franchisee prejudgment interest. *Id.* at 524.

54. An impound is a sum of money, usually equal to the initial franchise fee, held by the state until it is assured that the franchisor will fulfill his obligations to the franchisee. The impound requirement may be satisfied in many ways, including dedicated bank accounts, escrow, and bonds.

55. *See* CAL. CORP. CODE § 31101 (Deering 1979). The California statute exempts franchisors from the disclosure requirements if found financially sound as measured by criteria in the statute. *Id.* § 31101.

56. *See, e.g.*, CAL. CORP. CODE § 31113 (Deering 1979); ILL. ANN. STAT. ch. 121-½, ¶ 712 § 12 (Smith-Hurd Supp. 1982-1983); KY. REV. STAT. ANN. § 367.807 (Bobbs-Merrill Supp. 1980).

57. *See* WIS. STAT. ANN. § 553.22 (West 1980).

Compliance with franchise disclosure regulations does not end on registration; both federal and state law regulate advertising the sale of the franchise and require amendment of the disclosure document in the event of any material change.[58] Complete files should be maintained for each potential franchisee showing compliance with applicable franchise laws. Additionally, many states regulate the ongoing franchise relationship or termination of it.[59] In this regulation and disclosure process, the franchisor's officers and attorneys may have a personal duty to fairly present all material facts to the prospective franchisee.[60]

II. TEXAS LAW

A. *Texas Business Opportunity Act*

The Senate Judiciary Committee held hearings during the 67th Legislative Session to determine if Texas required legislation to regulate the sale of businesses to consumers. The Consumer Protection Division of the Attorney General's Office presented substantial evidence of the inadequacy of current law by producing complaints from numerous Texas citizens who had been defrauded by unscrupulous business opportunity sellers and left without any effective remedy.[61] Consequently, the Business Opportunity Act (BOA) was enacted, effective August 31, 1981.[62]

1. The Statute—Split Authority

The legislature intended that the Act be construed to "protect persons against false, misleading, or deceptive practices in the ad-

58. *See* TEX. REV. CIV. STAT. ANN. art. 5069-16.08 (Vernon Supp. 1982-1983); 16 C.F.R. § 436.1(a)(22) (1982). The official synopsis of FTC business opportunity advertising rules can be found in BUS. FRANCHISE GUIDE (CCH) ¶ 7527. State laws and regulations may be found at ¶¶ 3000-4999, 5000-5699.

59. Franchise relationships in certain industries such as automobile and gasoline sales are extensively regulated. *See* 15 U.S.C. §§ 1221-25 (1982) (Automobile Dealer Suits Against Manufacturer); *id.* §§ 2801-24 (Petroleum Marketing Practices Act).

60. *See* New York v. Carvel Corp., 1982-1 TRADE CAS. (CCH) ¶ 64,533 (N.Y. Sup. Ct., App. Div. Nov. 27, 1981); *see also* FTC v. H.N. Singer, Inc., TRADE REG. REP. (CCH) ¶ 21,734 (N.D. Cal. 1980) (franchisor's sales manager liable for sales representatives' deceptive practices of which he was aware).

61. *See* recorded tape for Senate State Affairs Committee on S.B. 533 (BOA).

62. TEX. REV. CIV. STAT. ANN. arts. 5069-16.01 to -16.15 (Vernon Supp. 1982-1983).

vertising, offering for sale or lease, and sale or lease of business opportunities to provide efficient and economical procedures to secure such protection."[63] These noble sentiments are virtually wasted, however, as the BOA leaves Texas citizens almost as defenseless against business opportunity and franchise abuse as they were before its enactment.

The BOA was modeled after a North Carolina statute.[64] A major difference, and corresponding structural flaw in the Texas Act, however, is that BOA registration is with the business oriented Secretary of State's Office[65] while enforcement is with the consumer oriented Attorney General's Office.[66] Applications for franchise registration are not substantively examined by the Secretary of State to determine if the disclosure documents accurately reflect statutory requirements.[67] This is not a failure on the part of the Secretary of State's Office, which has no investigatory power, but of the BOA.[68] The Act does not appear to vest the Secretary of State with authority to do anything but keep BOA records.[69]

---

63. *Id.* art. 5069-16.04.

64. *See* N.C. GEN. STAT. §§ 66-94 to 66-100 (Supp. 1981) (Business Opportunity Sales statute).

65. TEX. REV. CIV. STAT. ANN. art. 5069-16.08 (Vernon Supp. 1982-1983) (seller of business opportunity shall register with Secretary of State prior to sale).

66. *Id.* art. 5069-16.15, § (c) (Attorney General to review filings and enjoin sale of business opportunity if such registration fails to comply with Act).

67. *See id.* art. 5069-16.09. The Texas statute requires that the following language appear after the title in the disclosure statement given to the franchisee: "The State of Texas has not reviewed and does not endorse, approve, recommend, or sponsor any business opportunity. The information contained in this disclosure has not been verified by the state. If you have any questions about this investment, see an attorney before you sign a contract or agreement." *Id.* art. 5069-16.09.

68. The author wishes to publicly commend the Business Opportunity section of the Secretary of States's Office for their efforts in administrating the BOA.

69. The Secretary of State issued the following rules on August 31, 1981 pursuant to TEX. REV. CIV. STAT. ANN. art. 5069-16.01 (Vernon Supp. 1982-1983).

Section 97.1 Registration of Business Opportunities

(a) The acceptance of documents shall only be upon submission of a complete initial file and payment of applicable fee.

(b) Documents for submission must follow the format prescribed by the Office of the Secretary of State.

(c) Specifications pertaining to the prescribed format may be obtained by writing The Business Opportunity Section, Office of the Secretary of State, P. O. Box 13563, Austin, Texas 78711-3563.

1 TEX. ADMIN. CODE § 97.1 (McGraw-Hill May 1, 1982).

Section 97.21 Fees; General Information.

(a) The filing fee for an initial original file is $195 and is nonrefundable, and must

An initial attempt by the Secretary of State to advise concerned businessmen whether they were required to register under the BOA was stopped after the Attorney General observed that such legal determinations were the exclusive province of the Attorney General.[70] Because the BOA records are in the Secretary of State's office, however, the Attorney General has neither looked at, nor substantively examined, the filings. Without a substantive examination, the mere fact that a business opportunity franchisor has registered with the Secretary of State does not provide the Texas consumer with any additional protection. Conversely, because the huckster may represent, and the consumer confirm, that the business opportunity has been "accepted" by the Secretary of State, the implication is given that Texas has investigated the offering and found it reputable.[71]

The failure of the divided Texas system is further apparent when the abuses sought to be eliminated, or at least disclosed, are recalled; undercapitalization of the franchisor, negligible assistance by the franchisor, and reliance on franchise fees rather than royalties as the primary source of the franchisor's income are all items that reveal a probability of system-wide collapse and bankruptcy. These abuses are not prevented by the Secretary of State's current procedural review of the filings. Further, the single most important

---

be submitted in the form of a money order or cashier's check.

(b) The fee for supplemental or amendment filing is $25 and is nonrefundable, and must be submitted in the form of a money order or cashier's check.

(c) File material may be obtained in either a total or partial file format upon advance payment of the fees set out below:

(1) total file of a business opportunity registrant — $10;

(2) partial file — $.50 per page;

(3) certified copies — $1.00 per page plus $1.00 for the certificate; and

(4) certificate of record or no record — $2.00.

Id. § 97.21.

70. The Secretary of State's office published a Proposed Preliminary Examination Rule under which the Secretary of State would initially examine a prospective seller's business offering to determine if it was subject to registration under the BOA. This Rule was withdrawn due to objections by the Attorney General that such legal opinions were beyond the Secretary of State's jurisdiction.

71. The standard letter issued by the Secretary of State upon satisfying filing requirements does not indicate that the applicant has obtained a BOA registration. The complete text of this letter is: "This letter will acknowledge receipt for the above named instrument. Since the Texas Business Opportunity Act does not provide for a certificate of filing, you may use this letter as evidence of the filing in this office." In light of the Attorney General's jurisdiction over the BOA, however, no more than this is possible.

consideration in determining whether a franchisor will act responsibly is his amount and type of capitalization. Franchisors with a small shareholder's equity who seek large franchise fees up front are difficult to register in other states. Texas does not similarly protect its citizens.

Most states give complete business opportunity jurisdiction to an enforcement agency or commission that has experience with regulating business for the protection of the public.[72] In a state where the Secretary of State may belong to one political party and the Attorney General to another, as in Texas, it is counterproductive to divide BOA jurisdiction between them. The result is that the law is simply not enforced. Full jurisdiction and responsibility for both filing and enforcement should be with the Attorney General. Texas consumers are as unprotected now as before the enactment of the BOA.[73]

2. Gutting the BOA

The single most important section of the BOA provides that a business opportunity does not include: "the sale of a 'product franchise' or 'package franchise' as defined by the Federal Trade Commission Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures."[74]

The International Franchise Association (IFA) lobbied the Senate Judiciary Committee for this amendment. The rationale was that product and package franchises were already regulated by rule 436 and that failure to exempt them would cause pre-emption problems.[75] Regulation of product and package franchises was represented to be a complex area requiring the expertise of the FTC.

While some other states also have business opportunity acts that

---

72. *See* CAL. CORP. CODE § 31111 (Deering 1979) (filing and enforcement rests with state Commissioner of Corporations); ILL. ANN. STAT. ch. 121-½, ¶¶ 716, 718 §§ 16, 18 (Smith-Hurd Supp. 1982-1983) (registration and enforcement with attorney general).

73. As of January 13, 1983, 98 disclosure statements have been filed. In the BOA's first year, 58 filings were made. A copy of the Business Opportunity Section Worksheet is attached as Appendix A. To insure prompt filing, the application should be divided between Exhibits A, B, and C as shown in the Secretary of State's Worksheet.

74. TEX. REV. CIV. STAT. ANN. art. 5069-16.06, § (1)(C) (Vernon Supp. 1982-1983).

75. The caveat was added that unless the exemption were added, the IFA would use its influence to prevent passage of any bill.

do not apply to franchising, most of these acts are paired with companion franchise regulation acts.[76] The grievances sought to be redressed by the Texas Legislature in the BOA were those presented in legislative hearings. Many of these grievances concerned sales of businesses that had a name or mark and a promised marketing plan or tangible assistance to the franchisee that sold for over $500.[77]

As described above, package and product franchising was defined by the FTC in the broadest possible terms, with the intent of granting the FTC as much authority as possible. Unfortunately, the realities of rule 436 belie its apparent protections. Rule 436 falls far short of providing the protection it was thought would occur when the legislature excluded regulation of product and package franchise from the BOA. Specifically, rule 436:

(1) does not require registration or filing,[78]
(2) does not provide the protection of state or federal review of the disclosure statement before the purchaser relies on it,[79]
(3) does not provide a private cause of action,[80] and
(4) enforcement is limited due to a small FTC staff that can do little more than respond to complaints.[81]

As a practical matter, therefore, rule 436 is violated almost with impunity by the beginning franchisor. The FTC, due to its limited staff, has filed very few rule 436 suits; those filed are usually against large, visible franchisors.[82] Because of the provision ex-

---

76. *See generally* BUS. FRANCHISE GUIDE (CCH) ¶ 2001. It is important to note that Texas has no general franchise regulation law.

77. *See* recorded tapes for Senate State Affairs Committee on S.B. 533 (BOA).

78. 16 C.F.R. §§ 436.1(a), 436.1(d)(1) (1982).

79. *See id.* § 436.1(d)(1); *see also* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 6.07[1] (rev. ed. 1981).

80. *See* Holloway v. Bristol-Myers Corp., 485 F.2d 986, 988-89 (D.C. Cir. 1973); *see also* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 6.08[2] (rev. ed. 1981). *But see* 44 Fed. Reg. 49,971 (1979). The FTC guidelines express the opinion that "any person injured by a violation of the rule has a private right of action . . . ." *Id.* at 49,971.

81. The lack of action by the FTC is comparative only. The small staff responsible for rule 436 enforce it to the full extent possible. The problem is that there are many hundreds of violations per staff person. While in the author's experience the FTC staff has always been helpful and responsive to all inquires, they simply do not have sufficient personnel to fully police "franchising" as such. *Contra* FTC v. H.N. Singer, Inc., TRADE REG. REP. (CCH) ¶ 21,734 (N.D. Cal. 1980) (FTC may bring court action on behalf of individuals for violation of rule 436).

82. *See* FTC v. Enamelcraft, Inc., No. 81-C-1582 (D. Colo. filed Sept. 9, 1981); FTC v.

empting package and product franchises from BOA application and the lack of a private cause of action in rule 436, Texas citizens have no remedy for franchise-related business fraud.

The BOA does apply to certain nonexempted sales of business opportunities, such as multiple sales of vending machine businesses with the promise of assistance in securing locations, tax preparation service businesses with the promise of securing accounts, and possibly the sale of worm or chinchilla farm-type operations.[83]

3. BOA Quirks

Having asserted the meaninglessness of the BOA it hardly seems appropriate to continue. Certain quirks should be noted in passing, however, on the assumption that the "franchisors protection clause" will someday be repealed.

The exemption for "sales, production, or marketing programs offered in conjunction with a federally registered trademark or service mark"[84] is without rational basis. Any business opportunity seller willing to spend a few hundred dollars to obtain a federal registration may exempt himself without a corresponding benefit to Texas franchisees.[85]

The "businessman" exemption is extremely vague.[86] The intent was to exempt sales of franchises to businessmen as opposed to sales to consumers, on the theory that businessmen can look out for themselves. A securities type "sophisticated investor" exemption should be used instead, as the exact wording of the present

---

Marketing Assoc., Inc., No. 812-3070 (D. Colo. filed July 9, 1981); H. BROWN, FRANCHISING: REALITIES & REMEDIES § 6.08[2] (rev. ed. 1981).

83. *See generally* TEX. REV. CIV. STAT. ANN. art. 5069-16.05, § (2) (Vernon Supp. 1982-1983). The only case filed to date under the BOA of which the author is aware is Black v. Electronic Games, Inc., No. 83-CI-00192 (Dist. Ct. of Bexar County, 150th Judicial Dist. of Texas, January 5, 1983).

84. TEX. REV. CIV. STAT. ANN. art. 5069-16.05, § (2)(B)(ii) (Vernon Supp. 1982-1983).

85. If buy back or assistance in finding locations is promised, the franchisor will not be exempted by obtaining a federal registration. *See* TEX. REV. CIV. STAT. ANN. art. 5069-16.05, § (2)(B)(i), (iii) (Vernon Supp. 1982-1983).

86. *See id.* art. 5069-16.06, § (1)(F). The exemption applies to "a sale or lease to an existing or beginning business enterprise which also sells or leases equipment, products, and supplies or performs services (1) which are not supplied by the seller and (2) which the purchaser does not utilize with the equipment, products, supplies, or services of the seller." *Id.*

exemption leads to absurd results.[87]

The required disclosure statement of the BOA is worthy of note in three respects. First, the format conforms neither to rule 436 nor to the UFOC.[88] If actually enforced, the burden on the state in assisting franchisors with conforming their disclosure documents to the statutory requirements would be enormous. Although the Secretary of State's office will accept any format for filing purposes, this does not make the document acceptable under the BOA; only the Attorney General's Office has the authority to make that determination and it has not done so.[89] The second consideration is the requirement of the following verbatim statement: "[i]f the Seller fails to deliver the product, equipment, or supplies necessary to begin substantial operation of the business within 45 days of the delivery date stated in your contract, you may notify the seller in writing and cancel your contract."[90] The third consideration is the twelve and ten point type requirements.[91] Those familiar with the type size requirements of Texas Consumer Credit Code will recognize the great potential for litigation in this area.[92]

To effect the purpose of the Act as well as lessen its burden on both the state and the business community, the specific disclosure requirements should be replaced by either a simple direction to the Attorney General to implement a UFOC format for the disclosure document or a grant of authority to promulgate such regulations as the Attorney General deems will effect the intent of the BOA.[93]

If a seller "guarantees" certain representations made to a franchisee, he must establish a $25,000 trust account or bond in favor

87. *See id.*. A literal reading apparently extends the BOA's protection to a purchaser that is familiar with the type of business opportunity purchased but does not protect a purchaser that is unfamiliar with the type of business opportunity purchased.

88. *Compare* TEX. REV. CIV. STAT. ANN. art. 5069-16.09 (Vernon Supp. 1982-1983) (disclosure statement format) *with* 16 C.F.R. § 436.3 n.3 (1982) (disclosure statement outline) *and* Uniform Franchise Registration Application, *reprinted in* BUS. FRANCHISE GUIDE (CCH) ¶ 5750 (UFOC application and instructions).

89. *See* TEX. REV. CIV. STAT. ANN. art. 5069-16.15, § (c) (Vernon Supp. 1982-1983).

90. *Id.* art. 5069-16.09, § (q) (disclosure requirement number nine allows franchisee to cancel after 45 days if franchisor fails to perform). This type of verbatim requirement tends to unnecessarily burden national franchisors that must comply with various state laws.

91. *Id.* art. 5069-16.09.

92. *See id.* arts. 5069-6.01 to -7.10. There are numerous type size requirements throughout these two chapters of the Credit Code that have spawned dozens of cases.

93. The Attorney General should then allow the business community to use either the UFOC or the rule 436 disclosure statements.

of the state.[94] As a general rule, however, franchisors do not "guarantee" anything. Furthermore, since the Secretary of State does not have authority to substantively examine BOA applications, insertion of the statement that "applicant is not required by the Texas Business Opportunity Act . . . to post bond as a prerequisite for registration" is sufficient to avoid a bond requirement. In any event, a single $25,000 bond would not reasonably secure multiple franchisees.

It is clearly the responsibility of the Attorney General to issue rules and opinions for the BOA's operation. To date it has not issued a single rule or opinion. The FTC and other states with analogous acts have found such regulations and interpretive opinions necessary.[95] The Texas Attorney General's office should follow suit.

4. Remedies and Enforcement

The BOA simply incorporates the remedies provided in the Texas Deceptive Trade Practices Act (DTPA).[96] Unfortunately, the DTPA is not designed to remedy fraud in the sale of business opportunities. It does not, for example, grant rescission as an absolute right for knowing violations of the BOA.[97] The wronged franchisee, therefore, must plead and prove, in addition to the franchisor's violation of the BOA, all of the grounds for rescission including substantial impairment of value.[98] Further, since "actual damages" are common law damages,[99] the franchisee has the diffi-

---

94. TEX. REV. CIV. STAT. ANN. art. 5069-16.09 (Vernon Supp. 1982-1983) (requiring bond or trust account upon "guarantee" by franchisor). The Secretary of State's office will provide upon request Surety Bond forms for the Seller of a Business Opportunity in the State of Texas.

95. *See* ILL. ANN. STAT. ch. 121-½, ¶¶ 705.2, 727 §§ 5.2, 27 (Smith-Hurd Supp. 1982-1983); 44 Fed. Reg. 49,966 (1979); BUS. FRANCHISE GUIDE (CCH) ¶¶ 5000-5699.

96. TEX. REV. CIV. STAT. ANN. art. 5069-16.15, § (b) (Vernon Supp. 1982-1983).

97. *Compare* TEX. BUS. & COM. CODE ANN. § 17.50(b)(1)-(4) (Vernon Supp. 1982-1983) (no absolute right to rescission) *with* CAL. CORP. CODE § 31300 (Deering 1979) (franchisee may sue for rescission and damages) *and* FLA. STAT. ANN. § 559.813(1) (West Supp. 1982) (franchisee may rescind within one year after executing franchise contract) *and* GA. CODE ANN. § 106-1507(a) (Supp. 1980) (franchisee may void contract within one year after execution).

98. *See* Freeman Oldsmobile Mazda Co. v. Pinson, 580 S.W.2d 112, 114 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.) (to rescind under DTPA, must plead and prove substantial impairment of value); *see also* TEX. BUS. & COM. CODE ANN. § 17.50(b)(3) (Vernon Supp. 1982-1983).

99. *See* Smith v. Kinslow, 598 S.W.2d 910, 915 (Tex. Civ. App.—Dallas 1980, no writ)

cult burden of proving the value of the *new* franchise as a going business.[100]

Under the DTPA, the franchisee also has the burden of establishing that the franchisor "knowingly" failed to comply with the BOA to obtain treble damages.[101] The franchisee's damages are limited to those "produced" by the franchisor's failure to comply with the BOA.[102] These limitations prevent the use of wronged franchisees as "private attorney generals" to police an area of perceived abuse in lieu of expensive state enforcement.[103] Many other states have taken the private attorney general approach and given wronged franchisees the absolute right of rescission together with civil and criminal penalties against the franchisor.[104]

B. *Texas Deceptive Trade Practices Act*

The franchisor's most common sins are failure to adequately disclose: (1) his capitalization and method of generating revenues, (2) the capitalization required of the franchisee to be successful, (3) the amount of support to be given the franchisee, and (4) the probable success of the franchisee. Private DTPA causes of action for these failures may be based on the section 17.46(b)(23) prohibition against "failure to disclose information concerning goods or ser-

---

(actual damages under DTPA section 17.50(b)(1) means common law damages).

100. *See* Woo v. Great Southwestern Acceptance Corp., 565 S.W.2d 290, 298 (Tex. Civ. App.—Waco 1978, writ ref'd n.r.e.) (damages based on net value paid for distributorship); *cf.* City of Marshall v. Bryant Air Conditioning Co., 650 F.2d 724, 726 (5th Cir. 1981) (plaintiff must introduce proof as to damages to recover under DTPA).

101. *See* TEX. BUS. & COM. CODE ANN. § 17.50(b)(1) (Vernon Supp. 1982-1983) (if "conduct of the defendant was committed knowingly, the trier of fact may award not more than three times" actual damages); *cf.* Yates v. Medrano, 580 S.W.2d 49, 50 (Tex. Civ. App.—Houston [1st Dist.] 1979, no writ) (plaintiff must prove knowledge or intent to recover treble damages).

102. *See* TEX. REV. CIV. STAT. ANN. art. 5069-16.15, §§ (a)(1), (b) (Vernon Supp. 1982-1983).

103. The San Antonio Division of the Texas Attorney General's office on October 26, 1981 "interrupted" a gathering of business opportunity sellers. Each seller was permitted to continue only after signing an "Assurance of Voluntary Compliance" which was separately filed in Bexar County District Courts. This has been the only enforcement of the BOA by the Attorney General to date.

104. *See* CAL. CORP. CODE § 31300 (Deering 1979) (rescission and damages available); FLA. STAT. ANN. § 559.813(1) (West Supp. 1982) (rescission available within one year after execution of franchise agreement). *But see* Clapp v. Peterson, 327 N.W.2d 585, 586-87 (Minn. 1982) (franchisor may raise equitable defenses to suit for rescission based upon technical violation of Minnesota disclosure law).

vices" which may result in a fraud on the franchisee.[105] The section 17.46(a) prohibition of "[f]alse, misleading or deceptive acts or practices"[106] taken together with DTPA section 17.46(c)(1) directing the courts to be "guided by Subsection (b) of this section and the interpretations given by the Federal Trade Commission and federal courts to section 5(a)(1) of the Federal Trade Commission Act,"[107] provide the Attorney General with the power to obtain relief against franchisors who do not comply with rule 436.

Rule 436 specifically states "it is an unfair or deceptive act or practice within the meaning of section 5 of [the Federal Trade Commission] Act for any franchisor or franchise broker" to fail to comply with rule 436.[108] Thus a franchisor is in violation of the DTPA as a matter of law upon proof that he failed to supply rule 436 or equivalent disclosures. This proposed construction would fill the gap left in the BOA and permit the Attorney General to police package and product franchisors who are exempt from the BOA.[109] An initial enforcement effort would require that the Attorney General respond in the name of John Doe to the numerous advertised offers in Texas newspapers to sell franchises.[110] The problems referred to above with respect to undercapitalized franchisors and the difficulties in obtaining either damages, rescission, or both, will remain, however, until the BOA is amended.[111]

C. *Texas Antitrust Law*

1. Generally

Because of differences between Texas antitrust law and federal antitrust law, otherwise competent national franchisors and anti-

105. TEX. BUS. & COM. CODE ANN. § 17.46(b)(23) (Vernon Supp. 1982-1983).

106. *Id.* § 17.46(a).

107. *Id.* § 17.46(c)(1).

108. 16 C.F.R. § 436.1 (1982).

109. *See* TEX. REV. CIV. STAT. ANN. art. 5069-16.06, § (1)(C) (Vernon Supp. 1982-1983) (exemption of package and product franchise from application of BOA).

110. This is the method most commonly used by the consumer protection agencies of other states to police business opportunity act compliance.

111. The Texas antitrust law is antiquated and in need of revision; the Attorney General has made repeated but unsuccessful attempts to amend it to be more in line with Federal antitrust law. *See* Proposed Amendment to Business Opportunity Act, TEX. REV. CIV. STAT. ANN. arts. 5069-16.01 to -16.15 (Vernon Supp. 1982-1983), Tex. S.B. 975, 67th Leg. (1981).

trust counsel often prepare agreements which violate the Texas statute. The chief difference is that because of the Texas law's much greater specificity in defining a "trust," any violation is typically per se unlawful.[112]

The primary factor limiting application of the Texas antitrust law is that it applies only to transactions relating to the buying, selling, and transporting of "tangible personal property."[113] Purely service industries, therefore, would appear to not be regulated.[114]

Reliance on the federal commerce clause for exemption from Texas antitrust law is unavailable to the extent that the national franchisor's activities affect Texas.[115] Texas antitrust law is limited, however, in its application to the franchisor's activities that actually affect Texas.[116]

2. Exclusive Territories

With certain exceptions, any agreement preventing a party located in Texas from buying or selling goods to third persons is unlawful.[117] This is true regardless of the reasonableness of the re-

---

112. *Compare* 15 U.S.C. §§ 1-7 (1973) (trust is any contract or combination in restraint of trade) *with* TEX. BUS. & COM. CODE ANN. § 15.02(b)(1)-(7) (Vernon 1968) (specific listing of trust violations).

113. *See* Duggan Abstract Co. v. Moore, 139 S.W.2d 198, 201 (Tex. Civ. App.—Fort Worth 1940, writ dism'd judgmt cor.) (antitrust statute regulates merchandise, produce, and commodities in which public interested).

114. *See* State v. Southeast Tex. Chapter of Nat'l Elec. Contractor's Ass'n, 358 S.W.2d 711, 713 (Tex. Civ. App.—Texarkana 1962, no writ), *cert. denied*, 372 U.S. 965 (1963); *cf.* State v. Fairbanks-Morse & Co., 246 S.W.2d 647, 658 (Tex. Civ. App.—Dallas 1951, writ ref'd n.r.e.) (city cannot violate state antitrust laws). Note that the service of selling insurance would, however, appear to be covered. *See* TEX. BUS. & COM. CODE ANN. § 15.02(b)(5)(D) (Vernon 1968).

115. *See* E.F.I., Inc. v. Marketers Int'l, Inc., 492 S.W.2d 302, 306 (Tex. Civ. App.—Houston [1st Dist.] 1973), *writ ref. n.r.e. per curiam*, 506 S.W.2d 579 (Tex. 1974).

116. *Compare* Elray, Inc. v. Cathodic Protection Serv., 507 S.W.2d 570, 574 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ) (manufacture of goods within Texas sufficient to invoke application of Texas antitrust law) *and* Waters-Pierce Oil Co. v. State, 106 S.W. 918, 930 (Tex. Civ. App. 1907, writ ref'd) (performance within state violation of Texas antitrust law, even if contract not executed within state), *aff'd*, 212 U.S. 86 (1909) *with* E.F.I., Inc. v. Marketers Int'l, Inc., 492 S.W.2d 302, 305 (Tex. Civ. App.—Houston [1st Dist.] 1973) (performance of contract interstate, isolated acts committed within Texas, not sufficient to invoke Texas antitrust law), *writ ref'd n.r.e. per curiam*, 506 S.W.2d 579 (Tex. 1974).

117. *See* TEX. BUS. & COM. CODE ANN. § 15.03(a)(1) (Vernon 1968); *cf.* Hatchett v. Williams, 437 S.W.2d 334, 338 (Tex. Civ. App.—Houston [1st Dist.] 1968, writ ref'd n.r.e.) (if agreement stifles competition, subject to antitrust laws), *cert. denied*, 396 U.S. 963 (1969).

straint,[118] or whose favor the restraint is in.[119] Thus even if the buyer is free to resell anywhere, the contract is unlawful if the seller has agreed by a territorial exclusive provision to sell only to the buyer in that territory.[120] The granting of exclusive territories to franchisees has become very popular since the United States Supreme Court in *Continental T.V., Inc. v. GTE Sylvania, Inc.*[121] ruled they are not a per se violation of the federal antitrust laws.[122] This is particularly true because an exclusive sales territory often is in the best interests of both the franchisor and the franchisee. It is, therefore, a well-worn trap for the unwary.[123]

The preferred means used to deal with this Texas anamoly while at the same time prepare an agreement which is satisfactory in other states is to grant the franchisee an "area of primary responsibility."[124] The franchisor promises to not appoint other franchisees within this area;[125] he does not promise the franchisee that it is his exclusive marketing territory. The invading franchisees may even be required to pay "reasonable" pass-over payments[126] to the invaded franchisee in whose territory the goods are sold.[127] Such an

---

118. *See* Graphilter Corp. v. Vinson, 518 S.W.2d 952, 954 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.) (agreement not to sell goods, by itself, unlawful regardless of reasonableness of agreement).

119. *See* Climatic Air Distribs. v. Climatic Air Sales, Inc., 162 Tex. 237, 241-42, 345 S.W.2d 702, 704-05 (1961); W.T. Rawleigh Co. v. Land, 115 Tex. 319, 330-31, 279 S.W. 810, 813-14 (Tex. Comm'n App. 1926, judgmt adopted).

120. *See* M.I.I. v. E.F.I., Inc., 550 S.W.2d 401, 402-03 (Tex. Civ. App.—Houston [14th Dist.] 1977, writ ref'd n.r.e.), *cert. denied*, 435 U.S. 1008 (1978).

121. 433 U.S. 36 (1977).

122. *See id.* at 57-59 (restrictions are judged by rule of reason).

123. *See* Climatic Air Distribs. v. Climatic Air Sales, Inc., 162 Tex. 237, 241-42, 345 S.W.2d 702, 704 (1961).

124. *See* Sherrard v. After Hours, Inc., 464 S.W.2d 87, 89 (Tex. 1971); Erickson v. Times Herald Printing Co., 271 S.W.2d 329, 332 (Tex. Civ. App.—Dallas 1954, writ ref'd n.r.e.).

125. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365, 376 (1967), *overruled*, Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1976) (adopted rule of reason as standard for verticle restraint violation). A franchiser "of a product other and equivalent brands of which are readily available in the market may select his customers, and for this purpose he may 'franchise' certain dealers to whom, alone, he will sell his goods." *Id.* at 376; *see also* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 10.06[3] (rev. ed. 1981).

126. A "pass-over" payment, as a result of an "invading" franchisee consummating a sale in the former's market area, is a reimbursement to the "invaded" franchisee for preliminary sales activities, such as advertising, and subsequent activities, such as stocking spare parts. *See* Note, *Restricted Channels Of Distribution Under The Sherman Act*, 75 HARV. L. REV. 795, 814-17 (1962).

127. *See* White Motor Co. v. United States, 372 U.S. 253, 271 n.10 (1963) (Brennan, J.,

arrangement is lawful so long as the pass-over payments serve a reasonable business purpose and the sale of goods to third persons is not de facto prohibited.[128]

There are exceptions to the above general rule. First, because a "trust" requires two entities, no antitrust violations can occur between a principal and his agent as they are deemed a single entity.[129] Second, similar logic dictates that so long as the consignor owns the goods he can legally place whatever restrictions he wishes upon the consignee's treatment of the goods.[130] Third, while passage of title is the primary indicator of ownership, other factors may outweigh it.[131] Less clear is the ability of a real or personal property lessor to restrict the lessee to dealing in only the lessor's goods on the leased premises or with the leased equipment. Fourth, a patentee may impose restrictions upon a good until its first sale.[132] Fifth, contracts dedicating a seller's output or a buyer's requirements are judged under the rule of reason and are not per se unlawful.[133] An agreement to purchase only the goods of the seller, however, is unlawful.[134] A final exception, applicable to the national franchisor, applies when an out of state franchisor

---

concurring).

128. *See id.* at 271-72 n.12 (Brennan, J., concurring). *But see* Eiberger v. Sony Corp. of Am., 622 F.2d 1068, 1076-77 (2d Cir. 1980) (pass-over payment relating to warranty work held violative of Sherman Antitrust Act where such payment reduced intrabrand competition).

129. *See* American Brewing Ass'n v. Woods, 215 S.W. 448, 449-50 (Tex. Comm'n App. 1919, judgmt adopted); Cunningham v. Frito Co., 198 S.W.2d 772, 775 (Tex. Civ. App.—San Antonio 1946, no writ); Texas Brewing Co. v. Anderson, 40 S.W. 737, 738 (Tex. Civ. App. 1897, writ ref'd). Similarly, an individual acting alone cannot commit an antitrust violation. *See* Llewellyn v. Borin, 569 S.W.2d 946, 949 (Tex. Civ. App.—Texarkana 1978, no writ).

130. *See* Milburn Mfg. Co. v. Peak, 89 Tex. 209, 211, 34 S.W. 102, 103 (1896); Lemmon v. Furst & Thomas, 166 S.W.2d 755, 756-57 (Tex. Civ. App.—Dallas 1942, writ ref'd w.o.m.).

131. *See* Morris v. J.I. Case Credit Corp., 411 S.W.2d 783, 789 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.) (title retained by seller for security purposes only); *cf.* Stein Double Cushion Tire Co. v. Wm. T. Fulton Co., 159 S.W. 1013, 1016 (Tex. Civ. App.—Dallas 1913, writ ref'd) (despite appearance of sale, transfer of goods was consignment).

132. *See* General Talking Pictures Corp. v. Western Elec. Co., 305 U.S. 124, 127 (1938).

133. *See, e.g.*, Texas Indus. v. Brown, 218 F.2d 510, 511-13 (5th Cir. 1955) (requirements contract held enforceable); Portland Gasoline Co. v. Superior Mktg. Co., 150 Tex. 533, 535-36, 243 S.W.2d 823, 824-25 (1951) (output contract held legal and enforceable); Guadalupe-Blanco River Auth. v. City of San Antonio, 145 Tex. 611, 627, 200 S.W.2d 989, 999 (1947) (agreement to purchase all electricity does not create unlawful monopoly).

134. *See* Wright v. Southern Ice Co., 144 S.W.2d 933, 935 (Tex. Civ. App.—Texarkana 1940, writ ref'd) (agreement which obligated buyer to purchase goods only from specified seller violates Texas antitrust law).

agrees to sell the product to only the franchisee in a territory within Texas and to no one else. Standing alone, this restrains only interstate rather than intrastate commerce and is thus jurisdictionally beyond the scope of Texas antitrust laws.[135]

3. Other Violations

Most federal antitrust violations such as boycott, tie-ins, vertical and horizontal price fixing, and predatory pricing are also independent violations of Texas antitrust law.[136] These will be discussed below.

The unlawful agreement need not be a written contract but may be oral or established by conduct.[137] The franchisor's attorney must, therefore, carefully review the client's entire business operations to prevent violations.[138]

4. Remedies and Penalties

Damages under the Texas antitrust law are only single damages,[139] as compared to federal antitrust automatic treble damages.[140] Because of this a plaintiff with a large antitrust injury will typically rely on federal rather than state antitrust law.

Agreements in violation of Texas antitrust laws are absolutely

---

135. *See* Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 413 (5th Cir. 1962). The *Denison* court held that where a company's activities were "occasional and isolated and that the contract in question was interstate as to execution and performance," then federal law will apply, not Texas antitrust law. *Id.* at 413; *see* Albertype Co. v. Gust Feist Co., 102 Tex. 219, 221-22, 114 S.W. 791, 792 (1908). Note, however, that Texas antitrust laws will apply even to an interstate, nation-wide conspiracy if Texas is affected. *See* Waters-Pierce Oil Co. v. State, 106 S.W. 918, 930 (Tex. Civ. App. 1908, writ ref'd), *aff'd*, 212 U.S. 86 (1909).

136. *See* State v. Southeast Tex. Chapter of Nat'l Elec. Contractor's Ass'n, 358 S.W.2d 711, 714 (Tex. Civ. App.—Texarkana 1962, no writ) (state antitrust laws are supplementary to, and not excluded by, federal regulatory scheme), *cert. denied*, 372 U.S. 965 (1963).

137. *See, e.g.*, State v. Standard Oil Co., 130 Tex. 313, 329-30, 107 S.W.2d 550, 559-60 (1937) (conspiracy not limited to statutory definition of article 7428); Russell v. Hartford Casualty Ins. Co., 548 S.W.2d 737, 742 (Tex. Civ. App.—Austin 1977, writ ref'd n.r.e.) (conspiracy involves two or more persons acting unlawfully); Bourland v. State, 528 S.W.2d 350, 354 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.) (tacit understanding sufficient for conspiracy agreement to be formed).

138. *See* TEX. BUS. & COM. CODE ANN. § 15.04(b) (Vernon 1968).

139. *See* North Tex. Gin Co. v. Thomas, 277 S.W. 438, 439 (Tex. Civ. App.—Dallas 1925, writ ref'd); TEX. BUS. & COM. CODE ANN. § 15.32(a)-(c) (Vernon 1968).

140. *See* 15 U.S.C. § 15 (Supp. IV 1980).

void and unenforceable.[141] The court will literally "leave the parties where they find them."[142] Even if the agreement is based on several considerations, only one of which is unlawful, the entire agreement is void if not divisible.[143] Texas antitrust violations can be used to void debts or other unwanted agreements and retain all prior delivered benefits without set-off, restitution, or compensatory payment whatsoever.[144] Thus a purchaser or franchisee owing many thousands of dollars to his supplier or franchisor may keep all delivered goods and benefits without payment simply by proving a minor but indivisible Texas antitrust violation in the underlying agreement.[145]

Because of this difference in remedies the practitioner must carefully consider whether wiping out debts or obtaining treble damages is more advantageous under the circumstances.

D. *Texas Trade Secret and Noncompetition Law*

1. Trade Secrets

A trade secret "may consist of any formula, pattern, device, or compilation of information which is used in one's business, and which gives [one] an opportunity to obtain an advantage over competitors who do not know or use it."[146] The franchisor's attorney

---

141. *See, e.g.*, Sherrard v. After Hours, Inc. 464 S.W.2d 87, 89 (Tex. 1971) (distributorship contract is unenforceable if supplier gives distributor an exclusive territory); Graphilter Corp. v. Vinson, 518 S.W.2d 952, 954 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.) (services of seller not recoverable where underlying contract held violative of Texas Antitrust Act); Pram Laboratories, Inc. v. Pram Laboratories-South, Inc., 445 S.W.2d 533, 537 (Tex. Civ. App.—Dallas 1969, no writ) (agreement not to sell competing products held illegal and unenforceable).

142. *See* Patrizi v. McAninch, 153 Tex. 389, 395-96, 269 S.W.2d 343, 348 (1954); Henderson Tire & Rubber Co. v. Roberts, 12 S.W.2d 154, 155 (Tex. Comm'n App. 1929, judgmt adopted).

143. *See* Patrizi v. McAninch, 153 Tex. 389, 391-93, 397, 269 S.W.2d 343, 345-46, 349 (1954); *cf.* Pennsylvania Rubber Co. v. McClain, 200 S.W. 586, 587 (Tex. Civ. App.—Dallas 1918, no writ) (where separate consideration given by each party, neither party may enforce illegal contract even if both have been wronged).

144. *See* Wiggins v. Bisso, 92 Tex. 219, 225-26, 47 S.W. 637, 640 (1898) (court will leave parties where find them).

145. *See* Patrizi v. McAninch, 153 Tex. 389, 391-93, 397, 269 S.W.2d 343, 345-46, 349 (1954). Royalty payments for future use of a trademark appear to be similarly uncollectable. *See id.* at 391-93, 269 S.W.2d at 345-46.

146. RESTATEMENT OF TORTS § 757 comment b (1939); *see* Rimes v. Club Corp. of Am.,

must periodically review his client's method of operation to insure that no valuable proprietary information is given away by failure to protect it. A license of the franchisor's trade secrets to the franchisee is inevitably one of the several considerations in a franchise agreement.[147]

In trade secret cases, Texas focuses primarily on the breach of the confidential relationship rather than on the trade secret itself.[148] This reflects Texas' frontier-type policy of punishing the evil-doer in addition to preventing injury to the trade secret owner. Thus, while other states typically limit injunctive relief to the length of time it would have taken the defendant to lawfully discover the purloined trade secret (reverse engineering),[149] Texas courts may grant a perpetual injunction against use or disclosure of the trade secrets.[150]

The plaintiff, in addition to proving the other injunction prerequisities, must show: (1) the existence of a trade secret, (2) that the defendant acquired it through a confidential relationship or theft, and (3) that the defendant is using the trade secret to the plaintiff's detriment.[151] An injunction may be granted if the infor-

---

542 S.W.2d 909, 913 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.) (uses restatement definition of trade secrets).

147. The secret recipe or method of doing business is often one of the significant differences between one franchise chain's goods and services and those of another. It is, therefore, at least an implied obligation of the franchisor to protect the trade secrets for the benefit of all in the franchise system.

148. *See, e.g.*, K & G Tool & Serv. Co. v. G & G Fishing Tool Serv., 158 Tex. 594, 605-06, 314 S.W.2d 782, 790 (1958) (injunction proper for breach of confidential relationship); Hyde Corp. v. Huffines, 158 Tex. 566, 575-76, 314 S.W.2d 763, 769-70 (1958) (breach of confidential relationship basis of suit); Elcor Chem. Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 211-12 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.) (liability based on breach of confidential relationship in disclosing secret information).

149. *See, e.g.*, Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 475-76 (1974) ("reverse engineering" not protected by trade secret law); Droeger v. Welsh Sporting Goods Corp., 541 F.2d 790, 792 (9th Cir. 1976) (trade secret law not applicable to honest discovery); Analogic Corp. v. Data Translation, Inc., 358 N.E.2d 804, 808 (Mass. 1976) (trade secret protected at least until others are likely to discover it).

150. *See* Elcor Chem. Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 214 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.) (permanent injunction issued); *see also* Weed Eater, Inc. v. Dowling, 562 S.W.2d 898, 901-02 (Tex. Civ. App.—Houston [1st Dist.] 1978, writ ref'd n.r.e.); Annot., 38 A.L.R.3d 572 (1971).

151. *See* Hallmark Personnel, Inc. v. Franks, 562 S.W.2d 933, 935-36 (Tex. Civ. App.—Houston [1st Dist.] 1978, no writ); Thermotics, Inc. v. Bat-Jac Tool Co., 541 S.W.2d 255, 260 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ); Elcor Chem. Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 211-12 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.).

mation was confidential at the time of disclosure to the defendant even if it is in the public domain at the time of trial.[152]

The defendant will attempt to rebut any of the above, or show that: (1) the claimed secrets are mere general skills acquired on the job, or (2) the plaintiff never warned defendant that the information was secret.[153]

While it is not always necessary to have an express agreement to hold trade secrets in confidence, the careful franchisor will obtain express agreements proclaiming that relationships with its officers and employees and with franchisee's officers and employees are fiduciary relationships. Operations manuals and other items or premises embodying trade secrets should have both limited distribution and be liberally sprinkled with notices against copying and disclosure to insure that all parties have notice of the confidential nature of the information.[154]

2. Covenants Not to Compete

The problem of enforcing common law or contractual trade secret rights is the difficulty of proof. The franchisor typically has no more than a suspicion or second-hand report that his trade secrets are being used by an ex-employee. Breach of a noncompetition agreement is much easier to ascertain.[155] Additionally, under Texas law a competitor that knows one's employees are under noncompe-

152. *See* K & G Tool & Serv. Co. v. G & G Fishing Tool Serv., 158 Tex. 594, 605-07, 314 S.W.2d 782, 790 (1958). *See generally* Lieberstein, *Suing The Former Employee*, J. PAT. OFF. SOC'Y 705 (November 1977).

153. *See* Hallmark Personnel, Inc. v. Franks, 562 S.W.2d 933, 934-35 (Tex. Civ. App.—Houston [1st Dist.] 1978, no writ).

154. *See* Rimes v. Club Corp. of Am., 542 S.W.2d 909, 913-14 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.) (owner of trade secret must make effort to keep information from general public); Furr's, Inc. v. United Speciality Advertising Co., 385 S.W.2d 456, 459 (Tex. Civ. App.—El Paso 1964, writ ref'd n.r.e.) (owner of trade secret must take steps to protect self from harmful disclosure), *cert denied*, 382 U.S. 824 (1965); Lamons Metal Gasket Co. v. Traylor, 361 S.W.2d 211, 212-13 (Tex. Civ. App.—Houston 1962, writ ref'd n.r.e.) (violation of trade secret not actionable with voluntary disclosure).

155. Given that an ex-employee knows one's recipe for frying chicken and has a noncompetition agreement restraining him from working for a competing fried chicken business, it is easier to observe him working at the competing fried chicken restaurant across the street than to infiltrate the competitor's kitchen to observe whether one's recipe is being used. While the ex-employee may claim he is using a recipe that is in the public domain, he will be hard pressed to explain away a photograph of him at the stove in the competitor's restaurant.

tition agreements and nevertheless induces them to breach that agreement commits an actionable wrong.[156] The prudent franchisor will, therefore, include covenants not to compete in his franchise and employment agreements. While a covenant not to compete is not valid standing alone, it is usually upheld where ancillary to a franchise agreement or employment relationship.[157]

Texas courts will reform or "blueline" a covenant[158] which imposes a greater restraint than is reasonably necessary to protect the business and goodwill of the franchisor.[159] For example, if a covenant not to compete unreasonably precludes the defendant from opening a fast-food restaurant anywhere within the state of Texas, the court will redraw the covenant to apply for a reasonable area and time, such as one metropolitan area for two years.[160] Many other states simply void covenants in which the employer has overreached,[161] or completely prohibit the use of covenants not to compete.[162]

There are two limitations on overly-broad covenants. First, while a court will typically enforce a reasonable covenant, it may react against a blatantly unrealistic covenant by drastically narrowing

---

156. *See* Custom Drapery Co. v. Hardwick, 531 S.W.2d 160, 166 (Tex. Civ. App.—Houston [1st Dist.] 1975, no writ). Note, however, that an injunction is not proper if the employee contacts the new employer on his or her own initiative. *Id.* at 166; *see also* Arabesque Studios, Inc. v. Academy of Fine Arts Int'l, Inc., 529 S.W.2d 564, 567-68 (Tex. Civ. App.—Dallas 1975, no writ).

157. *See* Troyan v. Snelling & Snelling, Inc., 524 S.W.2d 432, 433 (Tex. Civ. App.—Dallas 1975, no writ) (covenant held enforceable where ancillary to employment contract); Williams v. Powell Elec. Mfg. Co., 508 S.W.2d 665, 667 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ) (seller of business may assign valid covenant not to compete if connected to sale of business).

158. "Blueline" is the term used to describe reformation of an agreement which is not enforceable as written by narrowing the scope and terms of the agreement to leave only that which is enforceable.

159. *See, e.g.*, Justin Belt Co. v. Yost, 502 S.W.2d 681, 685 (Tex. 1973) (contract not void for being overly-broad if court can reform it); Stocks v. Banner Am. Corp., 599 S.W.2d 665, 667 (Tex. Civ. App.—Texarkana 1980, no writ) (court will enforce reasonable territorial limit to prevent voiding covenant); Toch v. Eric Schuster Corp., 490 S.W.2d 618, 621 (Tex. Civ. App.—Dallas 1972, writ ref'd n.r.e.) (duration and scope of covenant must be reasonably incident to contract and essential to protection of business).

160. *Cf.* American Speedreading Academy, Inc. v. Holst, 496 S.W.2d 133, 135-36 (Tex. Civ. App.—Beaumont 1973, no writ) (no abuse of discretion where original covenant contained 1000 mile area restriction, and court limited covenant to one county).

161. *See* Abramson v. Blackman, 166 N.E.2d 729, 730 (Mass. 1960); Segal v. Fleischer, 113 N.E.2d 608, 611 (Ohio Ct. App. 1952); Annot., 61 A.L.R.3d 397, 461-69 (1975).

162. MICH. STAT. ANN. § 28.825 (Callaghan 1982).

it.[163] Second, if the covenant is overly-broad the franchisor will not be able to obtain damages for its breach even if the defendant violates the reformed covenant.[164] A franchisor should be sure the covenant is assignable by its terms.[165]

III. THE FRANCHISE AGREEMENT

A. *Trademark License*

The crux of the franchise agreement is the license of the franchisor's trademark. A McDonald's restaurant simply would not have the same profitability if the golden arches were taken down and it were renamed "Fred's."

Under federal trademark law, the Lanham Act, a trademark license is a "naked license" unless it reserves to the licensor the right to exercise quality control over the licensee.[166] A licensor that enters into a naked license forfeits his trademark rights to the next person who properly uses the mark, typically a licensee.[167] All franchise agreements, therefore, reserve to the franchisor the right

---

163. *See* American Speedreading Academy, Inc. v. Holst, 496 S.W.2d 133, 135-36 (Tex. Civ. App.—Beaumont 1973, no writ).

164. *See id.* at 135 (where covenant overly-broad, no injunction by former employer even though employee breached covenant).

165. Failure to include in the non-competition agreement a provision that it is assignable may preclude enforcement after the employer sells the business to another.

166. *See* Susser v. Carvel Corp., 206 F. Supp. 636, 641 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed per curiam*, 381 U.S. 125 (1965). "[T]he cornerstone of a franchise system is the trademark or trade name of a product. It is the uniformity of product and control of its quality and distribution which causes the public to turn to franchise stores for the product." *Id.* at 640; *see also* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 1.02[1] (rev. ed. 1981). An amendment to the Lanham Act, 15 U.S.C. §§ 1051-1127 (1977), intended to prohibit local governments from interfering with the franchisor-franchisee trademark relationship, became effective on October 12, 1982. Section 39a states that:

> No State or other jurisdiction of the United States or any political subdivision or any agency thereof may require alteration of a registered mark, or require that additional trademarks, servicemarks, trade names, or corporate names that may be associated with or incorporated into the registered mark be displayed in the mark in a manner differing from the display of such additional trademarks, servicemarks, trade names, or corporate names contemplated by the registered mark as exhibited in the certificate of registration issued by the United States Patent and Trademark Office.

Act of Oct. 12, 1982, Pub. L. No. 97-296, 96 Stat. 1316 (1982) (to be codified at 15 U.S.C. § 1121(a)).

167. *See* Haymaker Sports, Inc. v. Turian, 581 F.2d 257, 261 (C.C.P.A. 1978) (assignment of trademark constitutes 'naked license' in absence of control by licensor); 15 U.S.C. § 1060 (1977) (goodwill associated with mark passes on assignment).

to exercise quality control over the franchisee so as not to give up the trademark right.[168] A careful balance must be maintained in drafting these provisions to comply with the Lanham Act and yet not violate federal or state antitrust laws.[169]

B. *Money and Territory*

The boundary of the franchisee's exclusive territory is typically the only blank to be filled in on a franchise agreement. Occasionally a blank is provided for the amount of the franchise fee also. Because of the franchisor's legitimate need to treat all franchisees equally, he will usually not vary the preprinted terms unless his system needs the franchise fee to make payroll.[170] A Franchise Fee Comparison Study is attached as appendix B.[171]

To many franchisors, the franchise fee[172] is determined simply by what the market will bear. The prudent franchisor, however, will construct his system to be profitable without reliance upon a continued infusion of franchise fees. Indeed, since one of the potential franchisee's primary considerations concerning whether or not to buy a franchise is the up-front investment, the expansion-

---

168. *See* Sheila's Shine Prods., Inc. v. Sheila Shine, Inc., 486 F.2d 114, 123-24 (5th Cir. 1973); *see also* E. I. Du Pont De Nemours & Co. v. Celanese Corp. of Am., 167 F.2d 484, 487 (C.C.P.A. 1948).

169. While the franchisor must retain sufficient control to justify his continued exclusive right to the mark and maintain the public's trust and confidence in the franchise system's uniform high quality of goods and services, he must not overreach by unnecessarily controlling the franchisee's method of doing business on pain of unlawfully "restraining commerce" under the antitrust laws. Further, the "independent operator" clause which protects the franchisor from liability for the franchisee's wrongs may not be effective if the control over the franchisee is extensive.

170. *See* McCarthy, *Trademarks And Unfair Competition* §§ 18:19-20, 31:23-36 (1973). Some states require a showing as a prerequisite to termination that the franchisee has not been unreasonably discriminated against. WIS. STAT. ANN. § 135.02(6)(a) (West 1974). Further, if other than uniform terms are used for all franchisees, disgruntled franchisees may, in antitrust causes of action, claim they have been singled out for retaliatory termination or less favorable terms as part of the franchisor's scheme to pressure them into unlawful acts or to go out of business. These reasons for uniformity are not, however, an undeniable mandate for uniformity. Legitimate reasons such as wanting a particularly desirable potential franchise may cause unequal treatment of franchisees.

171. Franchise Fee Comparison Study, prepared in March 1983 by Francorp, Inc., 20200 Governors Drive, Olympia Fields, Ill. 60461. Francorp is one of a few enterprises that specialize in franchise development.

172. A "franchise fee" is the total consideration given by the prospective franchisee to the franchisor prior or soon after commencement of the franchisee's business for the privilege of becoming a franchisee of the franchisor under the terms of the franchise agreement.

minded franchisor should consider charging a franchise fee just high enough to cover the franchisor's initial expenses in opening the franchisee's franchise.

Franchise systems which are dependent upon franchise fees for profitability, rather than on royalties or sales of goods and services, may be "ponzi" or pyramid schemes doomed to eventual failure.[173] The prudent prospective franchisee will carefully examine the financial structure of the franchisor before committing to the system. The franchisee will invest the franchise fee, franchise capitalization, and his own personal work efforts.[174] Whether this investment is prudent depends largely on: (1) system wide factors, such as the franchised concept, the franchisor's financial stability, and the profit history of the franchisor's prior franchisees; (2) local factors, such as store location, franchisee's capitalization, and hard work; and (3) luck.

The franchisor wants maximum market penetration for the sale of his products or services and the sale of his franchises. The unscruplous franchisor may either grant franchises in marginal marketing areas while retaining better areas for himself, or use a franchisee as a stalking-horse and if the franchise is successful, replace it with a company store or open a company store across the street. The prospective franchisee should analyze the franchisor's track record in these regards.

A reputable franchisor must balance competing interests when deciding the size of the territory given the franchisee. The territory must be sufficiently large to permit the franchisee to have a reasonable probability of long term success, yet sufficiently small to allow the granting of enough franchises to achieve maximum sales

---

173. Typically the franchisee is utterly dependent on his franchisor for supplies, support and other necessities. If the franchise system is not self-sustaining, i.e. the franchisor requires profits from the sale of new franchises to cover his losses in servicing existing franchisees, the franchisor will necessarily go bankrupt when he can no longer sell new franchises quickly enough. There is some limit on the number of *XYZ* Franchise Burger Stands that the world will support. When that limit is approached, a new source of revenues must be found or franchisor services to franchisees must be reduced; if not, the bankrupt franchisor will also carry the franchisee under. The ponzi scheme is an investment fraud that takes its name from Charles Ponzi who in the 1920's swindled 40,000 people in eight months by promising a fifty percent profit in forty-five days.

174. In advising potential franchisees it should be emphasized that one of the primary reasons franchised businesses fail is lack of franchisee capitalization. Every effort should be made to dissuade the potential franchisee of his fixed idea that he only needs enough financing to make the franchise fee.

of the franchisor's goods and services, and thus royalties. The franchisee wants a territory large enough to insure him the fruits of his success. Both the franchisor and franchisee benefit by clustering franchises in regional or metropolitan areas. This facilitates supervision and groups the stores into the "critical mass" needed to justify advertising and public acceptance.

C. *Standards and Control*

The typical franchise agreement contains the innocuous statement that the "franchisee will operate and maintain the franchise in compliance with the Operations Manual as it may be revised from time to time."[175] The franchisee's attorney must impress upon the prospective franchisee that each and every part of the massive operations manual thereby becomes part of the agreement. Because it is usually an unlawful restraint of trade to require franchisees to purchase goods or services from the franchisor, the public's expectation of uniform quality is met by requiring the franchisee's goods and services to meet certain standards. For example, McDonald's the franchisor does not sell hamburgers to all of its franchisees for resale to the public. McDonald's the franchisor does, however, set strict standards for the quality of the hamburgers its franchisees sell.

A legitimate franchisor will offer or require training programs, assist in site location, and provide trained personnel at the store for the first few days of operation with periodic advice thereafter. Such assistance can be invaluable and is a large part of why a franchise can be a good business investment for the franchisee.[176] Inexperienced franchisors may provide no more than a few pages of general advice, such as "be courteous to customers," and a pat on the back.[177]

---

175. The typical provision requires the franchisees "[t]o comply with the Rules of Operation as now established by **LICENSOR** in the Operating Manual, copy of which has been furnished **LICENSEE**, or as revised or amended by **LICENSOR** from time to time hereafter, the right of revision and amendment being reserved by **LICENSOR**."

176. The second most common cause of small business failures (the first being undercapitalization) is poor management. One of the reasons the system of franchising has been so successful is that many typical poor management problems are avoided through the franchisor's specialized assistance and training.

177. The author is aware of one franchisor whose "expert" advice concerning site selection comprised asking a waitress at breakfast where a busy intersection in the franchisee's

While quality and control standards are absolutely necessary for the maintenance of a successful franchise system, they can also be the means whereby a franchisor squeezes or terminates unwanted franchisees.[178] Some franchisors include standards no franchisee can reasonably meet. After the franchisee has created a profitable franchise, these franchisors, using failure to meet quality standards as the reason, terminate the franchisee and step into the franchise.[179]

D. *Transfer and Termination*

The franchise agreement typically contains several pages of legalistic boilerplate near the end of the agreement covering the franchisee's right to transfer, terminate, and renew the franchise, and will typically include a covenant not to compete. This portion of the agreement is usually far from the thoughts of the potential franchisee. It is, however, the most important portion of the agreement because it effectively limits what the franchisee may do with his investment.

Buried within the termination provisions is the clause that any breach by the franchisee is a material breach for which termination is an appropriate remedy. Thus the franchisee's investment is perpetually at risk of being totally forfeited. This is particularly important since the "quality standards" provision found in the operations manual may be impossible to meet and thereby provide franchisor with a "material breach."[180] Likewise, the transfer and renewal provisions may be so onerous as to reduce the marketability of the franchise. Under such agreements the franchisee fee, the franchisee's capital investment, and his sweat equity are essentially

---

city was. This location was presented that afternoon to the franchisee as the scientifically-selected best location for a franchise. KSM, Inc. v. For Sale By Owner, Inc., No. SA-79-CA-68 (W.D. Tex. filed Feb. 13, 1979).

178. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES §§ 2.03[2], 3.02[2] (rev. ed. 1981).

179. *See id.* § 3.02[1][viii].

180. A typical contract provision provides that:

> Each detail of the Program is important and each term herein is reasonable and necessary for the protection of Franchisee, Franchisor, other franchisees and consumers who rely upon the uniformity, high standards, and strict enforcement of the Program. Franchisor's duties herein are expressly contingent upon strict compliance by Franchisee with this Agreement. Any breach hereof is deemed a material and substantial breach. Time is of the essence herein and all provisions shall be so interpreted.

forfeited upon losing the franchise for any reason. The threat of termination is, therefore, a powerful weapon in the hands of the franchisor.[181]

IV. FRANCHISE LITIGATION

A. *Termination*

Most franchise litigation begins with termination of the franchise by the franchisor.[182] Because the franchise agreement is written specifically for the purpose of allowing the termination by the franchisor, the contractual issues concerning the franchise relationship are usually conceded to the franchisor. The focus of the litigation thereafter concerns whether the franchisor has violated either common law or statutory standards of fair dealing and trade regulation which will prevent enforcement of the franchise agreement.

Franchise litigation, therefore, invariably centers around franchisee attacks on the franchisor and the franchisor's defense against these attacks. The franchisee's attorney will paint a verbal picture showing the foreclosure of a stuggling entrepreneur's grubstake by a large greedy franchisor. The court and jury will sympathize with the franchisee and be tempted to ignore the franchise agreement. The franchisor should, therefore, resort to termination only after the severest provocation. To minimize future expensive litigation, the franchisor should consider arbitration clauses and franchisor-promoted counsels for the presentation of franchisee grievances.

B. *Offensive Use of Collateral Estoppel*

The franchisee's most potent weapon in battling his franchisor is the offensive use of collateral estoppel. "[O]ffensive use of collateral estoppel occurs when the plaintiff seeks to foreclose the defen-

---

181. The mere threat of termination, coupled with a covenant not to compete, may be sufficient to effectively subjugate the franchisee. Alternatively, if transferability is restricted, the franchisor may gain the franchisee's equity in the business for less than fair market value. *See* Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650, 662 (1971).

182. This includes terminations for failure to pay monies owed by failing franchisees. Although some franchisees file "lack of support" suits, such suits are often pointless because those franchisors often quickly go bankrupt.

dant from litigating an issue the defendant has previously litigated unsuccessfully in an action with another party."[183] As distinguished from mutuality of estoppel, in which both the parties and issues are substantially identical as in the prior action,[184] an unfavorable finding in a prior proceeding will determine the factual and legal issues successfully litigated against a franchisor by independent franchisees.[185] The most concise listing of the requirements for applying this new principle is in *GAF Corp. v. Eastman Kodak Co.*[186] The franchisor typically has standardized contracts, manuals, and operating procedures for use with all franchise outlets. Thus, in similar suits the same issues will be litigated by subsequent franchisees against the same franchisor. As there is no privity between the franchisees, the franchisor's many victories are merely persuasive in subsequent cases. It takes but one loss by the defendant-franchisor, however, to possibly have that issue forever decided against him. Franchisees may also rely on prior administrative proceedings against their franchisors.[187]

---

183. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n.4 (1979). Conversely, "[d]efensive use occurs when a defendant seeks to prevent a plaintiff from asserting a claim the plaintiff has previously litigated and lost against another defendant." *Id.* at 326 n.4.

184. *See* Bigelow v. Old Dominion Copper Mining & Smelting Co., 225 U.S. 111, 117-18 (1912); Foltz v. Pullman, Inc., 319 A.2d 38, 41 (Del. Super. Ct. 1974). It is important to note that the United States Supreme Court has eliminated the mutuality requirement for federal courts. *See* Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326-27 (1979).

185. *See* R.E. Spriggs Co. v. Adolph Coors Co., 156 Cal. Rptr. 738, 743-45 (Ct. App. 1979), *cert. denied*, 444 U.S. 1076 (1980).

186. 519 F. Supp. 1203 (S.D.N.Y. 1981). The elements for the application of collateral estoppel are:

> (1) the party against whom collateral estoppel is asserted must have been a party, or in privity with a party, to the prior action;
>
> (2) there must have been a final determination of the merits of the issues sought to be collaterally estopped;
>
> (3) the issues sought to be precluded must have been necessary, material, and essential to the prior outcome;
>
> (4) the issues sought to be precluded must have been actually litigated in the prior action, with the party against whom the estoppel is asserted having had a full and fair opportunity to litigate the issues; and
>
> (5) the issues actually and necessarily decided in the prior litigation must be identical to the issues sought to be estopped.

Id. at 1211.

187. *See* International Tel. & Tel. v. American Tel. & Tel., 444 F. Supp. 1148, 1156 (S.D.N.Y. 1978). Collateral estoppel effect may only be given to a finding by an administrative agency if the agency was acting in a judicial capacity and the parties had "a full and fair opportunity to litigate the issues in the administrative proceeding . . . . The general rule in the case of *non*-adjudicatory agency action, however, is that collateral estoppel does

In addition to usual discovery methods, franchisor's house counsel should be deposed to uncover these prior determinations. Although such a request will be hotly contested, prior judicial proceedings do not appear to qualify for either attorney-client or work product privileges,[188] particularly if the prior proceedings are of public record.[189]

The franchisee cannot absolutely rely upon the trial court accepting the offensive use of collateral estoppel and should prepare to prove his case by independent means. The mere threat of wrecking the entire franchise system, however, substantially increases the franchisee's bargaining power.

C. *Franchisor Vicarious Liability*

The franchise agreement typically states that the "franchisee is an independent operator, is not an agent or employee of franchisor, and shall not permit any contrary representation to be made to the public."[190] The franchisee is also typically required to place on signs, letterhead, contracts, and written advertising that it is "independently owned and operated."[191] In the past this has been sufficient to protect the franchisor from liability for the torts of his franchisees.[192] The franchisor's need for uniformity in his system, the Lanham Act's requirements that the franchisor control the quality of his goods and services, and the public perception of franchise systems as monoliths have, however, undermined this cit-

---

not apply." *Id.* at 1156 (emphasis added).

188. *See* United States v. IBM, 66 F.R.D. 206, 211-12 (S.D.N.Y. 1974); *see also* R. HAYDOCK & D. HERR, DISCOVERY PRACTICE § 2.5.3 (1982).

189. *See* United States v. Tellier, 255 F.2d 441, 447-48 (2d Cir. 1958) (moment confidence ceases, privilege also ceases; if information is of public record no privilege); *see also* Diversified Indus. v. Meredith, 572 F.2d 596, 604 (8th Cir. 1977) (work product rule not applicable if prospect of litigation remote).

190. For an example of a similar provision, see Murphy v. Holiday Inns, Inc., 219 S.E.2d 874, 876 n.1 (Va. 1975).

191. *See* Drexel v. Union Prescription Centers, Inc., 428 F. Supp. 663, 666-67 (E.D. Pa. 1977).

192. *See, e.g.*, Drexel v. Union Prescription Centers, Inc., 428 F. Supp. 663, 666 (E.D. Pa. 1977) (defendant franchisor not liable where franchisor had no right of control and franchisee identified as independant owner of store); McLaughlin v. Chicken Delight, Inc., 321 A.2d 456, 459 (Conn. 1973) (franchise agreement failed to disclose any agency relationship); Murphy v. Holiday Inns, Inc., 219 S.E.2d 874, 877-78 (Va. 1975) (fact that franchisee used franchisor's trademark did not create right of control with corresponding agency relationship).

adel of the franchisor.

Real-world franchisors advertise the quality of their goods and services, provide detailed operations manuals to control the franchisee's day to day operations, maintain the right of inspection, and reap the benefits of consumer loyalty to the franchise marks. Real-world consumers pull off the highway at night in reliance upon the large lighted sign displaying the franchise mark at the franchise store. In recognition of these realities the clear trend is to find the franchisor vicariously liable for his franchisee's torts.[193]

Some courts, analogizing Restatement of Torts (Second) section 402A, have held that as a "link in the marketing enterprise" placing the product or service "within the stream of commerce," the franchisor is liable under the theory of enterprise liability.[194] Other theories for holding the franchisor vicariously liable are that an actual agency relationship exists because of the day to day control of the franchisee's operations,[195] or that an apparent agency relationship exists because of permissive use of the franchisor's name.[196] In an analogous example, a publisher was found liable when defective

193. *See* Drummond v. Hilton Hotel Corp., 501 F. Supp. 29, 31 (E.D. Pa. 1980) (fact that franchise agreement limits franchisor's liability not determinative); Hayward v. Holiday Inns, Inc., 459 F. Supp. 634, 635-36 (E.D. Va. 1978) (franchisor's operating manuals indicated right of control, thus agency relationship); *cf.* Coty v. United States Slicing Mach. Co., 373 N.E.2d 1371, 1375 (Ill. App. Ct. 1978) (if retain absolute power to prevent unsafe operating procedures, franchisor may be liable if negligent in failing to stop unsafe procedures); *see generally* Note, *Tort Liability Of Trademark Licensors*, 55 IOWA L. REV. 693 (1970) (possible theories of franchisor liability).

194. *See Trademark Licensor, Franchisor, and Endorser: Liability For Damages Caused By Defective Product Or Service*, 1 LICENSING L. & BUS. REP. (Clark Boardman) 89, 91 (March 1979). Enterprise liability has been described as follows:

> [U]nder the stream-of-commerce approach to strict liability no precise legal relationship to the member of the enterprise causing the defect to be manufactured or to the member most closely connected with the customer is required before the courts will impose strict liability. It is the defendant's participatory connection, for his personal profit or other benefit, with the injury-producing product and with the enterprise that created consumer demand for and reliance upon the product (and not the defendant's legal relationship (such as agency) with the manufacturer or other entities involved in the manufacturing-marketing system) which calls for imposition of strict liability.

Kasel v. Remington Arms Co., 101 Cal. Rptr. 314, 323 (Ct. App. 1972).

195. *See* City of Hartford v. Associated Constr. Co., 384 A.2d 390, 392-93 (Conn. Super. Ct. 1978) (strict liability can be imposed on franchisor with sufficient control over franchisee based on agency relationship).

196. *See* Billops v. Magness Constr. Co., 391 A.2d 196, 198-99 (Del. 1978) (franchisor may be liable based on apparent agency).

shoes resulted in a slip and fall and the plaintiff proved that the shoes were purchased in reliance on a "Good Housekeeping Consumer's Guarantee" published in defendant's magazine.[197] Similar results have been obtained by consumers that relied upon the following franchise slogans: "Trust your car to the man who wears the [Texaco] Star;"[198] "You expect more from [American Oil] Standard and you get it;"[199] and "Hilton Hotel."[200] Liability was imposed on the franchisor in these cases despite independent operator contract clauses.

D. *Common Law Claims*

As noted above the franchisor relies on the boilerplate in the franchise agreement and a deeper pocketbook with which to finance the litigation. The thrust of the litigation, however, will revolve around the franchisee's claims of ill treatment.[201]

1. Fraud and Misrepresentation

Either through routine sales pitches or in the franchise agreement through "whereas" recitals,[202] the franchisor invariably states that he can offer the prospective franchisee a valuable system or method of making money that is superior to a non-franchised business.[203] No franchise is ever sold without the salesman making at

---

197. *See* Hanberry v. Hearst Corp., 81 Cal. Rptr. 519, 523-24 (Ct. App. 1969).

198. *See* Gizzi v. Texaco, Inc., 437 F.2d 308, 310 (3d Cir.) (liability based on association with slogan used by franchisor), *cert. denied*, 404 U.S. 829 (1971).

199. *See* Johnston v. American Oil Co., 215 N.W.2d 719, 721 (Mich. Ct. App. 1974) (reliance on franchisor's slogan sufficient to raise question of agency relationship to avoid summary judgment).

200. *See* Drummond v. Hilton Hotel Corp., 501 F. Supp. 29, 31 (E.D. Pa. 1980) (indicia of agency relationship based on franchisor's right of control).

201. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 5.01 (rev. ed. 1981).

202. As is common in most contracts, the typical franchise agreement will set forth as recitals the advantages offered and sought by the parties. Unlike other contracts, however, franchise agreements rarely flesh out in the contractual portion of the agreement exactly what the franchisor is required to do. In Travelodge Int'l, Inc. v. Eastern Inns, Inc., 382 So. 2d 789, 792 (Fla. Dist. Ct. App. 1980), the whereas recital provided:

> "[W]hereas Travelodge had developed and implemented a plan for providing, and has provided, a network of motor hotels and related services of high quality and of distinguishing characteristics, . . . including (but not limted to) the following . . . ."

Id. at 792.

203. *See* Tarnoff v. Jones, 497 P.2d 60, 65 (Ariz. Ct. App. 1972) (franchisor misrepresented availability of site for franchise operation).

least some representations concerning what is being sold and what the franchisor will do to assist the franchisee. The franchisee will allege that: (1) the franchisor's promised "system" and benefits described in the promotional literature and by the salesman never existed and was never intended to be delivered;[204] (2) the franchisor, usually an expert having special knowledge, had a duty to disclose and failed to do so; and (3) the franchisor actively concealed these material facts.[205] The franchisor will defend by relying on the franchise agreements of contractual recitations to the contrary. Such fraud cannot, however, be contracted out of the transaction.[206]

2. Fiduciary Relationship

The franchisor-franchisee relationship can be characterized as a fiduciary one.[207] Although not universally accepted, it has been followed in a number of decisions.[208] The theory is that the franchisee places so much trust and confidence in the franchisor that his destiny is in the hands of the franchisor.[209] As a matter of equity the franchisor is prevented from abusing this position.[210] Once a fiduciary duty is established, the burden shifts to the franchisor to justify his questionable acts.[211]

---

204. *See* Northern v. McGraw-Edison Co., 542 F.2d 1336, 1348 (8th Cir. 1976) (misrepresentation in promotional brochure held actionable by franchisee); *see also* Hanberry v. Hearst Corp., 81 Cal. Rptr. 519, 521 (Ct. App. 1969).

205. *See* Walker v. KFC Corp., 515 F. Supp. 612, 617-18 (S.D. Cal. 1981).

206. *See* Moran v. Levin, 64 N.E.2d 360, 362 (Mass. 1945) (misrepresentation for goods sold disclaiming express or implied warranty held actionable). *See generally* Annot., 64 A.L.R.3d 6 (1975).

207. *See* Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650, 663-72 (1971). Brown argues that the basis for the fiduciary obligation is the "pervasive power of control" over the franchisee that the franchisor is able to exert. *Id.* at 664.

208. *See* Arnott v. American Oil Co., 609 F.2d 873, 880-86 (8th Cir. 1979); Shell Oil Co. v. Marinello, 294 A.2d 253, 261 (N.J. Super. Ct. Ch. Div. 1972), *modified and aff'd*, 307 A.2d 598 (N.J. 1973), *cert. denied*, 415 U.S. 920 (1974); Atlantic Richfield Co. v. Razumic, 390 A.2d 736, 739 (Pa. 1978). *See generally* Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971).

209. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 9.08 (rev. ed. 1981).

210. *See id.* § 9.09.

211. *See* Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L. REV. 650, 664-65 (1971).

3. Unconscionability

> "If the Court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made, the Court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."[212]

The typical franchise agreement is without any concrete obligations upon the franchisor and reserves to the franchisor the power to modify the agreement.[213] Some courts have held excessive price or unfair remedies unconscionable.[214] A related concept is that the contract or a part of it is unenforceable as an adhesion contract.[215]

All of the factors leading to unconscionability of the agreement should be explored: unequal bargaining power,[216] lack of meaningful choice,[217] lack of knowledge or understanding,[218] unequal sophistication of the parties,[219] and high pressure sales tactics.[220]

4. Implied Covenant of Good Faith

"Every contract or duty imposes an obligation of good faith in its performance or enforcement."[221] This is particularly true with

---

212. TEX. BUS. & COM. CODE ANN. § 2.302(a) (Vernon 1968) (Texas UCC). Although section 2.302 is limited to the sale of goods, it is at least persuasive authority in mixed transactions such as a franchise. *See* Division of Triple T Serv., Inc. v. Mobil Oil Corp., 304 N.Y.S.2d 191, 203-04 (Sup. Ct. 1969), *aff'd*, 311 N.Y.S.2d 961 (App. Div. 1970); *see also* Hewitt, *Good Faith or Unconscionability—Franchisee Remedies for Termination*, 29 BUS. LAW. 227, 231-36 (1973).

213. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 9.04 (rev. ed. 1981).

214. *See* Von Lehn v. Astor Art Galleries, Ltd., 380 N.Y.S.2d 532, 543 (Sup. Ct. 1976); *cf.* American Home Improvement, Inc. v. MacIver, 201 A.2d 886, 889 (N.H. 1964) (excessive price in improvement contract unconscionable).

215. A contract is one of adhesion to the extent the terms are withdrawn from negotiation, such as by use of a standard preprinted form. A. CORBIN, CORBIN ON CONTRACTS § 559 (1952).

216. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449-50 (D.C. Cir. 1965); Wade v. Austin, 524 S.W.2d 79, 84 (Tex. Civ. App.—Texarkana 1975, no writ).

217. *See* Kugler v. Romain, 279 A.2d 640, 651-52 (N.J. 1971).

218. *See* Wade v. Austin, 524 S.W.2d 79, 84-85 (Tex. Civ. App.—Texarkana 1975, no writ).

219. *See* Industralease Automated & Scientific Equip. Corp. v. R.M.E. Enters., Inc., 396 N.Y.S.2d 427, 432 (App. Div. 1977).

220. *See id.* at 430-31.

221. TEX. BUS. & COM. CODE ANN. § 1.203 (Vernon 1968) (Texas UCC).

respect to exclusive dealing agreements.[222] Breach of "good faith" causes of action are typically seen where the franchisor terminates the franchisee according to the literal terms of the franchise agreement but without "good cause."[223] This may serve as the basis for a virtual fishing expedition during discovery and for getting all possible facts before the jury that may tend to put the black hat on the franchisor.

5. Contract

While the franchise agreement contains little to comfort the franchisee, it usually promises delivery of an operations manual, permission to use a trademark, initial training, advertising assistance, and other benefits. The promised items will have been literally delivered in a three ring spiral notebook labeled "Operations Manual." What was actually meant by the parties, however, was that a *useful and valuable* operations manual would be delivered.

The franchisee's attorney must not fall into the trap of merely counting the items and services delivered; that is the franchisor's game. The franchisee's attorney must allege that the agreement contemplated the delivery of an expertly prepared operations manual, a valuable trademark with national identity, training adequate to give the novice franchisee a reasonable chance of success, and valuable advertising assistance. To establish a breach, he will then prove the worthlessness of the operations manual, the lack of na-

---

222. *See id.* § 2.306(b) & comment 5.

223. *See* Shell Oil Co. v. Marinello, 307 A.2d 598, 602 (N.J. 1973). "The Act [N.J. REV. STAT. § 56:10-5 (West Supp. 1982)] prohibits a franchisor from terminating, cancelling or failing to renew a franchise without good cause which is defined as the failure by the franchisee to substantially comply with the requirements imposed on him by the franchise." *Id.* at 602; *see* ABA Distrib., Inc. v. Adolph Coors Co., 542 F. Supp. 1272, 1286 (W.D. Mo. 1982) (good faith obligation imposed in agreement); *see also* 15 U.S.C. § 2802(b)(2)(B) (Supp. IV 1980) (Petroleum Marketing Practices Act prohibits termination of gas dealer franchise unless franchisee fails to "exert good faith efforts to carry out the provisions of the franchise"); Gellhorn, *Limitations On Contract Termination Rights-Franchise Cancellations,* 1967 DUKE L.J. 465, 495-505 (good faith as limit on unfair termination). In Lockewill, Inc. v. United States Shoe Corp., 547 F.2d 1024 (8th Cir. 1976), *cert. denied,* 431 U.S. 956 (1977), the Eighth Circuit stated that the franchisee, in a suit for wrongful termination, "might have a reasonable opportunity to recover [his] initial investment and expenses." *Id.* at 1029. In Keener v. Sizzler Family Steak Houses, 424 F. Supp. 482 (N.D. Tex. 1977), the court held that the proper measure of damages is "the value of the . . . franchise which reverted to the Defendant [franchisor] as a result of the breach." *Id.* at 484. *See generally* Annot., 19 A.L.R.3d 196 (1968).

tional trademark identity, and so on. The well known rule that agreements are construed against the draftsman applies with particular force to boilerplate agreements and is useful to the franchisee in this regard.[224]

E. *Statutory Claims*

1. Per Se and Rule of Reason Violations

Although many franchise suits involve federal antitrust claims, an in-depth review of them is beyond the scope of this article. Many excellent works exist concerning them.[225]

One of the categorizations of restraints on commerce for antitrust purposes is between vertical and horizontal restraints. A vertical restraint is an agreement or other restraint between merchants of different levels of commerce. Agreements between a manufacturer and a wholesaler, a wholesaler and a distributor, and a distributor and a retailer are "vertical" agreements because the parties are above and below each other.[226] Horizontal restraints are agreements between merchants operating on the same level of commerce, usually competitors. An agreement between two manufacturers, or between two wholesalers, is a "horizontal" agreement because the parties are on the same level.[227]

Horizontal agreements to fix prices or affect prices, to divide markets or customers, and collective refusals to deal (group boycotts) are usually per se unlawful.[228] Generally, per se unlawful ac-

---

224. *See* T.G.I. Friday's, Inc. v. International Restaurant Group, Inc., 569 F.2d 895, 898 (5th Cir. 1978). "[A] contract must be read in its entirety in order to ascertain the intent of the parties and any ambiguity must be construed against the party who drafted the contract . . . ." *Id.* at 898.

225. Because antitrust law is always changing, no one work is definitive. For a comprehensive work with a supplement service, see CALLMANN, THE LAW OF UNFAIR COMPETITION TRADEMARKS AND MONOPOLIES (L. Altman 4th ed. 1981). *See also* P. MARCUS, ANTITRUST LAW AND PRACTICE (1980); L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST (1977); ANTITRUST ADVISOR (C. Hills 2d ed. 1971). Additionally, the Texas Bar Association has an active antitrust section which should be joined.

226. *See* Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1004 (5th Cir.), *cert. denied*, 454 U.S. 827 (1982); Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15, 16 (4th Cir.), *cert. denied*, 454 U.S. 827 (1981).

227. *See* Turner, *The Definition Of Agreement Under The Sherman Act: Conscious Parallelism And Refusals To Deal*, 75 HARV. L. REV. 655, 658-60 (1962).

228. *See* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 218 (1940). *But see*

tivities require no proof other than their existence together with the damages caused to the plaintiff for him to prevail.[229] Vertical agreements to restrain trade are more likely to be judged under the rule of reason and require additional proof that the restraint on commerce complained of actually had an anti-competitive effect.[230] Basically, the franchisor and franchisee have a vertical relationship.[231] The antitrust sins of the franchisor may be either per se restraints,[232] or restraints that fall under the rule of reason.[233] While all possible claims should be asserted, only the per se claims such as tying,[234] price fixing,[235] and boycott[236] are reasonably avail-

---

Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1, 6 (1979) (intensive scrutiny of ASCAP and BMI blanket licensing procedure resulted in finding no per se violation).

229. *See* E.D. McQuade Tours, Inc. v. Consolidated Air Tour Manual Comm., 467 F.2d 178, 186 (5th Cir. 1972) (once per se arrangement is established, "no evidence of actual public injury is required . . . and no evidence of the reasonableness of defendant's conduct will be considered in justification"), *cert. denied*, 409 U.S. 1109 (1973).

230. *See* Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 54-55 (1977); Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 718-19 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980); VERTICAL RESTRICTIONS UPON BUYERS LIMITING PURCHASES OF GOODS FROM OTHERS, *A.B.A. Sec. Antitrust L.* (L. Pasahow 1982). While these statements are generally true, there are many exceptions that cannot be enumerated.

231. *Cf.* Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15, 16 (4th Cir.) (restraint imposed as result of conspiracy between manufacturer and dealers judged under rule of reason), *cert. denied*, 454 U.S. 864 (1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1004-05 (5th Cir.) (if manufacturer is source of conspiracy restraint, then judged under rule of reason), *cert. denied*, 454 U.S. 827 (1981).

232. *See* Dougherty v. Continental Oil Co., 579 F.2d 954, 959-60 (5th Cir. 1978), *vacated by stipulation of parties*, 591 F.2d 1206 (5th Cir. 1979); H. BROWN, FRANCHISING: REALITIES & REMEDIES § 10.03[2] (rev. ed. 1981).

233. *See* Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 49-50 n.15 (1977); *see also* Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292, 298 (5th Cir. 1981) (vertical customer and territorial restrictions reasonable). *See generally* Zeidman, *The Rule of Reason In Franchisor-Franchisee Relationships*, 47 ANTITRUST L.J. 873 (1978).

234. *See* Northern Pacific Ry. v. United States, 356 U.S. 1, 6-8 (1958); United States v. Paramount Pictures, Inc., 334 U.S. 131, 158 (1948). To establish an illegal tying agreement the plaintiff must prove: (1) that there were two separate products with the sale of one conditioned on the purchase of the other; (2) that the seller had sufficient economic power in the tying product market to appreciably restrain competition in the tied product market; and (3) that the tie-in affected a substantial amount of interstate commerce. VERTICAL RESTRICTIONS UPON BUYERS LIMITING PURCHASES OF GOODS FROM OTHERS *A.B.A. Sec. Antitrust L.*, (L. Pasahow 1982); *see also* Ogden Food Serv. Corp. v. Mitchell, 614 F.2d 1001, 1002 (5th Cir. 1980) (possible fourth requirement of coercion).

235. *See* California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 102 (1980); Dr. Miles Medical Co. v. John D. Park & Sons, Co., 220 U.S. 373, 394 (1911).

236. *See* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 210-14 (1959); Ron Tonkin Gran Turismo, Inc. v. Fiat Distribs., Inc., 637 F.2d 1376, 1381-85 (9th Cir.), *cert. denied*, 454 U.S. 831 (1981).

able to the down and out franchisee. This is because most franchisees cannot afford the extensive economic analysis required to sustain rule of reason violations.[237] If the franchisor has company owned stores, known as dual distribution, the franchisee's attorney should be alert to the potential for categorizing the franchisor's otherwise lawful vertical standards and controls as per se horizontal restraints.[238]

The area of tie-ins[239] is particularly troublesome because the Lanham Act requires franchisors to control the quality of goods and services delivered by franchisees.[240] Under certain conditions the Sherman Act, however, forbids franchisors from requiring the franchisee to purchase the goods or services from the franchisor or its affiliates.[241] The questions of whether the franchised trademark itself is a tying desired item and, if so, whether the tying mechanism is defensible as a legitimate means of quality control and goodwill protection are almost always raised in franchise tie-in suits.[242]

A second troublesome aspect of antitrust law for the franchisor is that activities that are lawful standing alone may constitute antitrust violations if used to effect an unlawful end.[243] Thus, the

---

237. *See* National Soc'y of Professional Eng'rs v. United States, 435 U.S. 679, 689-91 (1978); United States v. Topco Assoc., 405 U.S. 596, 607-10 (1972); Board of Trade v. United States, 246 U.S. 231, 238-39 (1918). In determining whether the restraint is an "unreasonable" restraint, the full facts relevant to the particular business and the nature of the restraint are considered to determine the effect upon the competitive conditions in the market place.

238. *See* Hobart Bros. Co. v. Malcom T. Gilliland, Inc., 471 F.2d 894, 900 (5th Cir.), *cert. denied*, 412 U.S. 923 (1973); *see also* Krehl v. Baskin-Robbins Ice Cream Co., 78 F.R.D. 108, 113 (C.D. Cal. 1978) (dual distribution discussed). *But see* H & B Equip. Co. v. International Harvester Co., 577 F.2d 239, 245-46 (5th Cir. 1978) (because of highly competitive market and reasonable consumer restrictions, franchisee had difficulty in establishing per se violations).

239. A tie-in exists when a seller requires a buyer to purchase another product as a condition to the purchase of the first product which buyer wants. These arrangements are per se unlawful under federal antitrust law. *See* IBM v. United States, 298 U.S. 131, 135-37 (1936).

240. *See* H. BROWN, FRANCHISING: REALITIES & REMEDIES § 10.05 (rev. ed. 1981).

241. *See* Warriner Hermetics, Inc. v. Copeland Refrigeration Corp., 463 F.2d 1002, 1013 (5th Cir. 1972).

242. *See* Principe v. McDonald's Corp., 631 F.2d 303, 308-09 (4th Cir. 1980), *cert. denied*, 451 U.S. 970 (1981); *see also* Krehl v. Baskin-Robbins Ice Cream Co., 78 F.R.D. 108, 114-16 (C.D. Cal. 1978) (trademark and ice cream not separate items).

243. *See* Lehrman v. Gulf Oil Corp., 464 F.2d 26, 37-38 (5th Cir.), *cert. denied*, 409 U.S. 1077 (1972).

franchisee's attorney should carefully review all of the activities of the parties together with their motivations in an attempt to show that the otherwise lawful actions of the franchisor were unlawful due to their result.

Certain caveats should be considered before taking a terminated franchisee-plaintiff's case on a contingent fee basis. A particularly effective defense is the maxim that the antitrust laws protect competition and not competitors.[244] The competition to be preserved is from the perspective of the consumer. Intrabrand quarrels, within a franchise system, will not typically violate the rule of reason as the consumer sees the same degree of interbrand competition if the franchisee is terminated for the purpose of replacing him with a more cooperative franchisee or even a company store.[245] As a result, although the terminated franchisee may have unfairly lost his life savings when terminated, he may have no antitrust cause of action. Further, even if an antitrust violation is proven the franchisee's damages are limited to the competitive injury caused by the illegal portion of the franchisor's conduct.[246] Additionally, a counterclaim for the franchisee's breach of the franchise agreement will be made.

2. State Statutes

The Business Franchise Guide[247] has the single best compilation of federal and state franchise statutes and regulations. These statutes are generally of four types: (1) regulation of franchise or business opportunity sales;[248] (2) regulation of franchise or dealership termination;[249] (3) state acts, known as "baby" FTC acts, against unfair and deceptive practices;[250] and (4) industry specific regulation.[251] The franchisor's attorney absolutely must be familiar with

---

244. *See* Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962).

245. *See* W.W. Blackburn v. Crum & Forster, 611 F.2d 102, 104-05 (5th Cir. 1980).

246. *See* Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 486-89 (1977); Kypta v. McDonald's Corp., 671 F.2d 1282, 1287 (11th Cir. 1982) (summary judgment in favor of franchisor due to franchisee's failure to show that being required to sell "Big Macs" caused actual injury).

247. BUS. FRANCHISE GUIDE (CCH).

248. *See id.* ¶¶ 3000-3500.

249. *See id.* ¶¶ 4000-4515.

250. *See id.* ¶¶ 5000-5490.25.

251. *See id.* ¶¶ 5700-5851.

these statutes in preparing the franchise agreement. Most of these statutes are implemented through regulations which should also be considered. Failure to incorporate state requirements into the "standard" franchise agreement will require numerous specific amendments as the franchisor enters new states, or worse, result in state law violations.[252] Further, franchisor's management will typically forget the various specific state legal memoranda generated by the franchisor's attorney and look to the franchise agreement to guide their relationship with the franchisee. As a practical matter, therefore, the only means of keeping the franchisor's conduct lawful is to incorporate the law into the agreement itself.

V. CONCLUSION

Franchising is something new under the sun. It brings together many different and difficult areas of law: trademarks, antitrust, trade secrets, trade regulation, and specific franchise regulations. Texas law is unique in each of these areas and therefore requires special treatment.

Franchise litigation can be dangerous for all involved; a burdensome system for the franchisee's attorney or a stake in the heart of the franchisor. The typical battle centers on whether the franchisor's acts have been "so bad" to refuse enforcement of the franchise agreement.

The common law does not adequately protect against a franchisor's failure to disclose his financial circumstances nor the inability of a bankrupt franchisor to respond in damages. Franchising is analogous to the sale of securities, long ago recognized as an industry requiring regulation for the public welfare. The only effective means of protecting Texas citizens against franchise abuses is to require a presale substantive review of the franchise opportunity together with the right of the state to require an impound if necessary. The BOA not only fails to address these problems but by its terms is excluded from franchise regulation.

---

252. *See, e.g.*, Martin Investors, Inc. v. Vander Bie, 269 N.W.2d 868, 873-74 (Minn. 1978) (offer of sale without proper state registration); Peck of Chehalis, Inc. v. C. K. of Western Am., Inc., 304 N.W.2d 91, 97 (N.D. 1981) (inadequate registration of franchise offering); State *ex rel* Healey v. Consumer Business Sys., Inc., 482 P.2d 549, 554-56 (Or. Ct. App. 1971) (failure to register under securities act).

APPENDIX A

Franchise Fee Comparison Study*

	Franchise Fee	Total Investment	Cash Requirement**	Royalty	Advertising
RESTAURANTS					
Church's Fried Chicken	10,000	360,000	100,000	4%	2%
McDonald's	12,500	350,000	120,000	11½%	4%
Taco Tico	7,500	370-430,000	50,000	3%	2%
Wendy's	15,000	500,000	80,000	4%	4%
Burger King	40,000	290,600	130,000	3½%	4%
Kentucky Fried Chicken	10,000	450,000	125,000	4%	4½%
Pizza Inn	15,000	350-460,000	150,000	4%	3%
HOTELS/MOTELS					
Granada Royale Hometels	50,000	12,000,000	3-5,000,000	4%	1-2%
Sheraton	15-40,000	5-10,000,000	1.5-3,000,000	5%	2%
Hilton	25-50,000	80,000/room	20% of Total Investment	5%	—
AUTOMOTIVE					
Meineke	17,000	70,000	39,000	7%	10%
Jiffy Lube	35,000	100-128,000	40-45,000	5%	4%
Grease Monkey	20,000	62,500	30,000	4%	4%
MISCELLANEOUS					
Computerland	75,000	250-350,000	120-145,000	8%	1%
Docktor Pet Center	15,000	125-145,000	60,000	4½%	0
Edie Adams Cut & Curl	12,500	80,000	50,000	6%	3½%
Insty Prints	12,000	65,000	32,500	3%	2%

* Reprinted by permission of Francorp; figures as of March 1983.

** Actual cash needed by franchise — balance is usually financeable.

APPENDIX B—Checklist for Business Opportunity Filing

Name:
Address:
City/State:
Phone(s): Type:_____

BUSINESS OPPORTUNITY

Sections:

___1) List of the names and addresses of salesmen (Attach as Exhibit A).

___2) Bond or Trust Account Notification or Statement that No Bond or Account is required (Exhibit B).

___3) REQUIRED DISCLOSURE STATEMENT (Exhibit C). Consists of the following:

a) Cover sheet entitled "Disclosures Required by Texas Law."
b) Seller's name(s), affiliates or partners; past name(s).
c) Names, addresses, and titles of seller's officers, directors, trustees, partners, executives and stockholders with 20% or more ownership.
d) Statement on length of time involved in current and prior Business Opportunity sale ventures.
e) Service Performance description.
f) Seller's Financial Statements.
g) Training description, if relevant.
h) Statement on services or agreements with equipment placement, if relevant.
i) Bond or Trust Account Statement, if relevant.
j) 45 day Contract Cancellation Statement.
k) Sales Earning Statement, if relevant.
l) Civil or Criminal Record Statement on Seller's or Salesman.
m) Bankruptcy or Insolvency Statement.
n) Copy of Business Opportunity Contract.

__4) SALESMAN UPDATE (Exhibit D) _____, _____,
_____, _____, _____, _____, _____, _____,
_____, _____, _____, _____, _____, Backside.

__5) FINANCIAL STATEMENT UPDATE (Exhibit E) _____,
_____, _____, _____, _____, _____, _____,
_____, _____, _____, _____, _____, Backside.

__6) DISCLOSURE STATEMENT UPDATE (Exhibit F) _____,
_____, _____, _____, _____, _____, _____,
_____, _____, _____, _____, _____, Backside.

Registration Checklist-UCC: 8/81

Initial Filing

Supplemental Filing