Can a Franchise Be a Security?

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As if there are not enough traps waiting to snare the unwary, there are circumstances when a franchise could be considered a security, thus requiring compliance with the relevant securities legislation, regulations and rules. The question of whether a franchise agreement constitutes a security is determined on a case-by-case basis and will depend on the facts of the arrangement at issue. U.S. and Canadian case law suggests that investor participation is a significant consideration in determining whether the sale of a security occurred. Unless the investors in the franchise opportunity will be active participants, performing essential managerial tasks, which will affect the failure or success of the enterprise, a franchise will likely be found to be a security.

Subsection 1(1) of the Ontario *Securities Act*[1] (the "OSA") contains 16 branches to the definition of "security"; two of these branches are relevant to a determination of whether a franchise can be considered a security. First, a security includes "any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company."[2] Second, a security is also defined to include any investment contract.[3] The question of what constitutes a security is central to the application of securities legislation. Many requirements of securities legislation are triggered when there is a distribution of securities involved, including the registration requirements[4] and the requirement that an issuer prepare and distribute a prospectus.[5]

The seminal case on the interpretation of the investment contract branch of the definition of security is *Pacific Coast Coin Exchange of Canada Ltd. v. O.S.C.*[6] In that case, the Supreme Court of Canada adopted the meaning of investment contract found in two leading U.S. cases:

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1 R.S.O. 1990, c. S.5 [*OSA*].
2 *OSA*, *ibid.*, s. 1(1) "security" (b).
3 *OSA*, *ibid.*, s. 1(1) "security" (n).
4 *OSA*, *ibid.*, s. 25.
5 *OSA*, *ibid.*, ss. 1(1) "distribution," 53.
6 [1978] 2 S.C.R. 112, aff'g (1976), 8 O.R. (2d) 257 (C.A.), aff'g (1975), 7 O.R. (2d) 395 (Div. Ct.) [*Pacific Coast*].

Securities and Exchange Commission v. W.J. Howey Co.[7] and *State of Hawaii Commissioner of Securities v. Hawaii Market Center Inc.*[8]

In *Howey*, W.J. Howey Company raised money for the cultivation of citrus crops by selling some of its acreage. Potential buyers were also urged to enter into service contracts with a subsidiary company that cultivated, harvested, and marketed the citrus crop. The subsidiary company pooled the fruit, sold it, and allocated profits based on the output of each tract. The U.S. Supreme Court held that the buyers were "attracted solely by the prospects of a return on their investment."[9] In holding that the combination of the land sale contract, the deed giving title to the land, and the service contract was a security, the court stated that four factors must be present for an investment contract to exist:

(1) the investment of money
(2) in a common enterprise
(3) with the expectation of profit
(4) solely from the efforts of a third party.

Three other important elements were enunciated by the court. First, the court stressed that most of the buyers were out-of-state residents who knew nothing about the citrus business and were therefore in need of the disclosure that would be furnished by compliance with securities legislation. Second, the court rejected the argument that a security did not exist because the investment was not speculative or promotional in character. The court held that only some risk is needed to create an investment contract. Finally, although it was argued that the land sales were not securities because the land had value independent of the success of the enterprise as a whole, the court held that substance, not form, governs the interpretation of what is a security, and an interest may be a security even though it has value independent of the enterprise as a whole.

In *Hawaii*, a risk capital test for the existence of an investment contract was provided by the Supreme Court of Hawaii. In that case, the court held that an investment contract existed even though certain investors in a retail store could generate profits through their own efforts, and therefore did not rely solely on the efforts of a third party. The court stated that an investment contract is created whenever:

(1) an offeree furnishes initial value to an offeror, and
(2) a portion of this initial value is subjected to the risks of the enterprise, and
(3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

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[7] (1946), 328 U.S. 293 [*Howey*].
[8] (1971), 485 P.2d 105 [*Hawaii*].
[9] *Supra* note 7 at 300.

The Supreme Court of Canada in *Pacific Coast* accepted the tests offered in the U.S. cases. However, the Court provided a modification of the word "solely" in the *Howey* test, stating that a strict interpretation of the word would not serve the purpose of the legislation. The Court adopted a more realistic interpretation: whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise. The Court also held that a "common enterprise" is an enterprise in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties. The commonality necessary for an investment contract is that between the investor and the promoter rather than between the investors themselves.

Franchising is one of the most common methods of expanding a retail business or becoming the owner of a business. There are four basic elements to a franchise. First, the franchisee is a legally independent component of the franchise, although economically it is dependent on the franchisor. Second, the franchisee is permitted and required to use the franchisor's name and standardization. Third, the purpose of the franchisee's business is to market the franchisor's goods or services. Finally, the franchisor and franchisee will enter into a "franchise agreement," the formal contract that establishes the relationship and provides for continuing association between the parties.[10]

The purchase of a franchise allows the small entrepreneur to become the owner of a typically high-volume business. However, it is this particular type of investor that securities legislation is designed to protect by requiring full, true and plain disclosure of all material facts relating to any securities issued or proposed to be distributed. Although there is a scarcity of Canadian cases dealing with the securities aspects of a franchise, there have been some developments and commentary on the subject in the U.S.

In *United States v. Herr*,[11] investors in a franchise were given the choice of taking an active or inactive management role in the business. If the investor chose to be inactive, the franchisor would hire, train, and manage any employees, and monthly profits would simply be forwarded to the franchisee. The franchisor represented to the potential investors that a 60% return on their investment could be expected. Most of the investors opted for the inactive management role and the court held that the arrangement constituted an investment contract under U.S. securities laws. Applying the *Howey* test, the court held that the investors "were led to believe that they could expect profits solely from the efforts of others."[12] Thus, investor participation is a significant consideration in determining whether the sale of a security occurred:

> In essence … the participation by the franchisee must be influentially discretionary, not just ministerial in the sense of being a key employee or store manager, to justify a franchise agreement not being an "investment contract." Under the real meaning of the *Howey* rule, the franchisee should have practical and actual control and opportunity to protect his own investment in order for him to be a realistically active participant, so as to negate the possibility of a franchise agreement being an

[10] Rex K. Linder, "Franchisor Liability Under Securities Law" (1974), 13 Washburn L.J. 68 [*Linder*].
[11] 338 F.2d 607 (7th Cir. 1964).
[12] *Ibid*. at 610.

> "investment contract" security. The degree of actual or physical participation by the franchisee may be great but yet his profit-influencing, decision-making participation may be very minimal. The latter quality should be decisive because it makes for the success of an enterprise, and it is this, rather than ministerial personal service, which should govern the determination of the nature of a franchise agreement. Highly restrictive, technical tests, leading to unrealistic conclusions, will defeat instead of further the purposes of the Securities Acts: to protect the public as fully as possible while not unduly obstructing or hampering business.[13]

In California, the Attorney General issued an opinion of whether a franchise sale could be considered a sale of a security.[14] The Attorney General considered three types of franchise arrangements:

1. Where the franchisee participates only nominally in the franchised business in exchange for a share of the profits.

2. Where the franchisee participates actively in the franchised business and where the franchisor agrees to provide certain goods and services to the franchisee.

3. Where the franchisee participates actively in the franchised business and where the franchisor agrees to provide certain goods and services to the franchisee, but where the franchisor intends to secure a substantial portion of the initial capital that is needed to provide such goods and services from the fees paid by the franchisee or franchisees.

The Attorney General stated that only in the second case would the franchise not be considered a security and that the other two arrangements involved an investment contract. Thus, with respect to the first arrangement, it appears that in California, more than minor discretionary functions on the part of the franchisee are required if the arrangement is not to be considered a security.

The third situation is based on the "risk capital" test adopted in *Hawaii*. In this situation, the franchisor uses the franchise fee as a part of the initial capital required to start the business. By structuring the franchise this way, "the investor is the only person really to lose money if the business fails. … On the other hand, if the business is a success, it is poor public policy to allow the promoter to make a great deal of money on someone else's investment."[15] Other states, in addition to California, have also adopted the risk capital approach.[16]

However, recently in *Gotham Print, Inc. v. American Speedy Printing*,[17] a modified version of the *Howey* test was applied on a motion for dismissal and summary judgment. In that case, the franchisor orally promised that Gotham Print, Inc., the "master franchisee," was to be provided

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[13] Bernard Goodwin, "Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations" (1969) 24 Bus. Law. 1311 at 1318-19.

[14] Augustine, *Franchise, Also a Security*, 12 Practising Law Institute Workshop on Representing Franchisors II, at 11 (1968) reprinting 49 Ops. Cal. Att'y Gen. 124 (1967) as cited in Erik Edward Joh, "Franchise Sales: Are they Sales of Securities?" (1970), 34 Albany L. Rev. 383.

[15] *Ibid*. at 392.

[16] *Hurst v. Dare To Be Great, Inc.*, 474 F.2d 483 (9th Cir. 1973) (applying Oregon securities law); *Frye v. Taylor*, 263 So. 2d 835 (Fla. App. 1972) as cited in *Linder, supra* note 10 at 78.

[17] 863 F.Supp. 447 (Dist. Ct. Mich. 1994).

with a certain sales territory and working capital loan; however, neither promise was mentioned in the executed franchise agreement. The franchisor promised to amend the agreement, but then filed for bankruptcy. The court noted that the U.S. Supreme Court restated its *Howey* investment contract definition in *United Housing Foundation, Inc. v. Forman*[18] as follows: "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[19] In holding that the arrangement did not constitute a security, the court stated that the master franchisee was intended as much more than a mere "passive" investor. The franchise agreement contemplated that profits would be derived primarily from the managerial/entrepreneurial efforts of the master franchisee in recruiting other franchisees. The franchise agreement further provided that the master franchisee was to itself operate 10 franchises in the territory. The court held that "[w]here, as here, a franchisee/plaintiff retains managerial duties with respect to hiring and firing of personnel, maintenance of good customer relations, and day-to-day business promotion and salesmanship, even though the franchisor retains certain rights, such as the right to specify the decor of the store, operating hours, store location, quality of merchandise and physical arrangement of equipment within the store, no 'investment contract' exists."[20]

In *Century 21 Real Estate Corporation*,[21] a franchise agreement was examined by the British Columbia Corporate and Financial Services Commission (the "Commission") with a view to determining whether the agreement constituted an investment contract or evidence of an interest in the earnings of a franchisee within the meaning of the equivalent definitions to those found in clauses (b) and (n) of the definition of "security" in the OSA.

Under the franchise agreement in *Century 21*, the franchisee was required to pay an initial fee and an annual service charge equal to a percentage of the franchisee's gross income in order to use the Century 21 system. The system included common use and promotion of the name "Century 21," centralized advertising programs, recruiting and sales training programs, and inter-office referral programs. Although the franchisee was characterized in the franchise agreement as an independent contractor responsible for carrying on the business, the franchisor retained the ownership of all right, title, and interest in the trade-name, trademarks, goodwill, and trade secrets of Century 21. The Commission concluded that the franchise agreement was not a "document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company." The Commission held that there was a distinction between the annual service payment based on gross income required by the franchise agreement, which is akin to a rental, and an interest in profits and earnings, which constitutes a security.

The Commission also concluded that the franchise agreement did not constitute an "investment contract." The Commission considered the principles set out in the *Howey* and *Hawaii* cases and rejected both tests in favour of a wider understanding of the term "investment contract," as articulated in *Pacific Coast*. However, even adopting this broad construction, the Commission held that the agreement did not constitute an investment contract. The franchisee would undoubtedly profit from the laying out of money or placing of capital in the form of franchise

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[18] 95 S. Ct. 2051 (1975).
[19] *Ibid.* at 2056.
[20] *Supra* note 17 at 455.
[21] May 30, 1975 C.F.S.D.W.S. 1 [*Century 21*].

and service fees; however, as the Commission notes, this is literally true of contracts for the purchase of goods for resale—a retailer must pay a wholesaler money to acquire goods for resale to the public at a profit. Thus, a literal application of the broad interpretation would result in a contract of sale constituting an investment contract, which would disregard substance for form and ignore economic reality. The Commission concluded that the price paid for the goods purchased did not subject it to the risks of the enterprise of the vendor, as required by the test set out in *Hawaii*. The arrangement was a contract for the supply of services rather than an investment contract, and by offering its system for sale, Century 21 was merely carrying on its own business, and not investing in the business of the franchisee.

Although the franchise agreement in *Century 21* did not constitute an investment contract, the Commission noted that this conclusion did not mean that a franchise agreement is necessarily beyond the scope of the definition of security.