

Chapter 1

The History of Franchising^{*}

I. An Introduction

A. A Definition of the Franchise Concept

In its broadest sense, a “franchise” is a contractual relationship between a “franchisor” and an independent “franchisee” whereby the former licenses the latter to distribute a specific product or service, or to engage in a prescribed method of doing business, using the franchisor’s trademark or service mark.¹ Beyond this, franchising is in the eyes of the beholder. For the retail consumer, franchising implies individual, unit ownership of some sort that manifests itself in look-alike restaurants, service stations, hotels, automotive parts stores, and the like that line up one after another along busy streets.

For the economist, franchising is “just one of many ways a firm can choose to distribute its product” or service.² It is an alternative to vertical integration; rather than own all the channels of distribution, a franchisor contracts with independent third parties to distribute its product or service to the end user. “The essential economic

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1. Federal legislation initially introduced into the United States Senate in the 1960s did not consider the licensing of a trademark a critical component of a franchise relationship. The 1967 version of a bill regulating franchising introduced in the Senate by Philip Hart, discussed later in this chapter, did not reference a trademark license in its definition of a franchise. Senator Hart’s amended version, introduced in 1969, added to the definition of a franchise that “the operation of franchisees’ business franchise is substantially associated with a franchisor’s trademark, service mark, trade name advertising or other commercial symbol ***.” According to Ernest A. Braun in *Policy Issues in Franchising*, 14 Sw. U. L. Rev. 155, 209 (1984), “the existence of a trademark license became a recognized constituent of franchising during and following the years of the *Carvel* litigation.” District Judge Dawson, in *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962), aff’d, 332 F.2d 505 (2d Cir. 1964), delivered the famous line that the franchisor’s trademark is the “cornerstone of a franchise system.”

2. Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. Corp. Fin. 9, 10 (1995).

rationale for franchising is that it permits transactors to achieve whatever benefits of large scale may be available in, for example, brand name development and organization design, while harnessing the profit incentive and retailing effort of local owners.”³ But, as the economist is quick to explain, this same economic rationale applies generally to any independent distribution arrangement and therefore does not distinguish franchising from other non-integrated methods of distribution.⁴ Similarly, according to the economist, the fundamental economic forces that underlie the franchise relationship (i.e., economic interests of the franchisor and the franchisee that coincide and those that conflict) also underlie independent distribution relationships.⁵

For the parties to the franchise agreement, franchising is more than “just a business.” It is a relationship. Normally, the franchisor and the franchisee share the economist’s view of the economic benefits of franchising. Franchisors thus consider franchising a means to distribute widely and rapidly a product, service, or method of doing business without the significant capital investment and risk attendant to owning all levels of distribution. The franchisee, in turn, sees franchising as an opportunity to make money by joining an established system of doing business—a system that features multiple locations, a recognized brand, and uniform products, services, or business methods. But there are also intangibles in the franchise relationship for the parties. Franchising is a means to fulfill the “American Dream” of owning one’s own business. It is a “business marriage” between two parties who are at the same time independent and interdependent. Not infrequently, both parties to the franchise agreement describe their relationship as “family.” One side cannot succeed without the other, yet their interests seemingly collide as frequently as they mesh.

To franchise counsel, it matters little whether consumers, economists, and the parties themselves call or consider a particular business relationship a franchise. What really matters is whether the relationship is a “franchise” under the various state and federal laws that regulate franchising. And this is a matter of definition, pure and simple. If a relationship satisfies the legal definition of a “franchise” under a particular statute or regulation, then the franchisor has various legal duties to its franchisee.⁶ As addressed more fully later in this casebook, in general a franchise exists for purposes of state and federal laws when three elements come together—the license by the franchisor to the franchisee of a right to use a trademark or service mark; the payment of a fee by the franchisee to the franchisor for that right; and either substantial control

3. *Id.*

4. *Id.* at 12.

5. *Id.* An excellent book discussing franchising from an economics perspective is Roger D. Blair & Francine Lafontaine, *The Economics of Franchising* (2005).

6. Labeling a particular relationship a “franchise” does have legal implications beyond application of state or federal statutes and regulations. For example, some courts tend to apply common law principles of agency differently to a franchise relationship. See William L. Killion, *Franchisor Vicarious Liability—The Proverbial Assault on the Citadel*, 24 *Franchise L.J.* 162 (Winter 2005).

of the franchisee by the franchisor, a marketing plan, or a community of interest, depending on the applicable law.⁷ The majority of relationships that we commonly consider a franchise fall squarely within the definition, but it is hardly a litmus test. The three-part legal test at times makes franchises out of seemingly traditional distribution relationships.⁸

B. An Outline of This Chapter

This is a casebook for students of the law of franchising. We therefore focus in this chapter on the history of franchising as it has affected the development of franchise law. In the process, we use the term “franchise” in the broadest sense, as defined previously.

We consider first the origins of the concept of “franchising” during the Middle Ages as the grant by a sovereign to a subject of the legal right to perform a public service for a fee and then the exporting of the concept of franchising from a Europe dominated by kings and other sovereigns to a United States governed by elected officials. In this country, it was the elected government, not the king, that “franchised” to private parties the right to perform public services, a role served still today principally by local governments. Private enterprise eventually applied the term “franchise” to private product distribution arrangements.

We address the appearance in the early 1900s of “product distribution franchising” or “traditional franchising,” a form of franchising in which the franchisor manufactures and sells finished or semi-finished products to its dealers or franchisees, who in turn resell the products to consumers or others in the chain of distribution. Product distribution franchising evolved out of the exclusive agency relationship that first appeared in the 1840s as a part of a shift in the United States economy from small firms serving a limited market to large suppliers selling into large regional markets.

Most importantly, we discuss the evolution of “business format franchising,” a unique franchising model that existed prior to World War II but did not reach full bloom until after the war. Unlike traditional or product distribution franchising, represented historically by automobile, service station, and soft drink franchising, business format franchising “includes not only the product, service, and trademark, but the entire business format itself: a marketing strategy and plan, operating manuals and standards, quality control, and a continuing process of assistance and guidance.”⁹

7. The definition of a “franchise” in the Connecticut Franchise Act, unlike the definitions in the FTC Rule (see Chapter 8) and other state laws, does not require the payment of a franchise fee. See Conn. Gen. Stat. § 42-133e(b) (2007 & West Supp. 2010).

8. For a discussion of the often thin line between a franchise and a non-franchise relationship under the law, see William L. Killion & Sarah J. Yatchak, *But It Doesn't Walk or Talk Like a Duck: The Perils of the Hidden Franchise*, *Bus. L. Today*, Sept.–Oct. 2007, at 54.

9. Andrew Kostecka, U.S. Dep't of Commerce, *Franchising in the Economy 1986–1988*, at 3 (1988).

Under the business format model, the franchisor licenses the franchisee to use both the franchisor's trademark and its "system." "System" is broadly defined in most franchise agreements as a set of fairly detailed methods and procedures established by the franchisor and followed by the franchisee in the operation of its business. The rules of operation are reflected in "system standards" established in manuals and similar documents issued to franchisees by the franchisor. The ultimate objective is to have each franchised location indistinguishable to the consumer from all others displaying the franchisor's brand. It is business format franchising that serves as the model for the fast-food, hotel, and other chains that are ubiquitous in the retail segment of our economy today. And it was primarily business format franchising, with its relative ease of entry and appeal to less sophisticated investors, that led to abuses of some franchisees by some franchisors. Those abuses became the grist for legislative, regulatory, and sometime judicial intervention in the relationship beginning in the 1960s, reaching a peak in the 1970s, and continuing still today.

The development of business format franchising is the poster child of Ralph Waldo Emerson's admonition that "there is properly no history; only biography."¹⁰ Business format franchising in particular is the story of entrepreneurs ultimately perfecting a unique method of distribution through trial and error. The method was not hatched out in the ivy-clad towers of academia. Few references to the concept exist even today in the textbooks used in business schools at our universities. It was not developed by MBA-degreed executives in large corporations. Modern business format franchising was ultimately the product of the drive and ambition of American entrepreneurs, often not particularly educated, with names like Harry Axene, a sales manager for a farm equipment company, who spread the Dairy Queen franchise throughout the United States; Kemmons Wilson, a high school dropout who developed the Holiday Inn chain of hotels;¹¹ Harland Sanders, who started Kentucky Fried Chicken at age 62 by licensing restaurants to use his secret herbs and spices in the preparation

10. Ralph Waldo Emerson, *History, in Essays: First Series* (1841).

11. In the summer of 1951, Kemmons Wilson, a successful home builder in Memphis, Tennessee, decided to take his family on a vacation to Washington, D.C. As had become the custom for summer vacations by that time, the Wilsons decided to take the tour in their new Oldsmobile. Unable to find suitable motel accommodations on their trip, Wilson decided to build a chain of motels. He was 38 years old at the time. Although he was a high school dropout, he had become a millionaire building houses. By August of 1952, Wilson had built his first Holiday Inn in Memphis. He opened 11 more motels in 1954, the first year in which he issued a franchise. "At one point," Wilson's chain "was building a new inn every two and a half days and a new room every fifteen minutes." David Halberstam, *The Fifties 173–178* (1993).

of chicken;¹² Al Tunick, the founder of the Chicken Delight franchise;¹³ Ray Kroc, a milkshake-machine salesman responsible for the development of the McDonald's system;¹⁴ and William Rosenberg, an eighth-grade dropout who established the Dunkin' Donuts franchise.

The line between wholesome free enterprise and harmful greed is often thin. The “wild west” of business format franchising that emerged after WWII and created substantial wealth for a broad variety of American citizens also served the interests of dishonest individuals looking to make a quick buck at the expense of vulnerable would-be franchisees. Unethical practices led to most of the state legislation and many of the common law developments that are the subject of this casebook. But in developing laws designed to protect franchisees from a lack of information about a franchise opportunity or to curb abusive practices by franchisors, our legislatures and courts have rarely lost sight of the importance of franchising to the American economy and the unique opportunities it presents to entrepreneurs. In enacting laws and handing down decisions, they have typically sought to achieve a careful balancing of the interests of franchisor and franchisee alike.

II. The Origins of Franchising

Franchising as a legal concept first appeared in the Middle Ages. A word out of the French lexicon meaning “to make or set free,” as in “to invest with a franchise or privilege,” a “franchise” in early history was a grant of rights by a sovereign ruler to a subject to perform public and other services in exchange for consideration.¹⁵ William Blackstone, in his *Commentaries on the Laws of England*, wrote that “[f]ranchise and liberty are used as synonymous terms: and their definition is, a royal privilege, or branch of the king’s prerogative, subsisting in the hands of a subject. Being therefore derived from the crown, they must arise from the king’s grant ***.”¹⁶ Franchises were,

12. Sanders had only a sixth-grade education. He operated a successful restaurant in Corbin, Kentucky, selling Kentucky Fried Chicken. In 1955, a new highway was built that bypassed his restaurant by seven miles, causing the Colonel to close his shop. He took his first \$105 Social Security check and traveled to restaurants in Indiana and Ohio, selling his Kentucky Fried Chicken concept. He leased cookers or converted existing stoves that would allow the restaurants to cook at high temperatures and sold his secret spices to the restaurants. He also sold, at cost, napkins, buckets, and the like with his image and the Kentucky Fried Chicken logo on them. *Faces Behind the Figures: These Businessmen Made News This Month*, *Forbes*, May 15, 1966, at 34, 36.

13. For a discussion of Tunick, see *infra* note 64.

14. For a discussion of Kroc, see *infra* text accompanying notes 41–47.

15. Thomas S. Dicke, *Franchising in America: The Development of a Business Method, 1840–1980* 1 (1992) (citation omitted).

16. Sir William Blackstone, *Commentaries on the Laws of England* 759–60 (William Carey Jones ed.) (1915) (footnote omitted).

according to Blackstone, infinite in number.¹⁷ The right of a number of persons to incorporate was a franchise, and each member of the corporation had a franchise or freedom. Franchises issued by the king to his subjects included the right to have a fair or market; the right to charge a toll for the use of public places such as roads, bridges, and wharfs; and the right “to have a forest, chase, park, warren, or fishery, endowed with the privileges of royalty.”¹⁸

In the United States, kings and other sovereigns of Europe were replaced by governments run by elected officials. The United States Supreme Court observed in *California v. Central Pacific Railway Co.* that “divested of the special form which it assumes under a monarchial government based on feudal traditions, a franchise is a right, privilege, or power of public concern, which ought not to be exercised by private individuals at their mere will and pleasure, but should be reserved for public control and administration ***.”¹⁹ Further, “no private person can establish a public highway or a public ferry or railroad, or charge tolls for the use of same, without authority from the legislature, direct or derived. These are franchises.”²⁰ According to the Illinois Supreme Court in *Lasher v. People*, “a right which belongs to the government when conferred upon the citizen is a franchise.”²¹ In 19th and early 20th century America, the term “franchise” was associated typically with grants of incorporation, especially for municipal services.²²

It was not until the 20th century that franchising was associated with private agreements governing the distribution of products or services. The literature does not identify when or how the word “franchise” was first applied to private business arrangements, but it does seem a natural fit. Like a traditional grant of rights by a sovereign to a subject, or a government to a citizen, a private franchise is a grant of rights from one private concern to another. Gurnick and Vieux explain the concept as follows:

Although reported cases do not indicate precisely when or why the franchise concept first applied to private agreements, the conceptual link can be inferred. Makers of brand name products exercised prerogatives, like those of a sovereign, over their property by granting exclusive rights to sales agents to sell or distribute them in defined geographic areas. In return, the grantee had to provide services (e.g., best efforts) or a portion of collections (e.g., a royalty). This arrangement could be made in a variety of business contexts.

David Gurnick & Steve Vieux, *Case History of the American Business Franchise*, 24 Okla. City U. L. Rev. 37, 39 (1999).

17. Id. at 760.

18. Id. at 762.

19. 127 U.S. 1, 40 (1888) (holding that the State of California may not tax a franchise granted by the U.S. Congress).

20. Id.

21. 55 N.E. 663, 665 (1899).

22. Dicke, *supra* note 15, at 1–2.

III. The Evolution from the Exclusive Sales Agency to the Product Distribution Franchise

Significant economic changes reshaped American business in the 1840s.²³ Prior to that time, small firms serving a limited market dominated business in this country. Dense urban markets had existed in the United States for decades, but the great size of this country and the tendency of its citizens to migrate to sparsely populated areas did not encourage the development of new methods of product distribution. By the 1840s, however, the growth of urban centers located throughout the United States east of the Mississippi encouraged manufacturers to develop new methods of getting their products to market. At the same time, remarkable technological changes made access to these large markets possible and allowed low-cost, high-volume production. The steamboat and the railroad in particular increased significantly the markets available to manufacturers for the distribution of their products.

The expansion of American markets in the 1840s created an increased need for someone to coordinate the movement of products from the manufacturer to the end user. Prior to that time, the wholesale jobber or “independent agent” served that function. Rather than adopting an integrated distribution system, manufacturers contracted with agents to sell products to independent retailers. These agents provided credits and working capital at both the manufacturing and retail ends of the distribution process. They typically distributed the product of more than one manufacturer, but beginning in the 1830s a new form of agency emerged: the “exclusive agent,” someone with the sole right to sell the manufacturer’s product into a particular market. In exchange for this exclusive right, the agent agreed to make substantial investments in equipment. “Once agents became dependent on a single manufacturer for the bulk of goods they sold and the expertise they possessed, they lost a great deal of their freedom of action and the relationship shifted from one of principal and agent to that of franchiser and franchisee.”²⁴ All the way back to 1850, Singer Sewing Machine Company’s network of sales and service agents has been cited as the prototype to modern franchising.²⁵

23. This section of this chapter is drawn largely from Dicke’s book, *Franchising in America: The Development of a Business Method*, *supra* note 15.

24. *Id.* at 17.

25. The Singer Sewing Machine Company was one of the first major manufacturers to use a form of franchising model to distribute its products.

Like Singer, farm implement manufacturers like McCormick Machine Harvesting Company were the early pioneers of product distribution franchising. Because the market for farm implements was scattered and seasonal and also required knowledge of local conditions, manufacturers could not practically own their own distribution systems. This factor, plus the high cost of equipment and the desire of farmers to see products in operation before purchasing them, led to the development of a dealer network. The relationship between McCormick and its dealers, for example, was eventually characterized by regular channels of communication, standardization of procedures, and the expansion of services to the dealers by the manufacturer, thus making McCormick one of the earliest examples of a product distribution franchisor.

By the turn of the century, product distribution franchising had become an established method of distributing products. General Motors issued its first franchise to William E. Metzger of Detroit in 1898. Henry Ford followed suit by franchising dealers to sell his Model T in the early 1900s. Coca-Cola issued its first franchise in 1899. In 1902, a group of independent druggists formed their own private label, called Rexall. The Rexall cooperative flourished and eventually established its own chain of stores. Following World War I, Rexall franchised independent stores to use its name and sell private-label products. Western Auto established a dealer network in 1909, and Ben Franklin's dime stores started marketing general merchandise through franchisees in 1920.

IV. The History of Modern Business Format Franchising

A. Prior to 1945

Much less common than product distribution prior to WWII was the business format franchise. Some authors believe that the earliest business format franchise was established by Martha Matilda Harper.²⁶ A domestic servant for many years, Harper started her first hairdressing salon in Rochester, New York, in 1891. She established her "Harper Method" of hair and skin care, which she expanded to other cities by offering to typically poor women a "franchise" to operate a Harper Hairdressing Parlor. She offered comprehensive training and continuing assistance, first at her parlor in Rochester and later at a school that she started in 1926. Harper assigned to candidates who finished their training program a territory within which to establish a parlor. There

26. One student of franchising believes Ben Franklin was the first franchisor in America when he contracted with Thomas Whitmarsh on September 13, 1731, to operate a shop in South Carolina printing Franklin's writings, a relationship Franklin entered with other printers throughout the colonies. Michael Seid, *The Evolution of Franchising*, Franchise Update, May 30, 2006, available at http://www.franchising.com/articles/the_evolution_of_franchising.html.

were more than 500 Harper shops worldwide by 1928. The Harper network was sold in 1972 to a competitor, who then closed the company and the remaining training centers.

Another early example of business format franchising was the Howard Johnson's chain of restaurants. Johnson began franchising restaurants in 1935, and by 1939, more than 100 restaurants carried his name.²⁷ Years earlier, in 1924, two businessmen by the names of Allen and White founded a franchised food service chain that carried their initials, A&W, and offered a distinctive root beer syrup.

It was the close of the Second World War, however, that set the stage for the ultimate introduction of business format franchising as we know it today.

B. 1945–1955: The Experimental Years

A number of forces came together after World War II and ultimately led to a franchising boom. The end of the war marked the return to civilian life of millions of servicemen and servicewomen looking for jobs, ready to start a family, ready to spend money. “[T]here were the hordes of returning G.I.s, their pockets bulging with mustering-out pay and their hopes high of once again striking out on their own.”²⁸ “The great expansion of the service and retail sectors in particular aided the growth of business-format franchising by increasing the size of its natural habitat, while growth in personal income increased people’s ability to buy both franchised goods and franchised businesses.”²⁹ But the contributors to the growth of franchising were also more subtle. They included, according to Thomas Dicke, a combination of the “American Dream” of owning your own business and a persistent belief in big business as a key to success. Franchisors sold franchising “as a method that combined the economic efficiency of big business with the personal satisfaction and social advantages of small business ownership.”³⁰

27. Howard Johnson’s began in 1925 when Howard Johnson turned a failing drug-store in Massachusetts into a soda fountain and sundries store. Johnson opened his first highway restaurant in 1935. He thereafter pioneered franchising as an avenue for rapid growth of a chain of restaurants. Johnson owned a one-half interest in each restaurant. The franchisee, in turn, provided half the capital investment and managed day-to-day operations. Johnson controlled the menu and operation system. Each store had to purchase from Johnson the ice cream that made up the famous 28 flavors, as well as some other food ingredients. Each building had a “roadside cathedral” look. By the end of 1939, there were 107 Howard Johnson restaurants; 150 by 1941; 255 by 1951. The restaurant chain peaked in 1979 with 870 units. See generally John A. Jakle & Keith A. Sculle, *Fast Food: Roadside Restaurants in the Automobile Age* 73–76 (1999).

28. Steven S. Anreder, *License for Growth: The Franchise Is Spurring Expansion in Such Diverse Lines as Snack Stands and Auto Parts*, *Barron’s Nat’l Bus. & Fin. Wkly.*, Nov. 27, 1961, at 3.

29. Dicke, *supra* note 15, at 124.

30. *Id.* at 126.

Although “conditions were ripe for the expansion of franchising after the war,” for the first 15 years it “grew rapidly but quietly.”³¹ The Federal Trade Commission (the FTC) estimated that there were probably fewer than 100 franchisors in 1950.³² The initial surge occurred in the franchising of soft-serve ice cream stores. Right after World War II, there were approximately 100 soft-serve stands in the United States.³³ By 1960, the soft-serve franchise market was saturated, with some 18,000 soft-serve stores in the United States.³⁴

The single biggest contributor to this tremendous growth in soft-serve franchises was Harry Axene, a farm-implement salesman from Missouri. J.F. McCullough developed the soft-serve ice cream cone and gave it the name “Dairy Queen,” but it was Harry Axene who grew the Dairy Queen system.³⁵ Axene went into business with McCullough and sold off large territories to “territory operators” (called “master franchisees” or “subfranchisors” in today’s parlance) who in turn sold subfranchises to store owners to operate individual Dairy Queen stores.³⁶ Axene eventually formed Tastee-Freez with another partner and continued selling large territories to

31. *Id.*

32. Franchising & Business Opportunity Ventures: Disclosure Requirements & Prohibitions, 43 Fed. Reg. 59,613, 59,623 (Dec. 21, 1978) (the Original FTC Rule—see *infra* Section VI and Chapter 8).

33. Franchise Selling Catches On, *Bus. Wk.*, Feb. 6, 1970, at 90.

34. *Id.*

35. Nathan Aaseng, *Business Builders in Fast Food* 65 (2001).

36. Harry Axene was a sales manager for Allis Chalmers when he encountered his first Dairy Queen store in East Moline, Illinois. Axene discovered that H.A. McCullough and his son, Alex, owners of an ice cream manufacturing facility in the Moline area, had developed the Dairy Queen concept. H.A. McCullough had already entered an agreement in 1939 with Harry Oltz, the inventor and holder of a patent on the soft-serve machine used in Dairy Queen stores. Under the agreement, Oltz received approximately two cents per gallon of soft-serve mix run through the freezer. McCullough and Oltz also agreed that McCullough had the right to license use of the patent in the western United States; Oltz had the eastern. The license agreement issued by McCullough and Oltz to third parties covered only the patent and had few quality controls. From 1943 through 1948, McCullough and Oltz sold some territories, but the major growth of the system came from Axene. Axene, over time, acquired from McCullough and Oltz the right to sell a number of exclusive territories to “territory operators.” By 1948, Axene had sold all of his territories, often an entire state at a time. The territory operators purchasing territories from McCullough, Oltz, and Axene were generally permitted to do whatever they wanted to do in their territories. In 1948, Axene and others formed the Dairy Queen National Trade Association to bring uniformity into the Dairy Queen system by developing standard sources of supply and advertising programs. The first meeting of the association was on December 6–8, 1948. One of the Dairy Queen suppliers attending the first meeting was Ray Kroc, a supplier of the Multimixer brand shake mixer.

master franchisees.³⁷ By the mid-1950s, the Dairy Queen system had 2,600 stores and Tastee-Freez had 1,500 stores scattered throughout the United States. In 1948, Thomas Carvel organized two corporations to issue Carvel franchises and sell freezers. The Carvel chain had approximately 180 stores by 1954.³⁸

Although there were thousands of soft-serve franchise locations throughout the United States by the mid-1950s, none of the major soft-serve franchisors served as a model of successful business format franchising. The significant franchisors had sold off large territories without retaining meaningful controls over the nature and quality of the goods sold under their trademarks. The franchise systems were built principally upon patented soft-serve machines as opposed to trademarks as the symbol of uniform products and services offered at every location featuring the franchisor's brand.

C. 1955–1970: The Boom Years

In some ways, business format franchising as we know it today began on April 15, 1955. On that day, Ray Kroc opened his first McDonald's restaurant in Des Plaines, Illinois. The spark that ignited the franchise boom had occurred, however, three years earlier when *American Restaurant Magazine* published an article about a "carry-out" drive-in in downtown San Bernardino, California.³⁹ The magazine reported how the McDonald brothers had created a self-service system capable of providing a sandwich, beverage, and french fries in 20 seconds. The brothers, according to the article, were also developing a nationwide franchise system that would "soon be made available to the industry."⁴⁰

The magazine article led to a pilgrimage of entrepreneurs to San Bernardino hoping to duplicate the success of the McDonald's system. One pilgrim was Ray Kroc, a milkshake-machine salesman from Illinois. Kroc was 52 years old in 1954 when he was in Los Angeles making routine calls and decided to drive 60 miles east to San Bernardino to see the McDonald's drive-in. He considered himself a "battle-scarred veteran of the business wars," with diabetes, incipient arthritis, and the loss of a gallbladder and most of his thyroid gland.⁴¹

Kroc was impressed with the operations and had dinner with the McDonald brothers that evening. He discovered that the brothers had already issued franchises

37. Leo Maranz introduced Axene to a new freezer, half the size of the Dairy Queen freezer, that Maranz had developed while Axene was still active in the Dairy Queen system. When the idea of a new freezer was rejected at the 1949 Dairy Queen convention, Axene severed his ties with Dairy Queen and formed a partnership with Maranz to develop Tastee-Freez as a market for its new freezer. Caroline H. Otis, *The Cone With the Curl on Top: The "Dairy Queen" Story* 39 (Susan Mundale ed., 1990).

38. *Susser v. Carvel Corp.*, 332 F.2d 505, 509 (2d Cir. 1964).

39. *One Million Hamburgers and 160 Tons of French Fries a Year*, *Am. Restaurant Mag.*, July 1952, at 44.

40. *Id.* at 44–45.

41. Ray Kroc, *Grinding It Out: The Making of McDonald's* 13 (1977).

for ten other sites in California and Arizona and were looking for someone to franchise their concept in the remainder of the United States.⁴² When Kroc flew back to Chicago after his meeting with the McDonald brothers, he was that person. He had a “freshly signed contract with the McDonald brothers in [his] briefcase.”⁴³

Ray Kroc was not the first to apply business format franchising to fast food. In fact, he walked into what was becoming a crowded field.⁴⁴ “Dave Edgerton became the first franchisee of InstaBurger King” in Miami, Florida, and soon started the Burger King franchise chain with Jim McLamore.⁴⁵ Joined by other hamburger franchise concepts like Burger Chef, Carl’s Jr., Wendy’s, and Jack-in-the-Box, McDonald’s and Burger King became the lead combatants in the “burger wars” of the 1960s that still continue today.

Although Kroc certainly did not invent the business format franchise concept, he did revolutionize it. As John Love explains, “what Kroc *was* inventing was a unique franchising system, one that set McDonald’s apart from all the other early fast-food franchisers.”⁴⁶ Kroc and his lieutenants at McDonald’s would eventually perfect business format franchising, establishing the model that guides all successful franchise systems today. McDonald’s built a central organization to develop standards of operation, train franchisees, and enforce compliance with standards through supplier relationships and field inspections. Although quality assurance is now the mantra of every fast-food franchisor, McDonald’s invented the concept through its QSV&C (Quality, Service, Value, and Cleanliness) program.

The McDonald’s numbers tell the story. “By 1960, there were more than 200 McDonald’s outlets across the country ***.”⁴⁷ By the time the company went public on April 15, 1965 (ten years to the day after Kroc had opened his first restaurant), there were 710 McDonald’s restaurants in 44 states producing \$171 million in annual sales. In 1972, with more than 2,200 McDonald’s restaurants and system sales of \$1 billion, Kroc received the Horatio Alger award. *Time Magazine* ultimately named him one of the 100 most influential Americans in the 20th century.

The McDonald’s system was not the only franchise success story that emerged in the years following World War II. Brands like Kentucky Fried Chicken, International House of Pancakes, Radio Shack, Ramada Inns, Perkins Pancake House, and Midas dotted the streets and highways of America. These systems, and many others, enjoyed significant growth in the late 1950s, but “[w]hat changed this rapid but steady

42. Id. at 67.

43. Id. at 13.

44. See generally John F. Love, *McDonald’s: Behind the Arches* 48–55 (1986).

45. Id. at 53.

46. Id.

47. Daniel Gross, *Forbes’ Greatest Business Stories of All Time* 177 (1996).

expansion to a boom was the publicity generated in the late 1950s when both the popular and the business press discovered franchising.”⁴⁸

Franchising eventually hit Wall Street. The public offering of Kentucky Fried Chicken in March 1966 “touched off” what *Newsweek* magazine described as “one of the decade’s daffiest booms—the great franchise explosion.”⁴⁹ By 1969, the stock prices of franchise companies had created a number of new multi-millionaires—on paper at least. Al Lapin, the founder of International House of Pancakes, was worth \$40 million on paper; Ray Kroc \$100 million; and John Brown and Jack Massey, the two partners behind the growth of Kentucky Fried Chicken, well over \$50 million apiece.

As 1969 drew to a close, franchising was at its zenith, although cracks had existed in the veneer of business format franchising from the very beginning. The estimated number of franchisors had grown from 789 to 900 during 1969 alone. Franchise “industry” revenues had grown 3,600 percent over the 15-year period from 1955 to 1970.⁵⁰ From 50,000 franchisees in 1955 grossing \$2.5 billion annually, franchising had grown by 1970 to 670,000 franchisees “selling everything from potato pancakes to pedigreed poodles and piling up volume of \$90 billion a year.”⁵¹ Franchising had become, according to *Newsweek*, “a game that everyone can play—from the biggest names in show business and the craftiest financiers of Wall Street to the man on the street.”⁵² “The latter,” the magazine reported, “has gotten in on the action either by buying a franchise or by buying one of the scores of stocks in franchise companies that have rushed to the market in the last year.”⁵³

D. 1970: The Bubble Bursts

The headline in *The Wall Street Journal* for Friday, May 29, 1970, said it all: “Many Franchise Firms Fall on Hard Times After a 15-Year Boom.”⁵⁴ According to the

48. Dicke, *supra* note 15, at 126. The popular press was just one contributor to the boom in franchising. Another was the massive migration starting in 1950 and continuing for 30 years of people from the cities to the farmlands that surrounded them, called suburbs. By 1970, there were, for the first time, more people living in the suburbs than in the cities. Halberstam, *supra* note 11, at 142. Unlike the pre-WWII suburbs connected by streetcars, the post-war suburbs were connected by the automobile. This changed the “very nature of American society,” including how citizens shopped for food and other goods and services. *Id.* It was in San Bernardino, California, a growing suburban area of approximately 100,000 residents, that the McDonald brothers opened their first drive-in hamburger stand, which they later replaced in 1948 with their now-famous first fast-food walk-up facility. Also contributing to the growth were the development of the national highway system and the attendant travel by tourists throughout the United States.

49. The Great U.S. Franchising Boom, *Newsweek*, Nov. 10, 1969, at 3 and 88.

50. James MacGregor, Many Franchise Firms Fall on Hard Times After a 15-Year Boom, *Wall St. J.*, May 29, 1970, at 1.

51. *Id.*

52. The Great U.S. Franchising Boom, *supra* note 49, at 88.

53. *Id.* at 88.

54. MacGregor, *supra* note 50, at 1.

article, “once considered the darling of Wall Street and the savior of the small businessman, franchising today is spurned on Wall Street and cursed on Main Street.”⁵⁵

Several things coalesced in 1970 to burst the franchising bubble. Most visible was the collapse of a huge bull stock market, “in which the franchisers flew high among the glamour stocks, soaring in the unaccustomed company of computer and electronics makers.”⁵⁶

Compounding the problem, some franchisors, under then-common accounting methods, recorded their entire initial franchise fee as income the day the franchise agreement was signed. The practice of “going public on the strength of earnings based entirely on one-shot franchise fees already in hand became happily known as ‘Minnie-Pearling it.’”⁵⁷ The Minnie Pearl’s Chicken System was started by two brothers and attorneys named Hooker. They formed Performance System, Inc., or PSI, to franchise Minnie Pearl’s restaurants. John Jay Hooker reportedly “sold franchises by the carload, knocking off whole territories in a single stroke to entrepreneurs who were to subfranchise (some were sold to companies organized and owned in part by Hooker himself).”⁵⁸ Each time Hooker sold a franchise, PSI booked the franchise fee as income. By the time it went public in May 1968, PSI had recorded nearly \$5 million from the sale of 405 franchises, although only a handful of restaurants were actually open.⁵⁹ PSI raised over \$7 million from the public offering, and its stock reached a peak of \$68 per share before the franchise bubble burst. By the end of 1969, only 263 Minnie Pearl restaurants were in operation, although PSI had sold franchises for 1,600 restaurants.⁶⁰ Ultimately, PSI stock fell to less than \$1 per share, and the Minnie Pearl franchise system eventually ceased to exist altogether.⁶¹

Adding to the discontent that practices like these generated was the emergence of the celebrity franchise systems in the late 1960s, systems for which the celebrities had done little more than lend their names. Johnny Carson, Edie Adams, and Mickey Mantle testified in January 1970 before the highly publicized Senate hearings on franchising chaired by New Jersey Senator Harrison Williams. They were not, however, the only celebrities to join the franchising game. Others included Tony Bennett, Eva Gabor, Ed McMahon, Jerry Lewis, Mahalia Jackson, Arthur Treacher, Fats Domino,

55. Id.

56. Franchising: Too Much Too Soon, *Bus. Wk.*, June 27, 1970, at 54.

57. J. Richard Elliott, Jr., Home to Roost: Excesses of the Fast Food Franchisers Are Catching up to Some, *Barron’s Nat’l Bus. & Fin. Wkly.*, Sept. 22, 1969, at 5.

58. Charles S. Burck, Franchising’s Troubled Dream World, *Fortune*, March 1970, at 116, 120.

59. Julie Bennett, What Really Happened to Minnie Pearl Fried Chicken?, *Franchise Times*, June–July 2007, available at <http://www.franchisetimes.com/June-2007/What-really-happened-to-Minnie-Pearl-Fried-Chicken/>. See also Norman Axelrad, Franchising—Changing Legal Skirmish Lines or Armageddon? Some Observation from the Foxhole, 26 *Bus. Law.* 695–707 (1971).

60. Burck, *supra* note 58, at 120.

61. Bennett, *supra* note 59.

Dizzy Dean, Eddie Arcaro, Rocky Graziano, Roy Rogers, Tennessee Ernie Ford, James Brown, Eddie Arnold, Al Hurt, Pat Boone, Chris McGuire of the McGuire sisters, and Willie Mays. The rise and fall of Broadway Joe's was emblematic of the celebrity franchise scandal. The owner of Broadway Joe's, a system named after quarterback Joe Namath, had opened just one restaurant when the franchisor went public in March 1969. The owner sold two million shares at \$10 apiece.⁶² After reaching a high of \$17 per share, by the summer of 1969 the shares traded at \$5 each.⁶³ Broadway Joe's soon joined Minnie Pearl as just a memory of past franchising abuses.

The decline of franchising manifested itself in, and was hastened by, lawsuits against franchisors, particularly class actions. No system experienced the negative impact of litigation more than Chicken Delight.⁶⁴ In January 1967, a group of franchisees filed a class action against Consolidated Foods Corporation, the owner of the Chicken Delight system, claiming that the franchisor had unlawfully tied the purchase of product to the purchase of the franchise.⁶⁵ Chicken Delight did not charge its franchisees an upfront fee or royalty, but instead earned its revenues from the sale of cookers, fryers, packaging, and mixes. The case went to trial in early 1970 and resulted in a jury verdict against the franchisor. The Ninth Circuit, in the now infamous *Siegel v. Chicken Delight*,⁶⁶ affirmed the trial court's finding of an unlawful tie under the Sherman Act Section 1 but reversed the damages award. The legal victory for the franchisees marked the end of the Chicken Delight franchise system. The franchisor ceased selling products in the wake of the jury verdict, and within a few months, half of the franchised locations were closed. By the time of the Ninth Circuit opinion, most of the franchisees and the franchisor had gone out of business.⁶⁷ Consolidated ultimately settled the class action for \$2.5 million, which, after payment of fees, put about \$2,600 in the pockets of each of the approximately 800 class members.⁶⁸ "Perhaps the ultimate irony is that a court under the prevailing law today would throw out the case on sum-

62. J. Richard Elliott, Jr., *Speculative Bellyache, Fast Food Franchisors Are Risking a Bout of Indigestion*, *Barron's Nat'l Bus. & Fin. Wkly.*, Aug. 25, 1969, at 3.

63. *The Great U.S. Franchising Boom*, *supra* note 49, at 88.

64. A.L. Tunick started his own company in 1950. The company was in the business of wrecking and dismantling plant machinery. In 1951, the company was about to dismantle a factory producing the Deacon cooker, a unique method of quick-cooking chicken under high heat, but the inventor of the cooker talked him into keeping the business open. Tunick opened a store in 1952 to encourage sales of his cooker by demonstrating the product it produced. The chicken and the store were a big hit, and Tunick started the Chicken Delight franchise. By 1960, there were 160 Chicken Delight locations in 40 states. By 1964, there were hundreds of Chicken Delight stores in nearly every state, and Tunick had his own office building, warehouse, and training school. Consolidated Foods Industries purchased Chicken Delight from Tunick and grew the system by 1970 to 800 stores.

65. For the history of the Chicken Delight system, see Harry Kursh, *The Franchise Boom* 261–64 (1968). For discussion of tying claims in franchising, see Chapter 5.

66. *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971).

67. Braun, *supra* note 1, at 180 n.106.

68. *Id.*

mary judgment, given Chicken Delight's lack of economic power in the tying product market."⁶⁹ By the time of the *Siegel* decision, there were many franchisors competing in the chicken franchisor market, not the least of which was Kentucky Fried Chicken. The Ninth Circuit nevertheless concluded that "Chicken Delight's unique registered trade-mark, in combination with its demonstrated power to impose a tie-in, established as a matter of law" market power.⁷⁰

Beyond the headline-catching problems of systems like Minnie Pearl's, horror stories of individual mom-and-pop franchisees losing their life savings to fly-by-night franchisors became commonplace. The empirical data supporting the claims of widespread abuse might have been inconclusive, but the rhetoric was not.

One source of the rhetoric was the office of the New York Attorney General, Louis Lefkowitz. Based on 1,000 questionnaires sent to franchisors in 1969, Lefkowitz's office concluded that "franchising companies are in many instances fly-by-night operations often with nothing more substantial than fancy multi-color brochures"; "citizens of this state are surrendering their life savings to buy worthless franchises"; and "criminal elements and high pressure salesmen have infiltrated into the franchise business."⁷¹ Chief among the critics was Boston lawyer Harold Brown, a franchisee advocate. Describing the franchise relationship as "characterized by [a] pervasive power of control" by the franchisor, Brown called upon the courts to make the franchisor a fiduciary.⁷² Brown described the typical franchisee as follows:

Generally franchisees are in their middle years, come from a sheltered existence, and appear to be totally unprepared for a violent change in their life pattern—numerous

69. William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 *Franchise L.J.* 23, 26 (2008). See also William L. Killion, *Franchisor Price Fixing: What Does Leegin Really Mean for Franchising*, 13 *LJN's Franchising Bus. & L. Alert* (Law Journal Newsletters, Philadelphia, PA.) Sept. 2007, at 2.

70. *Siegel*, 448 F.2d at 49.

71. *The Impact of Franchising on Small Business: Hearing Before the Subcomm. on Urban and Rural Econ. Dev. of the S. Select Comm. on Small Bus.*, 91st Cong. 526–38 (1970) (Copy of memorandum that David Clurman sent to Attorney General Lefkowitz, on Jan. 7, 1970, regarding franchising). See also *The Impact of Franchising on Small Business Before the Subcomm. on Urban and Rural Econ. Dev. of the S. Select Comm. on Small Bus.*, 91st Cong. 311 (1970) (statement of John V. Buffington, Gen. Counsel of Fed. Trade Comm.).

72. Harold Brown, *Franchising—A Fiduciary Relationship*, 49 *Tex. L. Rev.* 650, 664 (1971).

franchisors have stated that their franchisees are like children, demanding constant discipline and control. Franchising may well warrant analysis by psychologists.⁷³

Harold Brown, *Franchising—A Fiduciary Relationship*, 49 *Tex. L. Rev.* 650, 664 n.15 (1971).

Franchising's reputation by 1970 was in the pits. A May 29, 1970, *Wall Street Journal* article carried the subheading, "Investigations, Dealer Revolt, Market Saturation Plague Fast Food Firms, Others."⁷⁴ The article captured succinctly the apparent sentiments of the times:

It's clear the spectacular early success of franchising and the ease of entry into the field prompted many entrepreneurs with neither experience nor capital to become either enfranchisers or dealers. The franchise holder today is often no businessman at all but perhaps a plumber or electrician who has been told he needs no experience to profit handsomely and that the enfranchiser will teach him all he needs to know. Some business greenhorns have sunk all their savings into franchises only to see everything evaporate.

MacGregor, *supra* note 50, at 15.

Reflecting the public discontent with franchising was the introduction into the United States Senate of legislation designed to curb perceived abuses of franchisees by franchisors. Michigan Senator Philip Hart introduced a bill into the Senate in August 1967 titled "The Franchise Competitive Practices Act" (the "Bill"). He resubmitted the Bill on April 21, 1969, with additional amendments. As chairman of the Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee, Hart conducted hearings on franchising in 1965 and 1966 that led to his introduction of the Bill.

The revised 1969 Bill defined franchise relationships subject to its provisions and prohibited terminations, cancellations, and failures to renew the relationship for other than good cause. The Bill defined good cause as the failure of the franchisee to comply substantially with reasonable and essential requirements imposed upon it by

73. It is tempting to dismiss today these early statements by Brown as hyperbole. There were certainly some abuses, however, and in the confusion that surrounded franchising in 1970, Brown's statements found a receptive ear. *Business Week* reported that Senator Williams "hopes to 'unwrap the entire franchising package,'" including "the franchise agreement as a fiduciary relationship between the franchiser and franchisee." *Franchising Goes on the Griddle*, *Bus. Wk.*, Jan. 3, 1970, at 16. Brown appeared as a witness before the Williams subcommittee. The Eighth Circuit, in *Arnott v. American Oil Co.*, 609 F.2d 873, 884 (8th Cir. 1979), cert. denied, 446 U.S. 918 (1980), sustained a trial court finding that a fiduciary relationship existed between an oil company and a service station. The court later reversed itself in *Bain v. Champlin Petroleum Co.*, 692 F.2d 43 (8th Cir. 1982). Today, the courts uniformly reject claims that a typical franchisor-franchisee relationship creates fiduciary obligations. William L. Killion, Annotation, *Existence of Fiduciary Duty Between Franchisor and Franchisee*, 52 A.L.R. 5th 613 (1997). For further discussion of the notion that a franchisor can have fiduciary obligations, see Chapter 13.

74. MacGregor, *supra* note 50, at 1.

the franchisor. Finally, the Bill required that the franchisor give the franchisee at least 90 days' advance notice of termination.⁷⁵

Congress did not pass the Bill. Nevertheless, the proposed legislation and the hearings surrounding it stirred the pot of discontent and established the template for subsequent state legislation. As Norman Axelrad observed in a contemporaneous article published in *The Business Lawyer* in 1971, “[i]n the several years during which this widely publicized bill and its earlier version were in committee, it served as a model and stimulus for many states to embark on an equally ambitious legislative regulation of the franchise relationship.”⁷⁶

Departing from the regulatory approach reflected in the Hart Bill, New Jersey Senator Harrison Williams introduced on May 15, 1970, a bill called the “Franchise Full Disclosure Act of 1970.”⁷⁷ Rather than regulate the ongoing franchisor–franchisee relationship, the bill required “full disclosure” in the sale of business franchises in interstate commerce. It required that franchisors file a registration statement with the SEC containing information about the franchise opportunity, including the business and management of the franchisor, the nature and extent of celebrity involvement, exhibits that included the franchise agreement, and the conditions under which the franchisor might terminate or not renew the relationship.

Introduction of the Full Disclosure bill followed extensive hearings (known as the “Williams hearings”) before the Senate Subcommittee on Urban and Rural Economic Development of the Banking Committee, which was chaired by the New Jersey Democrat. Williams conducted several days of hearings in late January 1970. He described the hearings as his committee’s effort to “unwrap the entire franchising package.”⁷⁸ In addition to the celebrities identified earlier, the witnesses included Senator Hart, various franchisors and franchisees, and representatives of the FTC, the Small Business Administration (SBA), the Post Office Inspection Services, the Commerce Department of Minority Business Enterprise, the National Better Business Bureau, and the International Franchise Association.

Although franchising clearly had a black eye in 1970, there was a general consensus that the practice was a critical part of the American business landscape. Moreover, the empirical data did not support the rhetoric coming from franchising’s most vocal critics. John Buffington, then general counsel to the FTC, appeared before the Williams subcommittee on January 27, 1970. Buffington testified that “[f]rankly, the Commission does not know the extent of the use of exploitative practices in franchising. We receive relatively few complaints on such matters.”⁷⁹ He was quick to

75. Fairness in Franchising Act, S. 1967, 91st Cong. (1969).

76. Axelrad, *supra* note 59, at 713.

77. S. 3844, 91st Cong., 2d Sess. (1970), 116 Cong. Rec. 15,692 (1970).

78. Franchising Goes on the Griddle, *supra* note 73, at 16.

79. The Impact of Franchising on Small Business Before the Subcomm. on Urban and Rural Econ. Dev. of the S. Select Comm. on Small Bus., 91st Cong. 311 (1970) (statement of John V. Buffington, Gen. Counsel of Fed. Trade Comm.).

add that the small number of complaints did not mean that deceptive practices were a “minor problem,” but might mean only that “a fleeced franchisee realizes that the Commission cannot restore him to his former position.”⁸⁰

Congress never passed Williams’s Full Disclosure Act. Following the conclusion of the Williams hearings in 1970, the Senate Small Business Committee published a report titled “Impact of Franchising on Small Business.”⁸¹ The report concluded that statistical and empirical information about franchising was deficient in both quality and quantity.⁸² The SBA sought to fill the gap by commissioning a study by the University of Wisconsin. In 1971, Wisconsin Professors Ozanne and Hunt issued their report titled “The Economic Effects of Franchising.”⁸³ In their “recommendations,” the authors wrote:

We conclude that the net economic effects of franchising as a system of distribution are positive. Without franchising, thousands of small businessmen would never have had the opportunity of owning their own businesses. Similarly, franchising has enabled many entrepreneurs with little capital to take an idea and from it build a large multi-unit organization. Without franchising, these entrepreneurs would have had to give up their idea or attempt to sell it to some large corporation. Any system which opens up economic opportunities for the “little guy” should be carefully nourished and protected. Franchising represents a viable alternative to large, completely integrated corporate chains.

Since the net economic effects of franchising are positive, any legislation which would cripple this very important segment of our economy should be avoided.

S. Select Comm. on Small Business, 92nd Cong., *The Economic Effects of Franchising*, *supra* note 83, at 63.

The authors called for federal regulations requiring “full disclosure,” a “cooling off” period after execution of the franchise agreement, and termination for cause.⁸⁴

V. The History of Franchise Regulation

Some of the states filled the legislation gap left by Congress. Not surprisingly, California became a hot spot for the “franchising boom” and eventually for franchise

80. *Id.*

81. Alan Bible, *Impact of Franchising on Small Business*, S. Rep. No. 91-1344 (1970).

82. *Id.* at 2.

83. S. Select Comm. on Small Business, 92nd Cong., *The Economic Effects of Franchising* (Comm. Print 1971) (Report prepared by Urban B. Ozanne & Shelby D. Hunt). The report identified four pre-existing, major empirical studies on franchising: *The Franchise System of Distribution*, by Lewis and Hancock; *Partners for Profit*, by Curry, et al.; *Franchising: The Odds-On Favorite*, by Atkinson; and *The Vaughn Report on Franchising of Fast Food Restaurants*, by Charles L. Vaughn. *Id.* at 23.

84. *Id.* at 63–65.

regulation. By 1969, California had the largest number of franchisees of any state: approximately 5,600, which was nearly ten percent of the more than 600,000 franchisees in the entire United States.⁸⁵ Franchising in the state also generated many franchisee complaints. California's deputy attorney general reported during a hearing in Sacramento on November 7, 1969, that "[t]he number of complaints received by the Attorney General's office indicates that in the investment field franchise problems have now replaced promotional subdivision problems as the number one area of concern of California investors."⁸⁶

California became one of the first states to regulate franchising when, on January 1, 1971, its legislature enacted the California Franchise Investment Law (CFIL), a franchise disclosure law.⁸⁷ The legislature identified the following as harm it sought to remedy:

The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. Prior to the enactment of this division, the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to those transactions. California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

Cal. Corp. Code § 31001 (West, Westlaw through all 2012 Reg. Sess. laws, Gov. Reorg. Plan No. 2 of 2011–2012, and all propositions on 2012 ballots).

The solution to the problem, according to the legislature, was to provide disclosure of the elements of the franchise relationship and to preclude fraudulent sales:

It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where the sale would lead to

85. Barry Winyett Tyerman, Comment, A Tempest in a Chicken Bucket: Some Reflections on Franchise Regulation in California, 17 UCLA L. Rev. 1101, 1101 (1970) (hereinafter UCLA Comment).

86. *Id.* at 1103.

87. The CFIL is a part of the California Corporations Code. California State Senator Clark L. Bradley held hearings on November 13, 1969, to determine whether the state needed franchise regulations. At the conclusion of the hearings, Attorney General Thomas Lynch and Commissioner of Corporations Anthony Pier were asked to draft a franchise bill. The two distributed a draft bill on January 2, 1970, and asked for comments by January 20, 1970. The bill was redrafted twice thereafter and introduced into the California State Senate on March 18, 1970, as SB 647. Don Augustine & Ronald R. Hrusoff, Franchise Regulation, 21 Hastings L.J. 1347, 1375 (1970). The CFIL was based in large part on the California Corporate Securities Law, UCLA Comment, *supra* note 85, at 1123, and built on the definitions in the 1969 version of Senator Hart's U.S. Senate bill. Braun, *supra* note 1, at 209.

fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor and franchisee by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship.

Id.

The CFIL was remarkably similar to the Williams Full Disclosure Act. It was primarily a presale-disclosure statute, designed to require franchisors to provide franchisees with the "full and complete information" they needed to make an informed investment decision. The law required franchisors to furnish a disclosure document to each prospective franchisee within a certain period of time prior to execution of a binding agreement. It required that the disclosure document contain information regarding the franchise business and the experience of the franchisor, a statement of the terms and conditions of termination or refusal to renew the franchise relationship, any requirement that the franchisee purchase goods or services from the franchisor's designee, an explanation of the basis and data underlying any statement of estimated or projected earnings, and the identification of any exclusive territory. The law established a procedure for the franchisor to file with the California Commissioner of Corporations an "application for registration," along with the proposed offering prospectus and copies of the proposed franchise and related agreements, financial statements of the franchisor, and copies of advertisements offering the franchise opportunity. Although concerned principally with adequate disclosure to the prospective franchisee prior to sale, the act also declared unlawful the offer or sale of a franchise by means of any communication that contained an untrue statement of a material fact or that omitted a material fact necessary in order to make the statements made not misleading.⁸⁸

Although California was the first state to adopt a disclosure law, the state was not the first to regulate franchising. While the legislature was still debating the CFIL, the governor of Delaware signed into law on July 7, 1970, the Franchise Security Law. Unlike the California law, the Delaware legislation did not mandate presale disclosures, but instead established rules to govern the franchise relationship.

The Delaware law, which was patterned after Senator Hart's Franchise Competitive Practices Act, passed "virtually intact from the original draft" and "just two months after its introduction."⁸⁹ The legislation "fairly burst upon the scene without publicized public hearings or the benefit of outside consultation or recommendations."⁹⁰ A franchisor violated the Delaware act if it "unjustly" terminated or refused to renew a franchise or threatened to do either. The law required that a franchisor give franchisees at least 90 days' notice of any termination or election not to renew. New Jersey followed suit in 1971 with passage of its New Jersey Franchise Practices Act⁹¹

88. Cal. Corp. Code § 31201.

89. Axelrad, *supra* note 59, at 711–12.

90. Id. at 712.

91. N.J. Stat. Ann. § 56:10-1 (West, Westlaw through L.2012, c. 80 and J.R. No. 5).

prohibiting “arbitrary and capricious cancellation of franchises while preserving the right of franchisors to safeguard their interests through the application of clear and nondiscriminatory standards.”⁹²

Washington State entered the fray on February 19, 1971, with the introduction into both houses of its Franchise Investment Protection Act (FIPA).⁹³ The bill, as introduced, contained both disclosure provisions patterned after the California Franchise Investment Law and “fair practice” provisions based on a bill introduced into the Massachusetts legislature.⁹⁴ Washington thus became the first state to pass a disclosure law and a relationship law at the same time. FIPA passed in the 1971 legislative session and was signed by Governor Evans, but its effective date was delayed until May 1972 to allow franchisor interests an opportunity to seek amendments during the 1972 session. Washington’s assistant attorney general, William Clarke, said in October 1971 that “[t]he International Franchise Association is gearing up for a major attack on the bill.”⁹⁵ As it turned out, Clarke and the Washington attorney general met privately with franchisor representatives between legislative sessions and reached an agreement on a set of amendments, “which in several respects diluted the protection offered to franchisees by the Act.”⁹⁶ The amendments were attached to a “title-only” bill that passed in the 1972 session.

The International Franchise Association (IFA) played a critical role in the development of franchise laws in the 1970s and later. A trade association comprised of franchisors and their suppliers, the IFA held its first meeting during a “Start Your Own Business” trade show at the New York Coliseum in February 1960.⁹⁷ The groundwork for creation of the IFA had been laid the previous fall when representatives of about 50 franchisor companies met at a similar franchise trade show at the Chicago stockyards. According to William Rosenberg, the founder of the Dunkin’ Donuts franchise system who claims to have also founded the IFA, the association grew out of a concern among legitimate franchisors over the involvement of “fast buck artists” in franchising and the “fly-by-nighters” that had generated bad publicity for franchising.⁹⁸ A.L. Tunick,

92. Gen. Assemb. 2063, 194th Leg., 2d Ann. Sess. (N.J. 1971) (sponsors’ statement accompanying Assembly Bill 2063).

93. Donald Chisum, *State Regulation of Franchising: The Washington Experience*, 48 *Wash. L. Rev.* 291, 298, 335 (1973).

94. *Id.* at 335. Harold Brown takes credit for preparing the initial draft of the Massachusetts Franchise Fair Dealing Act. Brown, *supra* note 72, at 651 n.6.

95. William Wong, *Cracking Down: In the Absence of Federal Rules, More States Begin Regulating the Franchise Industry*, *Wall St. J.*, Oct. 11, 1971, at 22.

96. “Weakening amendments added in 1972 include several exemptions from registration; a provision apparently restricting the contents of the franchise offering circular; a provision restricting disclosures on prior franchise failures; a provision allowing earnings projections in franchise sales; a provision diluting the prior prohibition of ‘kick-backs.’” Chisum, *supra* note 93, at 336 n.223 (citations omitted).

97. William Rosenberg, *Time to Make the Donuts* 127–31 (2001).

98. *Id.* at 128.

the president of Chicken Delight and the first president of the IFA, said the association had “two chief aims to win recognition for franchising as a major method of merchandising, and to set up a code of ethics.”⁹⁹ By 1970, when it moved its offices from Chicago to Washington, D.C., the IFA had approximately 250 member companies, not the majority of franchisors at the time, but some of the most influential. The most important thing about the IFA for purposes of the history of franchising is the significant role it played in shaping the laws that developed in various state houses in the 1970s.

The IFA became the voice of franchisors before the courts, the Congress, and state legislatures. The organization submitted an *amicus curiae* brief to the Ninth Circuit Court of Appeals in the *Siegel* case and was an active participant in the development of California’s Franchise Investment Law. Indeed, on November 24, 1969, the Assistant General Counsel of the IFA sent a letter to various general counsel of franchisor members announcing the presentation of a model franchising disclosure and deceptive practices act to the association’s board of directors at its 1970 annual meeting.¹⁰⁰ Many of the provisions of the model act were incorporated into the California act.¹⁰¹ The IFA played a critical role in tempering the reach of the Washington Franchise Investment Protection Act in 1971. In the end, the IFA played a role in the legislative process in most of the states that regulated franchising.

Several states adopted disclosure and registration laws in the 1970s,¹⁰² and a number of states adopted franchise fair practices acts, also called franchise relationship laws, during the same period.¹⁰³ Today, 15 states have legislation requiring presale disclosure of specified information by a franchisor to a potential franchisee.¹⁰⁴ Eighteen states have legislation governing the franchise relationship.¹⁰⁵

99. Franchise Selling Catches On, *supra* note 33, at 90.

100. Axelrad, *supra* note 59, at 717 n.54. See also Bernard Goodwin, The Name of the Franchising Game Is: The Franchise Fee, The Celebrity or Basic Operations?, 25 Bus. Law. 1403, 1418 n.41 (1970).

101. Axelrad, *supra* note 59, at 717 n.54.

102. See Braun, *supra* note 1, at 206 n.201.

103. Delaware (1970); California (1971); New Jersey (1971); Washington (1972); Michigan (1974); Minnesota (1974); Wisconsin (1974); Hawaii (1974); Connecticut (1972); and Indiana (1976).

104. David A. Beyer & Scott P. Weber, Perilous Prospects—Part I: Lawsuits to Get into the Franchise System, 22 Franchise L.J. 224, 231 n.65 (2003).

105. *Id.* at 232 n.80. Rhode Island became the eighteenth state with enactment of its Rhode Island Fair Dealership Act effective June 14, 2007.

VI. 1970–Present

Nineteen seventy was the beginning of a new era in which franchising became a highly regulated method of doing business. In addition to the several states that adopted franchise disclosure laws, the Federal Trade Commission, exercising its authority under the Federal Trade Commission Act (FTC Act), established rules governing franchise sales at the national level. On November 11, 1971, the FTC announced that it was initiating proceedings for the promulgation of a trade regulation rule regarding disclosure requirements and prohibitions in the sales of franchise opportunities. As a part of its announcement, the FTC presented its proposed franchise rule. The Commission called for public comments and held public hearings in Washington, D.C., from February 14, 1972, through March 1, 1972. Ultimately, on December 21, 1978, the FTC issued its Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (the “Original FTC Rule”). The Original FTC Rule made it an unfair or deceptive act or practice within the meaning of Section 5 of the FTC Act for any franchisor or its broker to fail to furnish specific information required to be disclosed to franchisees. The disclosures required mirrored in large part those required by the California Franchise Investment Law.

Nineteen seventy also marked the beginning of one of the worst decades of economic performance in the United States since the Great Depression. Inflation averaged approximately 6 percent during the 1970s, topping out at 13.3 percent in 1979. Inflation joined forces with high unemployment to produce “stagflation.” By December 1980, the prime interest rate had reached 21.5 percent, the highest in the nation’s history. The 1970s also witnessed two energy crises, triggered by huge oil price increases in 1973 and 1979.

In the face of new regulations and a struggling economy, franchising as a method of doing business continued to prosper. The U.S. Department of Commerce (DOC) reported on franchising in the United States economy over a 15-year period. Its first report covered the years 1973 to 1975, and its final report covered 1986 to 1988. In its first report, the DOC wrote: “[r]esilient in the face of a slowing economy, franchising shows by its efficiencies that it can cope and move ahead.”¹⁰⁶ The report noted that there were 453,632 establishments engaged in franchising in 1973—a number that the DOC estimated would grow by 2 percent to 460,720 units by 1975. “[S]ince 1970,” the DOC wrote, “receipts of franchised business service establishments more than doubled and reached an estimated \$1.6 billion by 1976.”¹⁰⁷ In its 1976–1978 report, the DOC found that “franchising [was] continuing to break new records in sales,

106. Andrew Kostecka et al., U.S. Dep’t of Commerce, *Franchising in the Economy 1973–75*, at 3 (1975).

107. Andrew Kostecka et al., U.S. Dep’t of Commerce, *Franchising in the Economy 1975–77*, at 4 (1976).

employment and number of establishments.”¹⁰⁸ By 1980, franchising, like the rest of the economy, suffered from “[p]ersistent inflationary pressures, unprecedented fluctuation in interest rates, and a brief but sharp recession,” but the concept was still holding its own.¹⁰⁹

Franchising continued to prosper during the 1980s. In its final report for 1988, the DOC observed that “[f]ranchising sales of goods and services in more than 509,000 outlets are expected to reach almost \$640 billion in 1988, about seven percent higher than a year earlier and about 91 percent over the level of sales at the start of the 1980s.”¹¹⁰

The IFA has picked up where the DOC left off in studying the economic effect of franchising. The organization has funded two major studies of franchising by PriceWaterhouseCoopers, the first based on data from 2001 and the second on data from 2005. The most recent study sought to measure the “direct impact” on the U.S. economy of franchise businesses, the “total impact” of franchise businesses on the economy, and the employment generated by franchising, in various economic sectors. The report concluded that franchise businesses generate an annual economic output of \$2.3 trillion, or 11.4 percent of the total private U.S. sector output.¹¹¹

The story this data tells is that the continued health of franchising is important to the franchisor, franchisee, potential business owner, supplier, franchise employee, investor, individual consumer, and the economy as a whole. The observations of the DOC in its final report are as valid today as they were in 1988:

Franchising, a major force in the U.S. economy, continues its steady growth in sales, employment, units, and international expansion, offering tremendous opportunities to individuals seeking their own businesses and companies looking for wider distribution for their products, systems, and services. Franchising has become so powerful partly because economic factors have made growth through company-owned units difficult for many businesses. In addition, franchisees are enjoying a competitive edge over other small business entrepreneurs by the use of trade names, marketing expertise, acquisition of a distinctive business appearance, standardization of products and services, training, and advertising support from the parent organization.

Franchising represents the small entrepreneur’s best chance to compete with giant companies that dominate the marketplace. Without franchising, thousands of businesspersons would never have had the opportunity of owning their own businesses

108. Andrew Kostecka et al., U.S. Dep’t of Commerce, *Franchising in the Economy 1976–78*, at 1 (1978).

109. Andrew Kostecka, U.S. Dep’t of Commerce, *Franchising in the Economy 1979–81*, at 1 (1981).

110. Kostecka, *supra* note 9, at 1.

111. See *Franchising Outpaces Other Sectors of Economy in Growth, Jobs, International Franchise Association*, available at www.franchise.org/Franchise-News-Detail.aspx?id=38358.

and never have felt the immense satisfaction of being a part of the free enterprise system.

Kostecka, *supra* note 9, at 1.

As vital as the franchising sector of the economy remains, however, Roger Blair and Francine Lafontaine have reported two important caveats—one concerning growth and the other concerning failure rates. In *The Economics of Franchising*, published in 2005, the authors addressed the popular belief that, in recent years, the growth rate of franchising has exceeded that of the U.S. economy as a whole. “[F]or the last two decades at least,” they concluded, “franchising in the U.S. has grown, at most, at rates commensurate with the rest of the economy.”¹¹² With respect to failure rates, the authors noted the popular belief that a franchisee’s use of the franchisor’s trademark and (in business format franchising) system guarantees success. The authors found that “the notion that franchising poses substantially fewer business risks for franchisees than starting an independent business is not supported by the data.”¹¹³ Those caveats are worth bearing in mind as you study the material presented in the following chapters.

112. Blair & Lafontaine, *supra* note 5, at 20.

113. *Id.*