FRANCHISE REGULATION UNDER THE CALIFORNIA CORPORATE SECURITIES LAW

I. Introduction

Franchising is one of the fastest growing facets of business in the United States.[1] It has become one of the most successful marketing devices in the contemporary commercial world,[2] accounting for $65 billion annually—over 10 percent of the gross national product.[3] Credit for the tremendous growth of the franchising business has been attributed to the fact that it readily melds the know-how of big businessmen with the ambition of little businessmen.[4] The franchise system has the advantage of enabling numerous groups of individuals with small capital to become entrepreneurs. Such a system makes independent businessmen out of people who would otherwise be employees of a vast chain store network. This effect is generally good for the economy;[5] however, as can be expected, where experienced businessmen deal with the unsophisticated, individual hardship often results. One author, in describing one of the problems in the area, commented that the franchising business has more than its share of bunco schemes.[6]

The California Commissioner of Corporations was concerned with this same general problem when, in June of 1967, he requested advice from the California Attorney General concerning the applicability of the California Corporate Securities Law to franchise agreements. The Attorney General concluded that franchise agreements, under appropriate circumstances, would constitute a security, and in these cases would be governed by the Corporate Securities Law.[7] Pursuant to this opinion, the Corporations Commissioner published a bulletin containing guidelines to be considered in examining franchise agreements.[8]

In analyzing both the Attorney General's conclusion and the Commissioner's expansion of it, the basic premise that franchise agreements will be properly governed by the provisions of the Corporate

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1 Time, May 13, 1966, at 95.
2 Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 Bus. Law. 493 (1967).
3 Bus. Week, June 19, 1965, at 76.
4 Time, *supra* note 1.
5 *See generally* Susser v. Carvel, 206 F. Supp. 636 (S.D.N.Y. 1962).
6 H. Kursh, The Franchise Boom (1962).
7 49 Ops. Cal. Att'y Gen. 124 (1967).
8 Cal. Div. of Corp., Bull. No. 67-8 (July 14, 1967).

Securities Law will not be questioned.[9] Rather, attention will center upon the method of application of the Blue Sky Law[10] to these agreements.

The Attorney General's opinion will first be placed in historical context, emphasizing investment contracts. The opinion will then be analyzed as to its effect on franchise agreements. This will be followed by (1) a discussion of problems implicit in the approach taken by the Attorney General and the Corporations Commissioner; and (2) a suggested modification of this approach, which is intended to facilitate reasonable control of franchise agreements under the Blue Sky Law consistent with judicial history and interpretation of legislative intent.

II. BACKGROUND

The California Corporate Securities Law[11] includes within the definition of a security a certificate of interest in a profit sharing agreement, an investment contract, or a beneficial interest in title to property, profits or earnings.[12] Under appropriate circumstances, the term "franchise agreement" may be classified as either an investment contract or a beneficial interest in title to property, profits or earnings.

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[9] While we have defined the limits of this note to exclude discussion of the basic underlying premise that the proper mode of regulation of franchise agreements is the Corporate Securities Law, this restriction should not be interpreted as an acquiescence in the conclusion that the basic premise is necessarily correct. The California Attorney General argues that the Corporate Securities Law is applicable to franchise agreements. Although we have accomodated the Attorney General on this point, it would behoove parties litigating the issue, or parties otherwise interested, not to overlook the possible argument that franchise agreements would be better regulated in another way, such as through specific legislation. Inasmuch as a full discussion of this aspect of the expansive subject of franchise regulation would require greater breadth than a student note permits, we have chosen to emphasize current developments, and have, therefore, accepted the same general limitations of scope recently adopted by the Attorney General.

[10] This phrase has been adopted as a synonym for legislation providing for the regulation of securities. This meaning was derived from a United States Supreme Court opinion where, in upholding the validity of this type of legislation, the Court said that such laws were designed to protect the public against "speculative schemes which have no more basis than so many feet of blue sky . . . ." Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

[11] CAL. CORP. CODE §§ 25000-26104 (West 1955) [hereinafter referred to as the act].

[12] CAL. CORP. CODE § 25008 (West 1955),

"Security" includes all of the following:

(a) Any stock, including treasury stock; any certificate of interest or participation; any certificate of interest in a profit-sharing agreement; any certificate of interest in an oil, gas, or mining title or lease; any transferable share, investment contract, or beneficial interest in title to property, profits, or earnings.

(b) Any bond; any debenture; any collateral trust certificate; any note; any evidence of indebtedness, whether interest-bearing or not.

(c) Any guarantee of a security.

(d) Any certificate of deposit for a security.

The precise category within which a franchise agreement falls will not be determinative since the courts will scrutinize the substance rather than the form of a business transaction in order to ascertain whether it comes within the regulatory purpose of the Corporate Securities Law.[13]

The definition of a "security" under the California Corporate Securities Law has come to encompass not only well recognized corporate securities,[14] but other less obvious interests, whether issued by corporations, trustees, partnerships or individuals.[15] By using the word "includes" in section 25008, the California Legislature indicated that this section was not intended to be inclusive in its definition of a security. Furthermore, in deciding whether the particular instrument is to be considered a security within the meaning of section 25008, the California courts have consistently refused to define a security with any degree of finality[16] and instead have looked to the particular facts of each case to determine if these facts fall within the "regulatory purpose" of the statute.[17]

An early California case enunciated a definition of a security, holding that "[i]f the instrument of sale creates a present right to a present or future participation in either the income, profits or assets of a business carried on for profit, it is a 'security' . . . ."[18] This broad definition is of little value when confronted with specific facts, and of less value in defining an investment contract. It will be necessary therefore to consider some of the federal and California cases that have been instrumental in the development of the definition of a security, and more specifically, the definition of an investment con-

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13 SEC v. W. J. Howey Co., 328 U.S. 293 (1946); Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); People v. Syde, 37 Cal. 2d 765, 235 P.2d 601 (1951); Austin v. Hallmark Oil Co., 21 Cal. 2d 718, 134 P.2d 777 (1943); People v. Davenport, 13 Cal. 2d 681, 91 P.2d 892 (1939); Domestic & Foreign Pet. Co. v. Long, 4 Cal. 2d 547, 51 P.2d 73 (1935); People v. Hosher, 92 Cal. App. 2d 250, 206 P.2d 882 (1949); Hollywood State Bank v. Wilde, 70 Cal. App. 2d 103, 160 P.2d 846 (1945); People v. Steele, 2 Cal. App. 2d 370, 36 P.2d 40 (1934). *See also* People v. Sidwell, 27 Cal. 2d 121, 162 P.2d 913 (1945); Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343 (1945).

14 *E.g.*, stocks, bonds, debentures.

15 CAL. CORP. CODE § 25008 (West 1955).

16 People v. Syde, 37 Cal. 2d 765, 235 P.2d 601 (1951). *See also* 28 CALIF. L. REV. 410 (1940); 10 S. CAL. L. REV. 483 (1937).

17 Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). *See, e.g.*, People v. Syde, 37 Cal. 2d 765, 235 P.2d 601 (1951); *In re* Hatch, 10 Cal. 2d 147, 73 P.2d 885 (1937).

18 People v. Oliver, 102 Cal. App. 29, 36, 282 P. 813, 817 (1929). *See generally* Dahlquist, *supra* note 13, at 356-61.

tract, since both include investment contracts as a security within their respective Blue Sky Laws.

III. Investment Contracts

In cases not involving the obvious securities—stocks, bonds, or debentures—the courts developed the following test to determine what constituted a security. Where the purchaser invested for profit in a venture that was to be conducted largely by others, a security did exist. However, where he invested in a venture in which he expected to participate actively, no security existed.[19]

In *SEC v. Joiner Corp.*,[20] the United States Supreme Court held that the sale of oil and gas leases constituted an investment contract within the meaning of Section 2(1) of the Securities Act of 1933.[21] The Joiner Corporation had acquired 3,002 acres of land pursuant to an agreement that a test well would be drilled by Joiner. The corporation expected to finance the drilling from the resale of small parcels of acreage to the public. The prospectus that was mailed out assured the recipients that Joiner would complete the drilling of a test well to determine the oil-producing capabilities of the parcels to be sold. This literature characterized the purchase as an investment and as a participation enterprise. The Court did not accept the defendants' contention that their offerings were for the conveyance of an interest in real estate:

> In applying acts of this general purpose, the courts have not been guided by the nature of the assets back of a particular document or offering. The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be.[22]

The *Joiner* Court, although confronted with an investment contract, did not define the term, but restricted itself to a discussion of its elements.

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[19] *See, e.g.*, People v. Syde, 37 Cal. 2d 765, 235 P.2d 601 (1951); Austin v. Hallmark Oil Co., 21 Cal. 2d 718, 134 P.2d 777 (1943); People v. Davenport, 13 Cal. 2d 681, 91 P.2d 892 (1939); Domestic & Foreign Pet. Co. v. Long, 4 Cal. 2d 547, 51 P.2d 73 (1935); People v. Hosher, 92 Cal. App. 2d 250, 206 P.2d 882 (1949); Hollywood State Bank v. Wilde, 70 Cal. App. 2d 103, 160 P.2d 846 (1945); People v. Steele, 2 Cal. App. 2d 370, 36 P.2d 40 (1934).

[20] 320 U.S. 344 (1943).

[21] 15 U.S.C. § 77b(1) (1964). The Cal. Corp. Code § 25008 (West 1955) has adopted similar language.

[22] 320 U.S. at 352-53.

Three years after *Joiner*, the Supreme Court decided *SEC v. W. J. Howey Co.*,[23] considered to be the landmark case defining investment contracts.[24] W. J. Howey Company and Howey-in-the-Hills Service Company were Florida corporations under common control and management. The Howey Company owned large tracts of citrus groves, planting about 500 acres annually, half of which were retained, with the other half being offered to the public. Howey-in-the-Hills was a service company which cultivated and harvested its own groves as well as the groves sold, and marketed the entire yield. The superiority of Howey-in-the-Hills as a servicing company was emphasized, with prospective customers being offered both a land sale, and a servicing contract. For a specified fee, including the cost of labor and material, Howey-in-the-Hills was given full discretion and authority over the cultivation of the groves. The purchasers for the most part were from out of state, and consisted primarily of people who lacked the knowledge, skill and equipment necessary to cultivate the citrus trees. The sole indicia of the multiple ownership of the groves were found in small land marks, intelligible only through the perusal of a plat book record.

The Supreme Court held that the offering of the citrus groves, coupled with the service contract and the remittance of the net proceeds to the purchasers, constituted an investment contract under Section 2(1) of the Securities Act of 1933.[25] Initially, the Court noted that while the term "investment contract" was not defined in the Securities Act, it was a term common in many of the state blue sky laws prior to 1933.[26] Illustrative of this was the 1920 decision of *State v. Gopher Tire & Rubber Co.*,[27] wherein the Minnesota Supreme Court stated:

> No case has been called to our attention defining the term "investment contract." The placing of capital or laying out of money in a way intended to secure income or profit from its employment is an "investment" as that word is commonly used and understood.[28]

Thereafter, the *Howey* Court observed, this broad definition was judicially applied to situations where individuals were led to invest money in a common enterprise with the expectation that a profit

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23 328 U.S. 293 (1946).
24 1 Loss, SECURITIES REGULATION 483 (2d ed. 1961).
25 15 U.S.C. § 77b(1) (1964).
26 328 U.S. at 298. The term first appeared in a statutory definition of a "security" in the Minnesota Blue Sky Law of 1917. MINN. GEN. LAW, ch. 429, § 3 (1917).
27 146 Minn. 52, 177 N.W. 937 (1920).
28 *Id.* at 56, 177 N.W. at 938.

would be derived solely through the efforts of someone other than themselves.[29] Thus, the Supreme Court concluded in *Howey* that by including the term "investment contracts" in the Securities Act of 1933,

> . . . Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation . . . . [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . . Such a definition necessarily underlies this Court's decision in *S.E.C. v. Joiner Corp.* . . .[30]

The *Howey* Court rejected the argument that an investment contract is lacking where the venture is not speculative or promotional in character, emphasizing that the criteria for determining an investment contract are met where "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[31] The two essential elements are: (1) a common enterprise and (2) profits to come solely from the efforts of one other than the investor.[32] The second element of this test implies a third factor employed by the courts to determine the existence of a security, that of participation in the enterprise by the investor, *i.e.*, the degree of control the investor has over the enterprise.

The control element (participation by the investor) is apparently the main criterion applied by the courts.[33] Generally, if the investor participates actively in the management or conduct of the enterprise he is not purchasing a security.[34] Where the investor "share[s] in the conduct of the enterprise, the instrument representing an assignment of a fractional interest . . . is not a security within the act."[35]

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29 *E.g.*, People v. White, 124 Cal. App. 548, 12 P.2d 1078 (1932); State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922). *See also* Moore v. Stella, 52 Cal. App. 2d 766, 778, 127 P.2d 300, 306 (1942), where the court held, under a broader state definition (*see* People v. Oliver, 102 Cal. App. 29, 36, 282 P. 813, 817 (1929)), that a security was involved in

> all schemes for investment, regardless of the forms of procedure employed, which are designed to lead investors into enterprises where the earnings and profits of business or speculative ventures must come through the management, control, and operations of others and which, regardless of form, have the characteristics of operations by corporations, trusts or similar business structures.

30 328 U.S. at 298-99.

31 *Id.* at 301.

32 *Id.*

33 Dahlquist, *supra* note 13, at 358.

34 *E.g.*, Austin v. Hallmark Oil Co., 21 Cal. 2d 718, 134 P.2d 777 (1943); People v. Steele, 2 Cal. App. 2d 370, 36 P.2d 40 (1934).

35 Austin v. Hallmark Oil Co., 21 Cal. 2d 718, 727, 134 P.2d 777, 782-83 (1943).

But if the investor's role is merely a passive one, sharing in the proceeds or profits of the enterprise without controlling or participating in the management, it has been generally held that the sale of a security is involved.[36] Two California cases that vividly illustrate these principles are *People v. Syde*[37] and *Hollywood State Bank v. Wilde*.[38]

In the *Wilde* case, the Chapman Chinchilla Sales Company, a Nevada corporation, sold chinchillas through its sales agents for $3,200 a pair. Concurrently, the company contracted with the purchasers for the maintenance of the chinchillas on breeding farms at a reasonable monthly rate. Arrangements were also made for sale of the pelts through an affiliated company and for division of the profits with the investor-owners. Since none of the purchasers had any knowledge or skill in the handling or selling of the chinchillas or in the marketing of the pelts, the necessity for such a contract was stressed. In holding that these transactions constituted the sale of securities, the court said:

> [I]t is readily apparent that the investor in chinchillas did not rely alone upon the processes of nature to enrich him. He reckoned upon sharing profits to be earned by an intelligent, experienced and industrious organization in the care, breeding and sales of the rodents. The company candidly represented that it was selling its ingenious services along with the chinchillas . . . . Therefore it was not an investment in the animals only but in service as well . . . . By making such investments [the purchasers] had no thought but that they would profit by the combined and organized efforts of the two corporations . . . .[39]

This quotation emphasizes the inverse relationship between participation and the expectation of profits derived solely from the efforts of

36 Domestic & Foreign Pet. Co. v. Long, 4 Cal. 2d 547, 555, 51 P.2d 73, 76 (1935) wherein the court stated:

> Instruments such as those in . . . the instant case are not issued to persons who expect to reap a profit from their own services and efforts exerted in the management and operation of oil-bearing property, but to those in the category of investors, who, for a consideration paid, stipulate for a right to share in the profits or proceeds of a business enterprise or venture to be conducted by others. The defendants herein have less voice in the control of the enterprise than stockholders in a corporation, who may vote at stockholders' meetings.
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> In decisions in this state and in other jurisdictions where it has been contended that a transaction under attack did not come within the Corporate Securities Act because it constituted only a sale of specific real or personal property or an interest therein, the courts have looked through form to substance and found that in fact the transaction contemplated the conduct of a business enterprise by others than the purchasers, in the profits or proceeds of which the purchasers were to share.

37 37 Cal. 2d 765, 235 P.2d 601 (1951).

38 70 Cal. App. 2d 103, 160 P.2d 846 (1945).

39 *Id.* at 107, 160 P.2d at 847-48.

one other than the investor. A complete reliance on others for the management, control and production necessarily precludes any genuine participation by the investor.

In the *Syde* case, an independent movie production company contracted with parents to cast their children in film productions. The parents made cash down payments, plus further minimal payments for each rehearsal. The contract also provided that upon the sale or other disposition of the film, 60 percent of the gross receipts would be distributed equally among the members of the cast. The studio was to pay all costs and expenses of the production. They also reserved the right to reject any cast member, and had the complete control over the distribution and sales of any of the films. Since the agreements contemplated actual participation by the children in films from which they might have realized a profit, the contracts, down payments, and other fees, could not be considered as constituting an investment contract. The *Syde* court concluded that "[a]n agreement to render personal services for compensation could not be considered a security, even though the sale of a beneficial interest in such an agreement may come within the statute."[40]

Courts have held, however, that nominal participation alone will not preclude the application of the Corporate Securities Law. For example, the court in *State v. Gopher Tire & Rubber Company*[41] indicated that the investor's efforts in the conduct of the enterprise must be more than token participation.[42] In *Gopher Tire*, participation by an investor in the form of unofficial advertising services on behalf of the venture was not sufficient participation to take the transaction out of the scope of the securities regulations.

In *People v. Jaques*,[43] California accepted Minnesota's definition of an investment contract by announcing the following general rule:

> [I]f the enterprise is in the nature of a joint venture or if the investor is to have an active participation in its formation, or its operation is dependent for its success partly on the efforts of the particular investor, then, in any such event, the Corporate Securities Law does not apply.[44]

This broad statement was later put into proper perspective in *People*

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40 37 Cal. 2d at 768, 235 P.2d at 603.
41 146 Minn. 52, 177 N.W. 937 (1920).
42 *Id.* at 53, 177 N.W. at 938.
43 137 Cal. App. 2d 823, 291 P.2d 124 (1955).
44 *Id.* at 834, 291 P.2d at 131.

v. Mills,[45] where the court dispelled any intimation that personal services performed by the buyer could immunize a sale of stock without a permit, holding that the rulings in *Syde* and similar cases applied to situations that did not involve stock issuances, but rather, applied to investment contracts.[46]

From these cases it can be seen that participation by the investor has been a key factor in determining the existence of an investment contract. Where the investor actively participates, he will not be deriving profits solely from the efforts of others because his own efforts will be a factor in producing a share of the profits. The Corporate Securities Law was "not intended to afford supervision and regulation of instruments which constitute agreements with persons who expect to reap a profit from their own services or other active participation in a business venture."[47]

The preceding cases were all concerned with various judicial interpretations of what was needed to constitute an investment contract. These rules were rather general in nature since the courts examined each case on its own merits, rather than attempting to lay down any precise rules for future courts to follow. This generally was necessary, since specificity "would . . . aid the unscrupulous in circumventing the law."[48] This approach was applied somewhat mechanically until 1961, when the California Supreme Court decided a case that, although not involving an investment contract, could weigh heavily in the determination of the existence of an investment contract, and more particularly, in the treatment to be given a franchise agreement under the California Corporate Securities Law.

IV. THE SILVER HILLS CASE

Decided in 1961 *Silver Hills Country Club v. Sobieski*,[49] gave the Supreme Court of California another opportunity to define the term "security." This case involved a partnership established to organize a country club. As a first step toward the realization of their goal, the promoters contracted to purchase a parcel of improved land for $75,000. This contract provided for a down payment of $400, which represented the only cash investment to be made by the promoters. The large amount of additional capital necessary to finance the

45 162 Cal. App. 2d 840, 328 P.2d 1049 (1958).
46 *See also* People v. Clark, 215 Cal. App. 2d 734, 30 Cal. Rptr. 487 (1963).
47 People v. Syde, 37 Cal. 2d 765, 768, 235 P.2d 601, 603 (1951).
48 State v. Gopher Tire & Rubber Co., 146 Minn. 52, 53, 177 N.W. 937, 938 (1920).
49 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

project was to be raised through the sale of what were designated "memberships."[50] The California Commissioner of Corporations concluded that these "memberships" were securities within the meaning of the Blue Sky Law, and therefore issued a "desist and refrain order."[51] After a motion to vacate this order had been denied, a writ of mandate was sought from the Superior Court. The writ was granted and subsequently affirmed by the California District Court of Appeal.[52] The Commissioner then appealed to the California Supreme Court.

The supreme court, speaking through the now Chief Justice Traynor, reversed, holding that the sale of the memberships was the sale of a security and, thus, required a permit.[53]

The holding resulted from a consideration of two factors. First, the supreme court rejected the lower court's conclusion, holding that the situation fell within the literal meaning of the act since the purchaser of a membership had a contractual right to use the club facilities—a right that could not be revoked except for his own misbehavior or failure to pay dues. The court characterized such an irrevocable right as, "a beneficial interest in title to property within the literal language of subsection (a) of section 25008."[54] Second, the court went on to say that the crucial question was, whether the sale of such a membership comes within the regulatory purpose of the Corporate Securities Act, which is:

> [T]o protect the public against spurious schemes, however ingeniously devised; to attract risk capital . . . . [And] to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.[55]

[50] *Id.* at 812-13, 361 P.2d at 907, 13 Cal. Rptr. at 187. ("They plan to sell a total of 200 'charter memberships' for $150 each, thereby raising $30,000; 300 memberships for $200 each, thereby raising $60,000, and 500 memberships for $250 each, thereby raising $75,000.")

[51] CAL. CORP. CODE § 25514 (West 1955).

> Whenever in the opinion of the commissioner the further sale of any securities by any company would be unfair, unjust, or inequitable to the purchasers of the securities, the commissioner may order the company to desist and refrain from the further sale of its securities.

[52] Silver Hills Country Club v. Sobieski, 9 Cal. Rptr. 694 (1960).

[53] CAL. CORP. CODE § 25500 (West Supp. 1966).

> No company shall sell any security of its own issue, except upon a sale for a delinquent assessment against the security made in accordance with the laws of this State, or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it has first applied for and secured from the commissioner a permit authorizing it so to do.

[54] 55 Cal. 2d at 814, 361 P.2d at 908, 13 Cal. Rptr. at 188.

[55] *Id.* at 814-15, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

The sale in Silver Hills was found to be within the stated regulatory purpose.

On its face, *Silver Hills* seemed to conclude that the purpose of the Corporate Securities Law was generally to protect investors from investing in questionable schemes.[56] In the particular fact situation of *Silver Hills*, the court apparently believed that a project requiring capitalization of over $150,000 was not adequately stabilized by a promoters' investment of only $400. This was especially true since the success of the project was left entirely in the hands of the promoters, with the investors taking a passive position. In short, the court was of the opinion that the purchasers did not have a fair opportunity to realize the fruits of their investment.[57]

This concern for the investor, together with the fact that a beneficial interest in land was sold, led the court to conclude that the transaction was of the type that the legislature had contemplated in passing the act. Viewed in this light, the case appears to be a logical extension of prior decisions in the area. However, the significance of *Silver Hills* is to be found in the discussion of two concepts which the court employed in reaching its conclusion.

A. *Expectation of Profit*

The first of these concepts was the "expectation of profits" test. Traditionally, the opportunity for profit was an inherent feature of an investment contract; it was essential to finding a security.[58] The *Silver Hills* court, however, stated that the Corporate Securities Law even extended to transactions where no profits or material benefits could be realized; expectation of profit to the investor is not a test under the act, since the regulatory purpose of the act is "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in *one form or another*."[59] This is a significant

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[56] The court cites Dahlquist, *supra* note 13, at 360, wherein this commentator states:

> As a general rule, the sale of "securities" that is condemned by the courts involves an attempt by an issuer to raise funds for a business venture or enterprise; an indiscriminate offering to the public at large where the persons solicited are selected at random; a passive position on the part of the investor; and the conduct of the enterprise by the issuer with other people's money.

[57] 55 Cal. 2d at 815, 361 P.2d at 909, 13 Cal. Rptr. at 189.

[58] *See generally* BALLANTINE AND STERLING, CALIFORNIA CORPORATIONS LAW § 479 (1949); Dahlquist, *supra* note 13, at 358.

[59] 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188 (emphasis added). The court reaches this conclusion by analogy to other parts of the Corporate Securities Law:

departure from the "expectation of profits" rule previously followed by the California courts.[60]

Until *Silver Hills*, with one exception,[61] every state and federal case, which considered whether a membership or interest in property constituted a security, found either an expectation of profit to the investor[62] or evidence of an indebtedness.[63] While not ruling out the expectation of profit factor entirely, the *Silver Hills* court did assert that the expectation of material benefit was not a requirement that *must* be found to bring the transaction within the purview of the act. However, this assertion could be considered dicta; the members, although not expecting a cash return, were expecting "benefits" from the transaction. The court did say that "the act is as clearly applicable to the sale of promotional memberships in the present case as it would be had the purchasers expected their return in some such familiar form as dividends."[64]

Clearly, *Silver Hills* de-emphasized the "expectation of profit" element. In essence, this was done to emphasize the crucial test of the Corporate Securities Law: consideration of its "regulatory purpose." Implicit in this emphasis is a recognition that mechanical tests are often inadequate to deal with new schemes that threaten the public.[65] If a situation falls within the regulatory purpose of the act, it would seem unreasonable to force a court either to twist the facts to find an expectation of profit where none exists, or fail to give the full intended effect to the act because of a highly restrictive, technical test.

Silver Hills does not foreclose future consideration of "expectation

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"Thus from its exemption of certain nonprofit companies the act specifically excepts 'notes, bonds, debentures, or other evidence of indebtedness *whether interest-bearing or not.*'" (court's emphasis). *Id. See* CAL. CORP. CODE § 25102(a) (West Supp. 1966).

60 *See* 14 HAST. L.J. 181, 182 (1962).

61 Davenport v United States, 260 F.2d 591 (9th Cir. 1958). In this case the defendant sold "memberships" in the Mt. Hood Hardboard and Plywood Cooperative. By purchasing these memberships, the members were promised continuous employment and job security. The defendant was convicted for fraud in the sale of securities under section 17(a) of the Securities Act of 1933. Hence, the memberships must have been securities even without expectation of profit, to support the conviction.

62 *E.g.*, United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942); Hacker v. Goldberg, 263 Ill. App. 73 (1931); Lewis v. Creasey Corp., 198 Ky. 409, 248 S.W. 1046 (1923). *See generally* Annot., 87 A.L.R.2d 1140 (1963).

63 *E.g.*, United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942); SEC v. United Prosperity Plan, Inc., 1 S.E.C. Jud. Dec. 435 (D. Utah 1937). *But see* 24 OPS. CAL. ATT'Y GEN. 33 (1954).

64 55 Cal. 2d at 815-16, 361 P.2d at 909, 13 Cal. Rptr. at 189.

65 *See generally* 14 HAST. L.J. 181, 184 (1962).

of profit." This feature is inherent in many securities,[66] and can be useful as an *indication* of a security.[67] Nevertheless, "expectation of profit" is not a requirement and therefore is not a *test.* The *Silver Hills* case put "expectation of profit" in its proper perspective.

B. *Risk Capital*

The second significant concept is "risk capital." This phrase was first judicially employed in *Silver Hills*, but it is safe to say that it has not made its last judicial appearance. The phrase "risk capital" was used throughout the opinion, but it was never defined. A precise definition is necessary in order to apply the concept to franchise agreements to determine if they are securities.

The court used "risk capital" and "risk" in several contexts.[68] In light of these uses, it appears that there are three basic definitions of "risk capital" consistent with its use in the *Silver Hills* opinion. One possibility is that it was used to mean initial capital: capital used to promote a previously nonexistent project. Support for this definition can be found in the court's observation that "[w]e have here nothing like the ordinary sale of a right to use existing facilities."[69] This may mean that if the money is used to improve an existing facility rather than to begin one, it will not involve a security.[70] Further, the court

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66 *E.g.*, stocks, bonds.

67 *See* Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (1964); Craft v. Brooks, 204 Cal. App. 2d 187, 22 Cal. Rptr. 68 (1962).

68 "Risk" or "risk capital" was used in the following instances:

> Section 25008 defines a security broadly to protect the public against spurious schemes, however ingeniously devised, to attract *risk capital.*

Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 814, 361 P.2d 906, 907, 13 Cal. Rptr. 186, 187 (1961) (emphasis added).

> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the *risk capital* with which to develop a business for profit. The purchaser's *risk* is not lessened merely because the interest he purchases is labelled a membership. Only because he *risks his capital* along with other purchasers can there be any chance that the benefits of club memberships will materialize.

Id. at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188 (emphasis added).

> Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who *risk their capital* at least a fair chance of realizing their objectives in legitimate ventures . . . .

Id. (emphasis added).

> Hence the act [applies to the memberships in this case]. Properly so, for otherwise it could too easily be vitiated by inventive substitutes for conventional means of raising *risk capital.*

Id. at 815-16, 361 P.2d at 909, 13 Cal. Rptr. at 189 (emphasis added).

69 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

70 *See* Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. Rev. 1, 7 (1964).

found that "[p]etitioners [were] soliciting *risk* capital with which to develop a business for profit."[71] In fact, the petitioners were soliciting *initial* capital with which to develop a business for profit, and the court may have been using the term "risk capital" in this very restrictive sense.

Another possibility is that the phrase "risk capital" was used to indicate capital invested in a scheme which incorporates features making it *risky* or questionable. This interpretation is indicated by the court's concern over the great disparity in the amount to be raised from the sale of the memberships and the amount furnished by the promoters.[72] In the court's judgment the proposed project lacked a stable foundation, *i.e.*, it was a *risky* investment. Implicit in the court's statement that there was no sale of a right to use an existing facility,[73] is its assurance, although admittedly not voiced, that had this been such a sale, the result would have been different. It was argued above that the difference lay in the *stage* of the project. Since the facilitity did not exist, money invested was *initial* capital. It is now suggested that the court could have meant that the situation would have been different because, had the club existed, the purchase of a membership would involve less risk of loss. The project undertaken by the promoters would not have been as "risky" if the facilities had already been completed. Unfortunately, however, the court only mentioned that the situation would have been different; it did not indicate why.

The court offered further support to this meaning of the term "risk capital" where it asserted that

> [t]he purchaser's *risk* is not lessened merely because the interest he purchases is labeled a membership. Only because he *risks* his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.[74]

Here again the court was concerned with the "riskiness" of the venture and the corresponding financial danger to the investor.

A third possibility is that the court used the phrase "risk capital" to define a much broader situation than the two discussed above. The phrase may have been used to mean "risked" capital, meaning money

[71] 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188 (emphasis added).
[72] The promoters furnished $400 as compared to the $165,000 to be raised by selling memberships.
[73] 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.
[74] *Id.* (emphasis added).

invested with a risk of loss, or more precisely, any capital invested with less than a fair chance of realizing a return. This interpretation would include all investment defined as "risky" and probably a large percentage of investments of "initial capital"; however, "risked capital" would also include investments in ventures which were much safer than those included within the definition of "risky capital," as well as investments into ventures which, being partially completed, are not considered "initial capital." This definition of risk capital can also find logical support in the *Silver Hills* opinion. The court reasoned that a "security" is defined broadly, so as to "protect the public against spurious schemes, however ingeniously devised, to attract risk capital."[75] While the court relied on *People v. Syde*[76] for this general proposition, the phrase, "to attract risk capital," was not used in *Syde* but was added by the *Silver Hills* court. If the court meant that "risk capital" denotes either *initial* or *risky* capital, then the meaning of the *Syde* case was indeed limited in *Silver Hills.* If risk capital means initial capital, then the court has restricted the rule of the *Syde* case so that the purpose of the act is to protect the public against spurious schemes designed to attract only initial capital. If risk capital means risky investments, then the court may have meant that the act only protects the public against highly speculative schemes. However, the court may have intended merely to restate the *Syde* rule, not to restrict it. This would be accomplished if "risk capital" means "risk*ed* capital." Thus the phrase, "to protect the public against spurious schemes . . . *to attract risk capital,*"[77] could be paraphrased to read: to protect the public against *schemes which have less than a fair chance of success.* In fact, later in the opinion the court states directly that the purpose of the act is "to afford those who risk their capital at least a fair chance of realizing their objectives . . . ."[78] This view of the act would seem to support the broad meaning of "risk capital."

Confronted with the particular fact situation in *Silver Hills,* the court's conclusion was the proper one. It matters not that the court failed to delineate whether the *ratio decidendi* was that the investment was "risky," that the money was "initial capital," or that the investor had less than a fair chance of realizing a return for his

[75] *Id.* at 814, 361 P.2d at 907, 13 Cal. Rptr. at 187.
[76] 37 Cal. 2d at 768, 235 P.2d at 601.
[77] 55 Cal. 2d at 814, 361 P.2d at 907, 13 Cal. Rptr. at 187 (emphasis added).
[78] *Id.* at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

money. All three of these conditions existed, and thus there was no doubt that the situation would fall within the purview of the act. Nevertheless, in applying the "risk capital" test to other situations where only one of the three circumstances is present, it will be necessary to decide which of the definitions is represented by the phrase. If the "risk capital" test is to be used in situations which are not identical to that in *Silver Hills*, there are several problems which must be faced and resolved.

If risk capital means initial capital, can it be said that *any* offering which solicits money for a project untried and nonexistent, will require a permit? That is, would the fact that the money was to be part of the initial capital be sufficient in itself to bring the transaction within the scope of the Blue Sky Law, regardless of other circumstances? For instance, assume that the business is very carefully planned with the maximum amount of caution and good business judgment, or that the entire project is underwritten so that the investor is to incur none of the risk. If "risk capital" means initial capital, and the protection of the act extends only to investments of risk capital, would an investment into a very "risky" business be denied the protection of the act, merely because the money was not initial capital in the strict sense? Could an investment into an existing business, which operated on the fringes of bankruptcy, be considered "initial" in the sense of reorganization capital?

Problems also arise in relation to the other definitions. For example, if the definition of risk capital is "risky capital," there would, of course, be a problem of drawing the line between those investments which are "risky" and those which, although unsafe, are not "risky." Would an investment which ordinarily would be within the scope of the act, be denied the protection of the act, where the investor is sophisticated and fully apprised of the risks of the investment by the offeror before entering into the transaction? Conversely, can an offering, which would ordinarily not be within the scope of the act, be brought under the control of the Commissioner because it makes the investment seem much safer to the uneducated buyer than it really is?

As yet, these questions have not been judicially answered, and, of course, they represent only a small portion of the potential problems that will arise regardless of which definition of "risk capital" is accepted.

V. Control of Franchises Under Securities Law

According to *Black's Law Dictionary*, the word "franchise" was originally defined in England as a royal privilege conferred by the crown upon a subject. Today, in this country, we understand a franchise to be a special privilege, not enjoyed by the public in general, which is granted by one person, real or artificial, to another.[79] A whole range of franchise plans can be imagined, encompassing the simple grant of a license to use a name or formula, as well as a more complicated arrangement involving a complete business—including supplies, operating instructions, advertising, and employees. The purchaser may intend to exercise the franchise as his sole business, or he may intend to remain in another occupation and exercise the franchise merely as an investment.[80] In the spectrum of possible franchise arrangements there are some situations where a security clearly does exist, and others where it is equally clear that a security does not exist. Between the two extremes is a vast gray area in need of deeper consideration.

The first portion of this note was concerned with the historical elements of a security—primarily, the components of an investment contract—and the current developments—mainly, the *Silver Hills* case and the concept of "risk capital." The remainder will be devoted to an examination of the recent California Attorney General's opinion and the elaboration thereon by the California Corporations Commissioner. These opinions elucidate situations under which franchise agreements are subject to regulation under the California Corporate Securities Law.

A. *The Attorney General's Opinion*

The California Attorney General has constructed three hypothetical situations to determine whether a franchise agreement would constitute a security within the meaning of the California Corporate Securities Law.[81]

First, the franchisee (investor) participates only nominally in the franchised business in exchange for a share of the profits.

Second, the franchisee participates actively in the franchised busi-

79 Black's Law Dictionary 786-87 (4th ed. 1957).
80 *See generally* Coleman, *supra* note 2.
81 49 Ops. Cal. Att'y Gen. 124-25 (1967).

ness and the franchisor agrees to provide goods and services to him.

Third, the franchisee participates actively in the business and the franchisor agrees to provide goods and services, but further intends to acquire a substantial portion of the initial capital needed to do so out of the franchise price.

Each of these situations raises the issue of participation by the franchisee in the venture. As previously noted, the investor's active participation will normally remove the transaction from the purview of the Corporate Securities Law.

Since the franchise is a "nominal" participant in the first hypothetical posed by the Attorney General, the perplexing problem of the *degree* of participation arises. Nominal participation alone will not be sufficient to remove a transaction or venture from the area of securities regulation. This was evidenced by the cases following *Howey*,[82] which did not attach a literal meaning to the word "solely" in the phrase, *profits to come solely from the efforts of the promoter or a third party.*[83] The participation must be genuine, with some discretion left to the franchisee.[84] To hold otherwise would only thwart the purpose of the securities regulations, which is to afford the fullest protection to the investing public and the least interference with honest business. Each case will have to be examined on its own merits in order to determine the degree of participation by the franchisee in the venture. The agreement itself may provide the sole indication of where the line should be drawn between participation and nonparticipation. The franchise agreement may dictate many of the operational functions to the franchisor, including: the price to be charged, the mode of advertising, the source of supplies, the type of building, the hours of operation, and innumerable other possibilities. An agreement that strips the franchisee of the major decision-making responsibilities may preclude him from being an "active" participant, even though he still "manages" the business, keeps the books, pays the bills, and hires and fires the employees. However, it is possible that complete physical participation, along with only mini-

[82] *E.g.*, Blackwell v. Bensten, 302 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954); People v. Jaques, 137 Cal. App. 2d 823, 291 P.2d 124 (1955).

[83] SEC v. Howey, 328 U.S. 293 (1946).

[84] *See generally* State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920); People v. Jaques, 137 Cal. App. 2d 823, 291 P.2d 124 (1955). "The line is drawn, however, where neither the element of a common enterprise nor the element of reliance on the efforts of another is present." 1 Loss, SECURITIES REGULATIONS 491 (2d ed. 1961).

mal decisional participation, would obviate the aegis of the Corporate Securities Law. But inasmuch as the theory, which underlies nonparticipation as an element of a security, is that a person participating in the business has an opportunity to protect his own investment and does not need the protection of the act,[85] it would seem that only participation that actually allows the franchisee a real opportunity for self-protection should take the agreement out of the auspices of the security regulations. An agreement allowing a minimum of decisional participation conceivably does not allow sufficient opportunity for the franchisee to protect himself, regardless of the degree of physical or ministerial participation. Decision-making, rather than personal service, is generally the significant factor in developing profit and success.[86]

Another variation of this problem arises when the franchisee is offered the *choice* of only nominally participating *or* of actively participating in the franchised business. While the offer, as well as the sale of unregistered securities, is contrary to the provisions of the act,[87] it does not necessarily follow that, if the investor has the choice between the two alternatives, the form of the offer must control the legal characterization of the sale. Both *Joiner* and *Howey* indicate that the terms of the *offer* would control, whether in fact a security is being offered. *Joiner* stated the test of a security to be the "character the instrument is given in commerce by the terms of the offer . . . and the economic inducements held out to the prospect."[88] In that case, the sales literature did not mention the alternative of the purchaser doing his own drilling for oil, but rather, stressed that the Joiner Corporation would undertake this operation.

In *Howey*, the test was whether the investor "is led to expect profits"[89] from one other than the investor. The importance of the form of the offer, as determinative of the characterization of the

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85 *See* People v. Syde, 37 Cal. 2d 765, 235 P.2d 601 (1951). *See also* Coleman, *supra* note 2.

86 The *Syde* case presents a different aspect of the problem. In that case the participation by the child actors defeated the application of the Corporate Securities Law even though their participation did not extend to any decision making activities. In the *Syde* case, it is arguable that personal service, or the talent of the participants was the significant profit producing activity. This situation is distinguishable from the usual franchise situation where decision making is the more significant profit producing activity. Note, however, that the courts have not yet attempted to delineate the exact *quality* of participation necessary to preclude the control of the act.

87 *See* CAL. CORP. CODE § 25009 (West 1955).

88 320 U.S. at 352-53.

89 328 U.S. at 299.

transaction, is emphasized in *Howey* by the facts of the case—only 85 percent of the purchasers of the citrus groves signed a service contract with Howey-in-the-Hills Service Company, but even as to the 15 percent who did not sign this service contract, a sale of a security was present.

These factual illustrations indicate that there is a distinction between *Joiner* and *Howey* and situations where the offer would provide, *as an alternative*, either active or nominal participation in the operation of the franchised business.

To determine whether a security is being offered as well as being sold, when the franchise offer provides alternatives, a reasonable test should consider the underlying *economic realities* of the venture, in addition to the economic inducements held out to the public.[90] This analysis does not solve the problem presented because a security is still being offered in the form of the nonparticipating agreement regardless of what is finally sold. The form of the Corporate Securities Law prevents the resolution of this particular problem as it requires filing for a permit for the offer as well as the sale of a franchise providing such alternatives. This requirement serves as an unnecessary interference with and an unjustifiable expense to business.

The second situation posed by the Attorney General—where the franchisee is to participate actively in the franchised business and the franchisor is to supply him with goods and services—presents no substantial problem. The rule in situations of this type was succinctly stated in *People v. Syde:* "[T]he Corporate Securities Law was not intended to afford supervision and regulation of instruments which constitute agreements with persons who expect to reap a profit from their own services or other active participation in a business venture."[91]

B. *Risk Capital Concept Applied to Franchises*

The third hypothetical posed by the Attorney General is that in which the franchisee participates actively, yet the franchisor is to provide goods and services and intends to secure a substantial portion of the initial capital needed to provide these services, from the franchisee.

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90 *See* Coleman, *supra* note 2, at 507-08.
91 37 Cal. 2d at 768, 235 P.2d at 603.

This situation is exactly the same as the second, with the added factor that some of the franchisee's money is to be used by the franchisor as initial capital, thereby enabling him to provide goods and services to the franchisee. The second situation is clearly not a security because of the franchisee's active participation; but the third situation does represent a security in the opinion of the Attorney General, even though it is clear that the franchisee does intend to participate actively. In defense of his conclusion, the Attorney General's opinion adds that the "risk capital" test should be applied to augment the participation test.

This opinion is apparently the first to recognize and use the "risk capital" test in discussing franchise agreements.[92] Without first offering a definition of risk capital, the Attorney General uses the term as follows: "If a franchisor solicits fees from his franchisees in order to raise a substantial portion of his initial capitalization (*i.e.*, 'risk capital'), the analogy to the *Silver Hills* fact situation is complete."[93] From this interchangeable use of the expressions "risk capital" and "initial capital," the conclusion could be drawn that, in the opinion of the Attorney General, their meaning is identical. He cites that portion of the *Silver Hills* case where the court recognized that the transaction was not an "ordinary sale of a right to use existing facilities."[94] However, observe that the Attorney General stated, "a *substantial* portion of the initial capital (*i.e.*, 'risk capital')." Thus it is unclear whether risk capital means merely initial capital or rather a *substantial portion* of the initial capital. The latter construction is supported by the passage: "Finally, it is not clear what degree of undercapitalization by the franchisor will cause the fees paid by the franchisee to be characterized as 'risk capital' . . . ."[95] This indicates that if the investor's money were only a minimal portion of the initial capital (as opposed to a "substantial portion") then it would not be characterized as risk capital, since there would be no undercapitalization by the franchisor in relation to the minimal investment of the franchisee. So interpreted, "risk capital," that is, a substantial portion of initial capital, is more restrictive than initial capital. This limited definition would encompass only situations of excessive undercapitalization.

In terms of the three possible definitions discussed above, the

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92 49 OPS. CAL. ATT'Y GEN. 124 (1967).
93 *Id.* at 128.
94 *Id. See* 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.
95 49 OPS. CAL. ATT'Y GEN. at 129.

Attorney General is persuaded that the *Silver Hills* court used "risk capital" to mean "risky, initial capital."[96] Accordingly, in the opinion of the Attorney General, in no case will money which is not initial capital be characterized as risk capital, regardless of what other circumstances exist.

This definition of "risk capital" seems entirely consistent with the *Silver Hills* case, but the important question is whether it will be useful in its application to other fact situations. A situation where money is invested in an unproven venture, which is set up such that the investor stands less than a fair chance of success and is unable to protect himself, would indeed, seem to come within the regulatory purpose of the Corporate Securities Law. The Attorney General is convinced that this situation exists where the franchisor agrees to supply goods and services to the franchisee, intending to use the franchisee's money to accomplish this goal. He contends that providing risk capital is

> a separate business risk apart from the success or failure of the franchisee's conduct of the franchised business, and should be treated as such for purposes of the Corporate Securities Law. Moreover, . . . this accords with the intent of the parties; the incentive for franchise arrangements is to give the franchisee the status of an independent businessman apart from the franchisor.[97]

The Attorney General reasons that the franchisee is investing in two separate business ventures. One is the operation of the franchised business. In this aspect the franchisee does not need the protection of the act, since he is to control the profitability of the enterprise through his own efforts. The other business venture involves investment into the operation which is to be conducted by the franchisor to provide goods and services to the franchisee. In the latter venture, the franchisee takes a passive position with no control and, therefore, needs the protection of the act. This "double-investment" analysis is subject to serious doubt. Why should the franchisee be concerned with what the franchisor intends to do with the money received from the sale of the franchise? Naturally, the franchisee would be interested in the ability of the franchisor to continue to provide the necessary goods and services, but this is one of the normal risks of the franchised business, not a separate risk as suggested by the Attorney General.

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96 *Id.*
97 *Id.*

It is axiomatic that if money is paid to a franchisor with the expectation that goods and services will be forthcoming, and the success or failure of the business turns on the continued supply of such goods and services, the money is being ventured on the franchisor's future performance. Is it not as valid to say that where, for example, the franchisee invests considerable sums erecting a building, buying equipment, and otherwise making expenditures[98]—the usefulness of which depend on the continued supply of the goods and services—the money is being ventured on future performance by the franchisor. Granted, the money paid is held, in one case by the franchisor, and in the other by some third person, but such a difference would be of little significance in the mind of the franchisee. Therefore, it is arguable that whenever, for the success of his venture, the franchisee depends on the franchisor to provide goods and services, all of the money is risked on further performance by the franchisor, a division of the total amount of investment into two separate investments would be logically unsupportable.

If the above objection to the double-investment analysis is resolved, a further hurdle must be overcome. The argument could be made that even though the franchisee takes a passive role, he expects no monetary return and, therefore, the agreement is not a security. This argument, of course, would have had greater impact prior to *Silver Hills* where the expectation of monetary profit as an element of security was tempered. In the Attorney General's third hypothetical, even though the franchisee expects a return of goods and services, he will have to pay for such goods and services as they are received, in addition to the franchise price. The relationship of the parties to the agreement to provide goods and services seems to be no more than that of two parties to a simple contract for goods and services.

C. *A Hypothetical Franchise*

To bring the discussion from the abstract to the concrete, consider this illustration: Hot-Dogs Inc. offers to franchise, for $20,000, one hot dog stand with a complete "formula for successful operation." The franchisor agrees to provide all of the physical facilities necessary, along with detailed printed instructions telling the franchisee exactly how to operate the stand. The agreement also provides that the franchisee must purchase his entire supply of hot dogs from the

98 These are expenses that otherwise would have been incurred by the franchisor if he distributed the product himself.

franchisor. Hot-Dogs Inc. envisions this franchising program as a method of establishing an extensive, reliable market for the sale of its hot dogs. While both parties recognize that this arrangement is advantageous to the franchisor, the franchisee is convinced that the other features justify the acceptance of the exclusive buying clause as a part of the franchise agreement. The franchisor has already paid for and obtained all of the physical facilities to be provided to the franchisee, and the instruction manual is complete and available in large quantities. Still, he does intend to use the money paid by the franchisee in the operation of his hot dog plant.

To be compatible with the Attorney General's approach, this agreement would be classified as a security. Arguably, the franchisee is taking a risk that the business of the franchisor may not continue to succeed, and he is investing money and taking a passive interest in the hot dog supplying business of his franchisor. The theory is that a portion of the $20,000 is for the "formula for success," and a portion is allocated to secure the continued supply of hot dogs. However, inasmuch as the franchisee will be paying for the hot dogs as they are delivered, is it not just as logical to say that all of the money paid was for purchase of the franchised business, and no money was risked on the franchisor's ability to continue to supply the hot dogs? Suppose the hot dogs supplied by the franchisor are of inferior quality and are higher priced than others available on the market. In this situation, the franchisee would be unconcerned over the possibility that the franchisor will fail to meet his obligation, and might even want to be free to seek his supply of hot dogs from another source. Certainly the franchisee does not need the protection of the Corporate Securities Law to insure a continued supply of inferior, overpriced hot dogs. The fact that the franchisor happens to be using the money, contributed by the franchisee to supply the hot dogs, should not necessarily mean that the franchisee has invested in the hot dog business. It seems entirely possible, if not probable, that the elements which really interested the buyer, and those for which he was willing to pay, did not include the agreement to purchase hot dogs from the franchisor.

Consider an exaggerated situation where the right to use the name "Hot-Dogs Inc." alone is considered to be worth $20,000, but a sale is made of the whole package, described above, for $10,000. Would the franchisee still be providing risk capital, and would a security therefore exist, merely because the money is being used by the franchisor to provide the goods and services? It is submitted that the possibility that the franchisee intends to invest into the franchisor's business is clearly obviated by the hypothetical facts. Although the franchisee receives more than full consideration with the granting of the privilege to use the name, it is not necesary to invoke the protection of the Corporate Securities Law to secure any further benefits to the franchisee. In this situation, the Attorney General's double-investment analysis is not consistent with reality and should not be employed.

The Attorney General's opinion should be qualified, so that a security would exist in circumstances such as the following. Assume facts similar to those of the hypothetical posed above, except that the hot dogs are made according to a secret formula held only by Hot-Dogs Inc. The stands have no special appeal, other than the fact that the public has shown a great appreciation for the unusual taste of the hot dogs. The method of operation and the other ingredients provided for the franchisee are considered of relatively little value; clearly, the real value of the franchise is the license to buy hot dogs made from the special formula. In addition, the franchisor is fully extended financially because the idea is relatively new and unproven. Thus, the initial stages of the operation have been financed on a shoestring, forcing the franchisor to use the money which he receives from the sale of a franchise, in order to provide the goods and services. This is the type of situation where the franchisee *depends* on the services to be rendered, and has no way of protecting his investment because his participation is limited to his own stand and does not extend to the hot dog factory.

The wisdom of limiting the application of the Blue Sky Law to situations where initial capital is contributed is also dubious. If the purpose of the Corporate Securities Law is to protect the investing public against spurious schemes, why does the Attorney General not define risk capital to include schemes to raise capital for an existing but unproven business, as well as schemes to raise initial capital? This criticism would apply with equal validity, even if initial capital includes the capitalization of new ventures within a going business, such as a new franchising program organized by an existing business. It is submitted that *any* attempt to raise money should fall within the act, if the other components of a security are present. The limitation to initial capital is unnecessarily restrictive.

In summary, the conclusion that a security is described by the third hypothetical posed by the Attorney General is susceptible to attack. The problem is not analyzed thoroughly. In conjunction with the elements of active participation, an agreement to provide goods and services, and the existence of risk capital, it should also be necessary to find that the success of the franchised business depends, at least in part, on the goods and services to be provided, *and* that the franchisee contemplates, or the facts show, that part of the money paid must be allocated for the privilege of receiving the goods and services. Where all of the elements mentioned are present, the situation falls within the regulatory purpose of the Corporate Securities Law and a security is evinced.

D. *The Division of Corporations Guidelines*

In July of 1967, shortly after the opinion of the Attorney General was written, the "risk capital" test was applied for the second time to the subject of franchise agreements in a bulletin from the Division of Corporations.[99]

In this bulletin, the California Corporations Commissioner takes special interest in the third situation posed by the Attorney General.[100] The Commissioner, in paraphrasing the opinion of the Attorney General, declares that "[p]ursuant to the opinion . . . [a] franchise constitutes a security . . . where . . . a substantial portion of the initial risk capital of the franchisor is to be contributed by the franchisee."[101] Note that the Commissioner uses the phrase "initial risk capital," while the Attorney General used either "initial" *or* "risk" capital. However, the Commissioner purports to be merely paraphrasing the Attorney General and, therefore, any change in the terms that might appear could be the result of an inadvertant combination of words. At any rate, the semantic discussion should be abandoned in discovering which characteristics the Commissioner perceives as significant to the resolution that a particular franchise agreement comprises a security. According to the Commissioner, the implication will arise that a security exists unless the franchisor can show: (1) adequate capital to operate the franchising program for an indefinite length of time, without the necessity of resorting to the funds to be contributed by the franchisee; (2) successful business operation in the past; and (3) adequate facilities to successfully administer the franchising

99 CAL. DIV. OF CORP., Bull. No. 67-8 (July 14, 1967).
100 49 OPS. CAL. ATT'Y GEN. at 125.
101 CAL. DIV. OF CORP. Bull. No. 67-8 (July 14, 1967).

program.[102] The Commissioner insists that ordinarily this implication will arise unless *all* three enumerated conditions coexist.

Regardless of the meaning the Commissioner attaches to "initial risk capital," it is obvious from the guidelines that the emphasis is on general protection of the franchisee-investor. The franchisor has to be financially sound; he must have proven his stability in the past; and it must appear that he will be solid in the future. If the franchisor was or is operating an unsound business, any investment which depends on the continued operation of that business will be considered a security. If the franchisor has demonstrated his stability, as required by the three guidelines, then the operation is considered safe. The investment would involve a low level of risk, and would not be a security. No doubt, there is general consensus that where the circumstances surrounding a franchise agreement embody *all* of the described conditions, the presence of a security is not indicated. The question, however, is whether the absence of any or all of these factors would *necessarily* indicate that a security existed. The Commissioner amplifies his statement by adding that if any one of the factors is missing, the franchise *may* be a security, and that if paragraph 1 is not present, then the franchise will ordinarily be a security. Paragraph 1 restates, in essence, the composition of paragraph 3 of the Attorney General's opinion: the franchisor intends to secure the

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102 *Id.* The content of this bulletin is as follows:

Subject: Franchises

Pursuant to the opinion of the Attorney General dated June 2, 1967, No. 66/284, a franchise constitutes a security subject to the permit requirement of the Corporate Securities Law where either the franchisee is to take a passive role in the franchised business, or a substantial portion of the initial risk capital of the franchisor is to be contributed by the franchisee. Accordingly, in these circumstances the Commissioner of Corporations will entertain permit applications for the sale of franchises.

In circumstances where the franchise constitutes a security, it may not be offered or sold without first obtaining a permit.

Where the franchisee actively participates in the operation of the franchised business, all circumstances must be considered in determining whether the franchise constitutes a security. Ordinarily the existence of all of the following factors will lead to the conclusion that a particular franchise is not a security:

1. The franchisor, without resort to funds to be contributed by the franchisee, has sufficient capital to operate the franchising program, to provide the facilities, paraphernalia, and services promised to the franchisees, and to continue these activities for an indefinite period of time.
2. The franchisor's business has a history of successful operation for a sufficient length of time to adequately demonstrate the public demand for the franchised product or service.
3. The franchisor has adequate organization, facilities, management, and other experienced personnel available or on call, justifying the conclusion that he will be able to successfully administer the franchising program and to confer upon the franchisee the benefits offered by the program.

If any one of the foregoing factors is lacking, the franchise may be a security. If the factor mentioned in paragraph 1 is lacking, the franchise ordinarily will be deemed a security.

necessary risk capital from his franchisee so as to supply goods and services. Difficulties inherent in that situation are discussed above in relation to the Attorney General's opinion, and the same criticism applies here.

The Commissioner is understandably concerned with the possibility that the franchisor may be undercapitalized, thereby forcing the franchisee to accept risks in addition to those included in the operation of the franchised business. This type of concern is warranted under the Corporate Securities Law, but it appears that the Commissioner, in his zeal to prevent the franchisee-investor from suffering the burdens of undercapitalization, is forcing the franchisor to suffer the burdens of overcapitalization. Empirically, it would seem very unusual to find a business that was running without resort to all available funds from any source. It would be considered poor business management to leave large sums of capital idle. Businessmen strive to maintain all available funds active in the business to produce further profit.

To conceptualize the problem, imagine a case where a corporation is running a successful hotel. A decision is made to franchise an identical hotel in another city. The agreement provides that the franchisor is to supply everything needed to operate the new hotel, the franchisee need only walk in, hire his staff and begin business. The original hotel has been run successfully for years under the direction of a man considered to be outstanding in hotel management. In the opinion of "Wall Street experts," the franchisee will undoubtedly succeed under the guidance of the franchisor. Providing the hotel itself and the "paraphernalia" necessary to operate the franchising program is naturally very expensive; therefore, the agreed price for the franchise is, for example, five million dollars. Does the Commissioner imagine that the franchisor will be able to put the five million dollars in the bank and, "without [resorting] . . . to funds to be contributed by the franchisee, [have] . . . sufficient capital to operate the franchising program . . . and to continue these activities for an indefinite period of time?"[103] It would be a very strange business practice to run such an operation. What the Commissioner is suggesting is tantamount to the conclusion that *every* sale of a franchise, where the franchisor is to provide goods and services, is the sale of a security and subject to the provisions of the Corporate Securities Law.

103 *Id.*

In his second paragraph, the Commissioner indicates that he will be looking for indication from the past that the franchisee will get what the sale was purported to include. He suggests, "a history of successful operation for a sufficient length of time to adequately demonstrate the public demand for the franchised product or service,"[104] but he adds that the absence of this factor *may*, but does not necessarily, indicate a security. Presumably if the historical indication is absent, as where a new enterprise is involved, the Commissioner would be willing to substitute some other indication that success is imminent.

In the third paragraph the Commissioner emphasizes the ability of the franchisor's organization to provide the promised benefits of the franchising program.

Despite the fact that the Attorney General suggested that, "[n]o definite guidelines can be drawn,"[105] and that each method of financing a franchising program should be "examined on its merits,"[106] the Commissioner chose to reduce consideration to three main factors. How precisely he intended the guidelines to be followed is not indicated.

It is submitted that the concern of the Commissioner would be more realistic if, instead of the guidelines stated, the test were as follows: If the franchisor is adequately financed and organized, such that, from past operation or from reasonable economic indications, it appears that the franchisee stands at least a fair chance of realizing the benefits that he bargained for and purchased, then the agreement is not a security. In other cases, it is, if the other elements of a security are present. This type of a test would be consistent with the *Silver Hills* interpretation of the regulatory purpose of the Corporate Securities Law.

VI. CONCLUSION

There are several express categories in which securities are classified; however, if franchise agreements are securities, the great majority come within the category of investment contracts.

Prior to the decision in *Howey*, the components of an investment contract had been variously interpreted by the courts. With the *Howey* decision, however, the elements of an investment contract were

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104 *Id.*
105 49 OPS. CAL. ATT'Y GEN. at 129.
106 *Id.*

clearly defined as a common venture, and the expectation of profits to be derived solely from the efforts of the promoter or a third party. Courts subsequently began applying the second element as two complementary factors. First, they required the expectation of monetary profits. Second, the *Howey* test was broadened by deleting the word "solely" and requiring only profits derived from the efforts of others. This second factor is controlled by the "participation element," termed the chief criterion of an investment contract. Necessarily, when the investor participates, his profits are not derived from the efforts of others. These factors were varied slightly in later decisions as demanded by the particular facts of each case, but generally the rules remained intact.

Fifteen years after *Howey*, the California Supreme Court decided *Silver Hills* in an opinion which stated unequivocally that the expectation of monetary profit was not a requisite element of a security. This represented a significant modification of the *Howey* test. Although *Silver Hills* was not concerned with investment contracts, it is possible to extract the decision's principles and apply them to investment contracts, thereby deriving an alternative to the *Howey* test.

A combination of the *Howey* test and the alternative derived from *Silver Hills* as applied to franchise agreements would require the following before a security is said to be present:

1. A common enterprise,
2. expectation of monetary profit or some other benefit and,
3. either
   a. nonparticipation or,
   b. a double-investment situation where there is a contribution of risk capital, as well as nonparticipation in the franchior's separate business.

In addition, it must appear that the situation falls within the regulatory purpose of the Corporate Securities Law.

Defining the test is difficult, but the real problem is presented in its application. The most troublesome problems concerning franchise agreements are: first, delimiting participation and nonparticipation; second, determining when the double-investment analysis should be applied; and third, discovering when risk capital is present.

In the normal franchise situation, in order to be participating, the buyer should have some discretionary, as opposed to ministerial control.

The determination that the double-investment analysis is appropriate and applicable requires that three conditions coexist: (1) the franchise contract must contemplate that the franchisor is to supply goods and services to the franchisee; (2) it must be found that the buyer intended, or the facts show, that a portion of the money paid to the franchisor be allocated to secure a continued supply of goods and services—that is, the franchisee is investing in the franchisor's business; (3) the franchisee's business must *depend* on the product or service to be supplied.

Even if it is found that the double-investment analysis is applicable, this fact will not be operative unless in addition it is ascertained that the money invested is risk capital. Such a finding necessitates a definitional interpretation of the phrase. Although the meaning is not delineated in *Silver Hills*, a clear construction is required to facilitate the application of the concept to franchise agreements. Analysis suggests that risk capital should be accepted as denoting money invested with less than a fair chance of success. Evaluation of the chances of success should be made with reference to circumstances such as the financial structure of the franchisor's business, the ratio of money to be invested by the franchisor as compared to that invested by the franchisee, the history of the franchisor's operation, the general economic conditions of the industry, and any other pertinent indications that may predict either imminent success or failure.

Where determinations are made such that all of the tests are satisfied, an investment contract exists, and additionally, should the situation fall within the regulatory purpose of the act, a security exists. This purpose is fulfilled if there is an offer to the public at large, with the investor taking a passive position in the franchisor's business, and the offeror intending to conduct the enterprise with the franchisee's money. Where the suggested test is satisfied, these features will ordinarily be present.

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