CHAPTER 35

Sole Proprietorships and Franchises

Anyone who starts a business must first decide which form of business organization will be most appropriate for the new endeavor. In making this decision, the **entrepreneur** (one who initiates and assumes the financial risk of a new enterprise) needs to consider a number of factors, especially (1) ease of creation, (2) the liability of the owners, (3) tax considerations, and (4) the need for capital. In studying this unit, keep these factors in mind as you read about the various business organizational forms available to entrepreneurs. You may also find it helpful to refer to Exhibit 40–4 on pages 831 and 832 in Chapter 40, which compares the major business forms in use today with respect to these and other factors.

Traditionally, entrepreneurs have relied on three major business forms—the sole proprietorship, the partnership, and the corporation. In this chapter, we examine the sole proprietorship and the franchise, which, though not really a separate business organizational form, is widely used today by entrepreneurs. In Chapter 36, we will examine the second major traditional business form, the partnership, as well as some newer variations on partnerships. The third major traditional form—the corporation—will be discussed in detail in Chapters 38 through 41. We will also look at the limited liability company (LLC), a relatively new and increasingly popular form of business enterprise, and other special forms of business in Chapter 37. We conclude this unit with a chapter (Chapter 42) discussing practical legal information that all businesspersons should know, particularly those operating small businesses.

SECTION 1 Sole Proprietorships

The simplest form of business is a **sole proprietorship.** In this form, the owner is the business; thus, anyone who does business without creating a separate business organization has a sole proprietorship. More than two-thirds of all American businesses are sole proprietorships. They are usually small enterprises—about 99 percent of the sole proprietorships in the United States have revenues of less than $1 million per year. Sole proprietors can own and manage any type of business from an informal, home-office undertaking to a large restaurant or construction firm.

Advantages of the Sole Proprietorship

A major advantage of the sole proprietorship is that the proprietor owns the entire business and receives all of the profits (because she or he assumes all of the risk). In addition, starting a sole proprietorship is often easier and less costly than starting any other kind of business, as few legal formalities are required.[1] No documents need to be filed with the government to start a sole proprietorship (though a state business license may be required to operate certain businesses).

This type of business organization also provides more flexibility than does a partnership or a corporation. The sole proprietor is free to make any decision he or she wishes concerning the business—such as whom to hire, when to take a vacation, and what kind of business to pursue. In addition, the proprietor can sell or transfer all or part of the business to another

1. Although starting a sole proprietorship involves fewer legal formalities than other business organizational forms, even small sole proprietorships may need to comply with zoning requirements, obtain licenses, and the like.

party at any time and does not need approval from anyone else (as would be required from partners in a partnership or normally from shareholders in a corporation).

A sole proprietor pays only personal income taxes (including Social Security and Medicare taxes) on the business's profits, which are reported as personal income on the proprietor's personal income tax return. Sole proprietors are also allowed to establish certain tax-exempt retirement accounts.

Disadvantages of the Sole Proprietorship

The major disadvantage of the sole proprietorship is that, as sole owner, the proprietor alone bears the burden of any losses or liabilities incurred by the business enterprise. In other words, the sole proprietor has unlimited liability, or legal responsibility, for all obligations that arise in doing business. Any lawsuit against the business or its employees can lead to unlimited personal liability for the owner of a sole proprietorship. Creditors can go after the owner's personal assets to satisfy any business debts. This unlimited liability is a major factor to be considered in choosing a business form.

The sole proprietorship also has the disadvantage of lacking continuity on the death of the proprietor. When the owner dies, so does the business—it is automatically dissolved. Another disadvantage is that in raising capital, the proprietor is limited to his or her personal funds and any personal loans that he or she can obtain.

The personal liability of the owner of a sole proprietorship was at issue in the following case. The case involved the federal Cable Communications Act, which prohibits a commercial establishment from broadcasting television programs to its patrons without authorization. The court had to decide whether the owner of a sole proprietorship that installed a satellite television system was personally liable for violating this act by identifying a restaurant as a "residence" for billing purposes.

CASE 35.1 Garden City Boxing Club, Inc. v. Dominguez

United States District Court, Northern District of Illinois, Eastern Division, 2006. __ F.Supp.2d __.

Background and Facts Garden City Boxing Club, Inc. (GCB), which is based in San Jose, California, owned the exclusive right to broadcast via closed-circuit television several prizefights, including the match between Oscar De La Hoya and Fernando Vargas on September 14, 2002. GCB sold the right to receive the broadcasts to bars and other commercial venues. The fee was $20 multiplied by an establishment's maximum fire code occupancy. Antenas Enterprises in Chicago, Illinois, sells and installs satellite television systems under a contract with DISH Network. After installing a system, Antenas sends the buyer's address and other identifying information to DISH. In January 2002, Luis Garcia, an Antenas employee, identified a new customer as Jose Melendez at 220 Hawthorn Commons in Vernon Hills. The address was a restaurant—Mundelein Burrito—but Garcia designated the account as residential. Mundelein's patrons watched the De La Hoya–Vargas match on September 14, as well as three other fights on other dates, for which the restaurant paid only the residential rate to DISH and nothing to GCB. GCB filed a suit in a federal district court against Luis Dominguez, the sole proprietor of Antenas, to collect the fee.

IN THE LANGUAGE OF THE COURT
LEINENWEBER, J. [Judge]

* * * *

Section 605(a) [of the Cable Communications Act] states "[a]n authorized intermediary of a communication violates the Act when it divulges communication through an electronic channel to one other than the addressee." Mundelein Burrito was clearly a commercial establishment. The structure of the building, an exterior identification sign, and its location in a strip mall made this obvious. Mundelein Burrito paid only the residential fee for the four fights it broadcast to its patrons. It was not an authorized addressee of any of the four fights. By improperly listing

CASE CONTINUES

CASE 35.1 CONTINUED

Mundelein Burrito as a residence, Antenas Enterprises allowed the unauthorized broadcast of the Event, and three additional fights, to Mundelein Burrito. Antenas Enterprises is liable under [Section] 605 of the Act.

* * * *

The unauthorized broadcast of the four separate events deprived GCB of the full value of its business investment. * * * [Under the Cable Communications Act] an aggrieved party * * * may recover an award of damages "for each violation of [Section 605(a)] involved in the action in a sum of not less than $1,000 or more than $10,000, as the court considers just." If the violation was willful and for purposes of commercial advantage or private financial gain, the court in its discretion may increase the award of damages—by an amount not more than $100,000. The court must award attorneys' fees to the prevailing party.

GCB argues that the Antenas Enterprises failure to properly list Mundelein Burrito resulted in four separate violations. According to the license fee charged for each of the four fights that were illegally broadcast by Mundelein Burrito, the proper amount would have been $20.00 times the maximum fire code occupancy (46) or $3,680.00. Instead, due to the improper identification of the account as residential, Mundelein Burrito paid only $184.40 to broadcast the four events. GCB did not receive any of the $184.40. * * *

* * * [Considering] the willfulness of the defendant's conduct and the deterrent value of the sanction imposed * * * twice the amount of actual damages is reasonable for this case. Therefore, Antenas Enterprises is liable to GCB for the sum of $7,360.00. Pursuant to the Act, GCB is also entitled to reasonable attorneys' fees. * * *

* * * *

GCB argues Luis Dominguez is personally liable for Antenas Enterprises' violation of [Section] 605 of the Act. The term "person" in the Act means an "individual, partnership, association, joint stock company, trust, corporation or governmental entity."

Antenas Enterprises is a sole proprietorship, owned by Dominguez. *A sole proprietor is personally responsible for actions committed by his employees within the scope of their employment.* Accordingly, Dominguez is personally liable for the damages caused by the violation of [Section] 605 of the Act. [Emphasis added.]

Decision and Remedy *The court issued a summary judgment in GCB's favor, holding that the plaintiff was entitled to the amount of Mundelein's fee, for which Dominguez was personally liable, plus damages and attorneys' fees.*

What If the Facts Were Different? *If Mundelein had identified itself as a residence when ordering the satellite system, how might the result in this case have been different?*

The Global Dimension *Because the Internet has made it possible for sole proprietorships to do business worldwide without greatly increasing their costs, should they be considered, for some purposes, the equivalent of other business forms? Why or why not?*

SECTION 2 Franchises

Instead of setting up a business form for marketing their own products or services, many entrepreneurs opt to purchase a franchise. A **franchise** is an arrangement in which the owner of a trademark, a trade name, or a copyright licenses others to use the trademark, trade name, or copyright in the selling of goods or services. A **franchisee** (a purchaser of a franchise) is generally legally independent of the **franchisor** (the seller of the franchise). At the same time, the franchise is economically dependent on the franchisor's integrated business system. In other words, a franchisee can operate as an independent businessperson but still obtain the advantages of a regional or national organization. Today, franchising companies and their franchisees account for a significant portion of all retail sales in this country. Well-known franchises include McDonald's, 7-Eleven, and Holiday Inn.

Types of Franchises

Many different kinds of businesses now sell franchises, and numerous types of franchises are available. Generally, though, franchises fall into one of three classifications: distributorships, chain-style business operations, and manufacturing or processing-plant arrangements.

Distributorship With a *distributorship,* a manufacturing concern (franchisor) licenses a dealer (franchisee) to sell its product. Often, a distributorship covers an exclusive territory. An example is an automobile dealership or beer distributorship, such as Anheuser-Busch.

Chain-Style Business Operation In a *chain-style business operation,* a franchise operates under a franchisor's trade name and is identified as a member of a select group of dealers that engage in the franchisor's business. The franchisee is generally required to follow standardized or prescribed methods of operation. Often, the franchisor insists that the franchisee maintain certain standards of performance. In addition, the franchisee may be required to obtain materials and supplies exclusively from the franchisor. McDonald's and most other fast-food chains are examples of this type of franchise. Chain-style franchises are also common in service-related businesses, including real estate brokerage firms, such as Century 21, and tax-preparing services, such as H & R Block, Inc.

A Manufacturing or Processing-Plant Arrangement With a *manufacturing* or *processing-plant arrangement,* the franchisor transmits to the franchisee the essential ingredients or formula to make a particular product. The franchisee then markets the product either at wholesale or at retail in accordance with the franchisor's standards. Examples of this type of franchise include Coca-Cola and other soft-drink bottling companies.

Laws Governing Franchising

Because a franchise relationship is primarily a contractual relationship, it is governed by contract law. If the franchise exists primarily for the sale of products manufactured by the franchisor, the law governing sales contracts as expressed in Article 2 of the Uniform Commercial Code applies (see Chapters 20 through 23). Additionally, the federal government and most states have enacted laws governing certain aspects of franchising. Generally, these laws are designed to protect prospective franchisees from dishonest franchisors and to prevent franchisors from terminating franchises without good cause.

Federal Regulation of Franchises in Certain Industries The federal government has enacted laws that protect franchisees in certain industries, such as automobile dealerships and service stations. These laws protect the franchisee from unreasonable demands and bad faith terminations of the franchise by the franchisor. If an automobile manufacturer–franchisor terminates a franchise because of a dealer-franchisee's failure to comply with unreasonable demands (for example, failure to attain an unrealistically high sales quota), the manufacturer may be liable for damages.[2] Similarly, federal law prescribes the conditions under which a franchisor of service stations can terminate the franchise.[3] Federal antitrust laws (to be discussed in Chapter 46) also apply in certain circumstances to prohibit certain types of anticompetitive agreements.

The Franchise Rule In 1978, the Federal Trade Commission (FTC) issued the Franchise Rule, which requires franchisors to disclose material facts that a prospective franchisee needs to make an informed decision concerning the purchase of a franchise.[4] The rule was designed to enable potential franchisees to weigh the risks and benefits of an investment. Basically, the rule requires the franchisor to make numerous written disclosures to prospective franchisees.

For example, a franchisor is required to disclose whether the projected earnings figures are based on actual data or hypothetical examples. If a franchisor makes sales or earnings projections based on actual data for a specific franchise location, the franchisor must disclose the number and percentage of its actual franchises that have achieved this result. All representations made to a prospective franchisee must have a reasonable basis. Franchisors are also required to explain termination, cancellation, and renewal provisions of the franchise contract to potential franchisees before the agreement is signed. Those who violate the Franchise Rule are subject to substantial civil penalties, and the FTC can sue on behalf of injured parties to recover damages.

Amendments to the Franchise Rule that went into effect in July 2007 allow franchisors to provide disclosure documents via the Internet as long as they meet certain requirements. For example, prospective

2. Automobile Dealers' Franchise Act of 1965, also known as the Automobile Dealers' Day in Court Act, 15 U.S.C. Sections 1221 *et seq.*

3. Petroleum Marketing Practices Act (PMPA) of 1979, 15 U.S.C. Sections 2801 *et seq.*

4. 16 C.F.R. Section 436.1.

franchisees must be able to download or save all electronic disclosure documents. The amendments also bring the federal rule into closer alignment with state franchise disclosure laws (discussed next) and require additional disclosures on lawsuits that the franchisor has filed against franchisees and settlement agreements that it has entered into with them.

State Protection for Franchisees State legislation varies but often is aimed at protecting franchisees from unfair practices and bad faith terminations by franchisors. Approximately fifteen states have laws similar to the federal rules requiring franchisors to provide presale disclosures to prospective franchisees.[5] Some states also require a disclosure document (known as a *Uniform Franchise Offering Circular*, or UFOC) to be filed with a state official. To protect franchisees, a state law might require the disclosure of information such as the actual costs of operation, recurring expenses, and profits earned, along with facts substantiating these figures. To protect franchisees against arbitrary or bad faith terminations, the law might also require that certain procedures be followed in terminating a franchising relationship. State deceptive trade practices acts (see Chapter 44) may also prohibit certain types of actions on the part of franchisors.

For example, the Illinois Franchise Disclosure Act prohibits any untrue statement of a material fact in connection with the offer or sale of any franchise. If Miyamoto, a franchisor of bagel stores, understates the start-up costs and exaggerates the anticipated yearly profits from operating a bagel shop to a franchisee, he has violated state law.[6]

The Franchise Contract

The franchise relationship is defined by a contract between the franchisor and the franchisee. The franchise contract specifies the terms and conditions of the franchise and spells out the rights and duties of the franchisor and the franchisee. If either party fails to perform its contractual duties, that party may be subject to a lawsuit for breach of contract. Furthermore, if a franchisee is induced to enter into a franchise contract by the franchisor's fraudulent misrepresentation, the franchisor may be liable for damages. Generally, statutes and the case law governing franchising tend to emphasize the importance of good faith and fair dealing in franchise relationships.

Because each type of franchise relationship has its own characteristics, it is difficult to describe the broad range of details a franchising contract may include. We look next at some of the major issues that typically are addressed in a franchise contract.

Payment for the Franchise The franchisee ordinarily pays an initial fee or lump-sum price for the franchise license (the privilege of being granted a franchise). This fee is separate from the various products that the franchisee purchases from or through the franchisor. In some industries, the franchisor relies heavily on the initial sale of the franchise for realizing a profit. In other industries, the continued dealing between the parties brings profit to both. In most situations, the franchisor receives a stated percentage of the annual sales or annual volume of business done by the franchisee. The franchise agreement may also require the franchisee to pay a percentage of the franchisor's advertising costs and certain administrative expenses.

Business Premises The franchise agreement may specify whether the premises for the business must be leased or purchased outright. Sometimes, a building must be constructed to meet the terms of the agreement. Certainly, the agreement will specify whether the franchisor or the franchisee is responsible for supplying equipment and furnishings for the premises.

Location of the Franchise Typically, the franchisor determines the territory to be served. Some franchise contracts give the franchisee exclusive rights, or "territorial rights," to a certain geographic area. Other franchise contracts, while defining the territory allotted to a particular franchise, either specifically state that the franchise is nonexclusive or are silent on the issue of territorial rights.

Many franchise cases involve disputes over territorial rights, and the implied covenant of good faith and fair dealing often comes into play in this area of franchising. Suppose that the franchise contract either does not give the franchisee exclusive territorial rights or is silent on the issue. If the franchisor allows a competing franchise to be established nearby, the first franchisee may suffer a significant loss in profits. In this situation, a court may hold that the franchisor's actions

5. These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.
6. *Bixby's Food Systems, Inc. v. McKay*, 193 F.Supp.2d 1053 (N.D.Ill. 2002).

breached an implied covenant of good faith and fair dealing.

Business Organization The franchisee's business organization is of great concern to the franchisor. As part of the franchise agreement, the franchisor may require that the business have a particular form and capital structure. The franchise agreement may also provide standards of operation in such aspects of the business as sales quotas, quality, and record keeping. Additionally, a franchisor may retain stringent control over the training of personnel involved in the operation and over administrative aspects of the business.

Quality Control Although the day-to-day operation of the franchise business normally is left up to the franchisee, the franchise agreement may provide for some degree of supervision and control by the franchisor so that it can protect the franchise's name and reputation. When the franchise is a service operation, such as a motel, the contract often states that the franchisor will establish certain standards for the facility and will be permitted to make periodic inspections to ensure that the standards are being maintained.

As a general rule, the validity of a provision permitting the franchisor to establish and enforce certain quality standards is unquestioned. Because the franchisor has a legitimate interest in maintaining the quality of the product or service to protect its name and reputation, it can exercise greater control in this area than would otherwise be tolerated. Increasingly, however, franchisors are finding that if they exercise too much control over the operations of their franchisees, they may incur *vicarious (indirect) liability* under agency theory for the acts of their franchisees' employees (see Chapter 32). The actual exercise of control, or at least the right to control, is the key consideration. If the franchisee controls the day-to-day operations of the business to a significant degree, the franchisor may be able to avoid liability, as the following case illustrates.

EXTENDED CASE 35.2 Kerl v. Dennis Rasmussen, Inc.

Wisconsin Supreme Court, 2004. 2004 WI 86, 273 Wis.2d 106, 682 N.W.2d 328.

***DIANE S. SYKES*, J. [Justice]**

* * * *

* * * [On June 11, 1999] Harvey Pierce ambushed and shot Robin Kerl and her fiancé David Jones in the parking lot of a Madison [Wisconsin] Wal-Mart where Kerl and Jones worked. Kerl was seriously injured in the shooting, and Jones was killed. Pierce, who was Kerl's former boyfriend, then shot and killed himself. At the time of the shooting, Pierce was a work-release inmate at the Dane County jail who was employed at a nearby Arby's [Inc.] restaurant operated by Dennis Rasmussen, Inc. ("DRI"). Pierce had left work without permission at the time of the attempted murder and murder/suicide.

Kerl and Jones' estate sued DRI and Arby's, Inc. [in a Wisconsin state court.] * * * [T]he plaintiffs alleged that Arby's is vicariously [endured for someone else] liable, as DRI's franchisor, for DRI's negligent supervision of Pierce. The * * * court granted summary judgment in favor of Arby's, concluding that there was no basis for vicarious liability. The [state intermediate] court of appeals affirmed. [The plaintiffs appealed to the Wisconsin Supreme Court.]

Vicarious liability under the doctrine of *respondeat superior* depends upon the existence of a master/servant agency relationship. Vicarious liability under *respondeat superior* is a form of liability without fault—the imposition of liability on an innocent party for the tortious conduct of another based upon the existence of a particularized agency relationship. As such, it is an exception to our fault-based liability system, and is imposed only where the principal has control or the right to control the physical conduct of the agent such that a master/servant relationship can be said to exist.

A franchise is a business format typically characterized by the franchisee's operation of an independent business pursuant to a license to use the franchisor's trademark or trade name. A franchise is ordinarily operated in accordance with a detailed franchise or license agreement designed to protect the integrity of the trademark by setting uniform quality, marketing, and operational standards applicable to the franchise.

CASE CONTINUES

CASE 35.2 CONTINUED

The rationale for vicarious liability becomes somewhat attenuated [weak] when applied to the franchise relationship, and vicarious liability premised upon the existence of a master/servant relationship is conceptually difficult to adapt to the franchising context. If the operational standards included in the typical franchise agreement for the protection of the franchisor's trademark were broadly construed as capable of meeting the "control or right to control" test that is generally used to determine *respondeat superior* liability, then franchisors would almost always be exposed to vicarious liability for the torts of their franchisees. We see no justification for such a broad rule of franchisor vicarious liability. If vicarious liability is to be imposed against franchisors, a more precisely focused test is required. [Emphasis added.]

* * * *

Applying these principles here, we conclude that Arby's did not have control or the right to control the day-to-day operation of the specific aspect of DRI's business that is alleged to have caused the plaintiffs' harm, that is, DRI's supervision of its employees. We note first that the license agreement between Arby's and DRI contains a provision that disclaims any agency relationship. * * *

The license agreement contains a plethora [a large number] of general controls on the operation of DRI's restaurant * * *.

These provisions in the license agreement are consistent with the quality and operational standards commonly contained in franchise agreements to achieve product and marketing uniformity and to protect the franchisor's trademark. They are insufficient to establish a master/servant relationship. More particularly, they do not establish that Arby's controlled or had the right to control DRI's hiring and supervision of employees, which is the aspect of DRI's business that is alleged to have caused the plaintiffs' harm.

The agreement's provisions regarding the specific issue of personnel are broad and general. * * *

By the terms of this agreement, DRI has sole control over the hiring and supervision of its employees. Arby's could not step in and take over the management of DRI's employees. * * * Accordingly, we agree with the court of appeals and the [trial] court that there is no genuine issue of material fact as to whether DRI is Arby's servant for purposes of the plaintiffs' *respondeat superior* claim against Arby's: clearly it is not. Arby's cannot be held vicariously liable for DRI's alleged negligent supervision of Pierce.

* * * *

We conclude that the quality, marketing, and operational standards and inspection and termination rights commonly included in franchise agreements do not establish the close supervisory control or right of control over a franchisee necessary to support imposing vicarious liability against the franchisor for all purposes or as a general matter. We hold that *a franchisor may be subject to vicarious liability for the tortious conduct of its franchisee only if the franchisor had control or a right of control over the daily operation of the specific aspect of the franchisee's business that is alleged to have caused the harm.* Because Arby's did not have control or a right of control over DRI's supervision of its employees, there was no master/servant relationship between Arby's and DRI for purposes of the plaintiffs' *respondeat superior* claim against Arby's. Arby's cannot be held vicariously liable for DRI's negligent supervision of Pierce. [Emphasis added.]

The decision of the court of appeals is affirmed.

QUESTIONS

1. Should a franchisor be allowed to control the operation of its franchisee without liability for the franchisee's conduct? Explain your answer.
2. What would constitute the "right to control" under a franchise contract?

Pricing Arrangements Franchises provide the franchisor with an outlet for the firm's goods and services. Depending on the nature of the business, the franchisor may require the franchisee to purchase certain supplies from the franchisor at an established price.[7] A franchisor cannot, however, set the prices at which the franchisee will resell the goods because such price setting may be a violation of state or federal antitrust laws, or both. A franchisor can suggest retail prices but cannot mandate them.

SECTION 3 Franchise Termination

The duration of the franchise is a matter to be determined between the parties. Generally, a franchise relationship starts with a short trial period, such as a year, so that the franchisee and the franchisor can determine whether they want to stay in business with one another. Usually, the franchise agreement specifies that termination must be "for cause," such as the death or disability of the franchisee, insolvency of the franchisee, breach of the franchise agreement, or failure to meet specified sales quotas. Most franchise contracts provide that notice of termination must be given. If no set time for termination is specified, then a reasonable time, with notice, is implied. A franchisee must be given reasonable time to wind up the business—that is, to do the accounting and return the copyright or trademark or any other property of the franchisor.

7. Although a franchisor can require franchisees to purchase supplies from it, requiring a franchisee to purchase exclusively from the franchisor may violate federal antitrust laws (see Chapter 46). For two landmark cases in these areas, see *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 87 S.Ct. 1956, 18 L.Ed.2d 1249 (1967); and *Fortner Enterprises, Inc. v. U.S. Steel Corp.*, 394 U.S. 495, 89 S.Ct. 1252, 22 L.Ed.2d 495 (1969).

Wrongful Termination

Because a franchisor's termination of a franchise often has adverse consequences for the franchisee, much franchise litigation involves claims of wrongful termination. Generally, the termination provisions of contracts are more favorable to the franchisor than to the franchisee. This means that the franchisee, who normally invests a substantial amount of time and financial resources in making the franchise operation successful, may receive little or nothing for the business on termination. The franchisor owns the trademark and hence the business.

It is in this area that statutory and case law become important. The federal and state laws discussed earlier attempt, among other things, to protect franchisees from the arbitrary or unfair termination of their franchises by the franchisors. Generally, both statutory and case law emphasize the importance of good faith and fair dealing in terminating a franchise relationship.

The Importance of Good Faith and Fair Dealing

In determining whether a franchisor has acted in good faith when terminating a franchise agreement, the courts generally try to balance the rights of both parties. If a court perceives that a franchisor has arbitrarily or unfairly terminated a franchise, the franchisee will be provided with a remedy for wrongful termination. If a franchisor's decision to terminate a franchise was made in the normal course of the franchisor's business operations, however, and reasonable notice of termination was given to the franchisee, normally a court will not consider the termination wrongful.

At issue in the following case was whether General Motors Corporation acted wrongfully in terminating its franchise with a motor vehicle dealer in Connecticut.

CASE 35.3 Chic Miller's Chevrolet, Inc. v. General Motors Corp.

United States District Court, District of Connecticut, 2005. 352 F.Supp.2d 251.

Background and Facts Chapin Miller began work as a mail clerk with General Motors Acceptance Corporation (GMAC). By 1967, Miller had succeeded sufficiently within the organization to acquire Chic Miller's (no relation) Chevrolet, a General Motors Corporation (GM) dealership, in Bristol, Connecticut. As part of its operations, Chic Miller's entered into lending agreements, commonly known as *floor plan financing,* to enable it to buy new vehicles from GM. At first, the dealership had floor plan financing through GMAC. In 2001, however, Miller felt that GMAC was charging interest "at an inappropriately high rate" and negotiated a lower rate from Chase Manhattan Bank. In November 2002, Chase

CASE CONTINUES

CASE 35.3 CONTINUED declined to provide further financing. Unable to obtain a loan from any other lender, Chic Miller's contacted GMAC, which also refused to make a deal. Under the parties' "Dealer Sales and Service Agreement," GM could terminate a dealership for "Failure of Dealer to maintain the line of credit." GM sent several notices of termination, but Chic Miller's remained open until March 2004, when it closed for seven days. GM sent a final termination notice. Chic Miller's filed a suit in a federal district court against GM, alleging, among other things, a failure to act in good faith in terminating the franchise. GM filed a motion for summary judgment.

IN THE LANGUAGE OF THE COURT
***ARTERTON*, District Judge.**

* * * *

* * * [T]here is no dispute of material fact concerning Chic Miller's lack of floor plan financing after November 2002. * * * [T]he dealership contract unambiguously places the burden on the dealer to find and maintain floor plan financing. Without floor plan financing, the plaintiff was in clear breach of * * * the dealership contract, justifying GM's termination of the contract * * * .

* * * *

In order to lawfully terminate a franchise under the Connecticut [Franchise Act, which applies in this case], a franchisor must: provide notice that complies with statutory requirements; have "good cause" for the termination; and act "in good faith." [Emphasis added.]

"Good cause" exists [under the statute] if "[t]here is a failure by the dealer to comply with a provision of the franchise which is both reasonable and of material significance to the franchise relationship * * * ." According to James Ragsdale, Northeast Region Zone Manager for GM, floor plan financing is a material aspect of a dealership agreement because "without floor plan financing, a dealership is unable to purchase motor vehicle inventory, which, in turn, severely limits a dealership's ability to earn income from vehicle sales. * * * If a dealership is without floor plan financing for an extended period of time, it will eventually lose its ability to generate revenues and become financially insolvent, and will not be able to conduct customary sales and service operations." Miller does not dispute that floor plan financing is a material term of his franchise contract with GM. As discussed above, GM was justified under the contract in terminating Miller's franchise for failure to maintain floor plan financing. Because that term is material to the agreement, GM had "good cause" under the Connecticut dealer statute for terminating the franchise because of Miller's uncured breach.

GM also had good cause to terminate the contract because it has shown that Chic Miller's Chevrolet failed to conduct customary sales and service operations between March 1 and March 8, 2004. A sign posted on the door of the dealership during that time stated: "CHIC MILLER'S CHEVROLET IS CLOSED. Please bring your vehicle to the dealer of your choice. Thank you for your past patronage." Although Miller asserts that the dealership was only temporarily closed for repair, the sign does not say that the dealership would reopen, and the phrases "bring your vehicle to the dealer of your choice" and "thank you for your past patronage" certainly suggest permanent closure * * * . [T]he dealership contract permits GM to terminate the agreement for "[f]ailure of the Dealer to conduct customary sales and service operations during customary business hours for seven consecutive business days." Since that term is material to the agreement, GM had "good cause" under the Connecticut dealer statute for terminating the franchise because of Plaintiff's breach.

Chic Miller's Chevrolet alleges that by "prematurely seeking the ultimate remedy of termination of the dealership franchise, the Defendant has not acted in good faith * * * ." The undisputed record shows that GM extended the period several times for Miller to try to obtain replacement floor plan financing after his arrangement with Chase ended. GM first notified Plaintiff of its breach of the dealership contract on December 20, 2002, with an amended notice on January 2, 2003 * * * . [O]n March 7, 2003, GM extended the deadline until March 31, and when Miller was still unable to find a lender, GM gave him another extension until July 1. * * * While Miller may have expected, based on GM's past practices, more than GM provided to him, Miller has not offered evidence to show that GM was acting "prematurely" or in bad faith during the course of the dealings recounted above.

* * * *

CASE 35.3 CONTINUED

Because Plaintiff has not offered evidence from which a factfinder could conclude that GM acted without good cause or good faith, GM is entitled to judgment as a matter of law on Plaintiff's claims under the Connecticut Franchise Act.

Decision and Remedy *The court granted GM's motion for summary judgment. GM acted in good faith, with good cause under the applicable state statute to terminate Chic Miller's franchise. The dealer failed to maintain floor plan financing, a material requirement under the franchise agreement. The dealer also failed to conduct sales and service operations for seven consecutive business days, another material requirement under the parties' contract.*

What If the Facts Were Different? *Suppose that in March 2004, Chic Miller's had placed one newspaper ad promoting its services and had sold one car. Would the result have been different?*

The Global Dimension *Should General Motors Corporation, or any domestic franchisor, be allowed to impose different contract terms on franchisees in foreign countries than it does on franchisees in the United States? Why or why not?*

REVIEWING Sole Proprietorships and Franchises

Carlos Del Rey decided to open a Mexican fast-food restaurant and signed a franchise contract with a national chain called La Grande Enchilada. The contract required the franchisee to strictly follow the franchisor's operating manual and stated that failure to do so would be grounds for terminating the franchise contract. The manual set forth detailed operating procedures and safety standards, and provided that a La Grande Enchilada representative would inspect the restaurant monthly to ensure compliance. Nine months after Del Rey began operating his restaurant, a spark from the grill ignited an oily towel in the kitchen. No one was injured, but by the time firefighters were able to put out the fire, the kitchen had sustained extensive damage. The cook told the fire department that the towel was "about two feet from the grill" when it caught fire, which was in compliance with the franchisor's manual that required towels be placed at least one foot from the grills. Nevertheless, the next day La Grande Enchilada notified Del Rey that his franchise would terminate in thirty days for failure to follow the prescribed safety procedures. Using the information presented in the chapter, answer the following questions.

1. What type of franchise was Del Rey's La Grande Enchilada restaurant?
2. If Del Rey operates the restaurant as a sole proprietorship, who bears the loss for the damaged kitchen? Explain.
3. Assume that Del Rey files a lawsuit against La Grande Enchilada, claiming that his franchise was wrongfully terminated. What is the main factor that a court would consider in determining whether the franchise was wrongfully terminated?
4. Would a court be likely to rule that La Grande Enchilada had good cause to terminate Del Rey's franchise in this situation? Why or why not?

TERMS AND CONCEPTS

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QUESTIONS AND CASE PROBLEMS

35-1. Maria, Pablo, and Vicky are recent college graduates who would like to go into business for themselves. They are considering purchasing a franchise. If they enter into a franchising arrangement, they would have the support of a large company that could answer any questions they might have. Also, a firm that has been in business for many years would be experienced in dealing with some of the problems that novice businesspersons might encounter. These and other attributes of franchises can lessen some of the risks of the marketplace. What other aspects of franchising—positive and negative—should Maria, Pablo, and Vicky consider before committing themselves to a particular franchise?

35-2. QUESTION WITH SAMPLE ANSWER

National Foods, Inc., sells franchises to its fast-food restaurants, known as Chicky-D's. Under the franchise agreement, franchisees agree to hire and train employees strictly according to Chicky-D's standards. Chicky-D's regional supervisors are required to approve all job candidates before they are hired and all general policies affecting those employees. Chicky-D's reserves the right to terminate a franchise for violating the franchisor's rules. In practice, however, Chicky-D's regional supervisors routinely approve new employees and individual franchisees' policies. After several incidents of racist comments and conduct by Tim, a recently hired assistant manager at a Chicky-D's, Sharon, a counterperson at the restaurant, resigns. Sharon files a suit in a federal district court against National. National files a motion for summary judgment, arguing that it is not liable for harassment by franchise employees. Will the court grant National's motion? Why or why not?

- **For a sample answer to Question 35-2, go to Appendix I at the end of this text.**

35-3. Otmar has secured a particular high-quality ice cream franchise. The franchise agreement calls for Otmar to sell the ice cream only at a specific location; to buy all the ice cream from the franchisor; to order and sell all the flavors produced by the franchisor; and to refrain from selling any ice cream stored for more than two weeks after delivery by the franchisor, as the quality of the ice cream declines after that period of time. After two months of operation, Otmar believes that he can increase his profits by moving the store to another part of the city. He refuses to order even a limited quantity of the "fruit delight" flavor because of its higher cost, and he has sold ice cream that has been stored longer than two weeks without customer complaint. Otmar maintains that the franchisor has no right to restrict him in these practices. Discuss his claims.

35-4. Omega Computers, Inc., is a franchisor that grants exclusive geographic territories to its franchisees with retail locations, including Pete's Digital Products. After selling more than two hundred franchises, Omega establishes an interactive Web site. On the site, a customer can order Omega's products directly from the franchisor. When Pete's sets up a Web site through which a customer can also order Omega's products, Omega and Pete's file suits against each other, each alleging that the other is in violation of the franchise agreement. To decide this issue, what factors should the court consider? How might the parties have avoided this conflict? Discuss.

35-5. Franchise Termination. In 1985, Bruce Byrne, with his sons Scott and Gordon, opened Lone Star R.V. Sales, Inc., a motor home dealership in Houston, Texas. In 1994, Lone Star became a franchised dealer for Winnebago Industries, Inc., a manufacturer of recreational vehicles. The parties renewed the franchise in 1995, but during the next year, their relationship began to deteriorate. Lone Star did not maintain a current inventory, its sales did not meet the goals agreed to by the parties, and Lone Star disparaged Winnebago products to consumers and otherwise failed to actively promote them. Several times, the Byrnes subjected Winnebago employees to verbal abuse. During one phone conversation, Bruce threatened to throw a certain Winnebago sales manager off Lone Star's lot if he appeared at the dealership. Bruce was physically incapable of carrying out the threat, however. In 1998, Winnebago terminated the franchise, claiming, among many other things, that it was concerned for the safety of its employees. Lone Star filed a protest with the Texas Motor Vehicle Board. Did Winnebago have good cause to terminate Lone Star's franchise? Discuss. [*Lone Star R.V. Sales, Inc. v. Motor Vehicle Board of the Texas Department of Transportation,* 49 S.W.3d 492 (Tex.App.—Austin 2001)]

35-6. Franchise Termination. In the automobile industry, luxury-car customers are considered the most demanding segment of the market with respect to customer service. Jaguar Cars, a division of Ford Motor Co., is the exclusive U.S. distributor of Jaguar luxury cars. Jaguar Cars distributes its products through franchised dealers. In April 1999, Dave Ostrem Imports, Inc., an authorized Jaguar dealer in Des Moines, Iowa, contracted to sell its dealership to Midwest Automotive III, LLC. A Jaguar franchise generally cannot be sold without Jaguar Cars' permission. Jaguar Cars asked Midwest Auto to submit three years of customer satisfaction index (CSI) data for all franchises with which its owners had been associated. (CSI data are intended to measure how well dealers treat their customers and satisfy their customers' needs. Jaguar Cars requires above-average CSI ratings for its dealers.) Most of Midwest Auto's scores fell below the national average. Jaguar Cars rejected Midwest Auto's application and sought to terminate the franchise, claiming that a transfer of the dealership would be "substantially detrimental" to the distribution of Jaguar vehicles in the community. Was Jaguar Cars' attempt to terminate this franchise reasonable? Why or why not? [*Midwest Automotive III, LLC v. Iowa Department of Transportation*, 646 N.W.2d 417 (Iowa 2002)]

35-7. CASE PROBLEM WITH SAMPLE ANSWER

Walik Elkhatib, a Palestinian Arab, emigrated to the United States in 1971 and became an American citizen. Eight years later, Elkhatib bought a Dunkin' Donuts, Inc., franchise in Bellwood, Illinois. Dunkin' Donuts began offering breakfast sandwiches with bacon, ham, or sausage through its franchises in 1984, but Elkhatib refused to sell these items at his store on the ground that his religion forbade the handling of pork. In 1995, Elkhatib opened a second franchise in Berkeley, Illinois, at which he also refused to sell pork products. The next year, Elkhatib began selling meatless sandwiches at both locations. In 1998, Elkhatib opened a third franchise in Westchester, Illinois. When he proposed to relocate this franchise, Dunkin' Donuts refused to approve the new location and added that it would not renew any of his franchise agreements because he did not carry the full sandwich line. Elkhatib filed a suit in a federal district court against Dunkin' Donuts and others. The defendants filed a motion for summary judgment. Did Dunkin' Donuts act in good faith in its relationship with Elkhatib? Explain. [*Elkhatib v. Dunkin' Donuts, Inc.*, __ F.Supp.2d __ (N.D.Ill. 2004)]

- **To view a sample answer for Problem 35-7, go to this book's Web site at academic.cengage.com/blaw/clarkson, select "Chapter 35," and click on "Case Problem with Sample Answer."**

35-8. The Franchise Contract. On August 23, 1995, Climaco Guzman entered into a commercial janitorial services franchise agreement with Jan-Pro Cleaning Systems, Inc., in Rhode Island for a franchise fee of $3,285. In the agreement, Jan-Pro promised to furnish Guzman with "one (1) or more customer account(s) . . . amounting to $8,000.00 gross volume per year. . . . No portion of the franchise fee is refundable except and to the extent that the Franchisor, within 120 business days following the date of execution of the Franchise Agreement, fails to provide accounts." By February 19, Guzman had not received any accounts and demanded a full refund. Jan-Pro then promised "two accounts grossing $12,000 per year in income." Despite its assurances, Jan-Pro did not have the ability to furnish accounts that met the requirements. In September, Guzman filed a suit in a Rhode Island state court against Jan-Pro, alleging, in part, fraudulent misrepresentation. Should the court rule in Guzman's favor? Why or why not? [*Guzman v. Jan-Pro Cleaning Systems, Inc.*, 839 A.2d 504 (R.I. 2003)]

35-9. Sole Proprietorship. James Ferguson operates "Jim's 11-E Auto Sales" in Jonesborough, Tennessee, as a sole proprietorship. In 1999, Consumers Insurance Co. issued a policy to "Jim Ferguson, Jim's 11E Auto Sales" covering "Owned 'Autos' Only." *Auto* was defined to include "a land motor vehicle," which was not further explained in the policy. Coverage extended to damage caused by the owner or driver of an underinsured motor vehicle. In 2000, Ferguson bought and titled in his own name a 1976 Harley-Davidson motorcycle, intending to repair and sell the cycle through his dealership. In October 2001, while riding the motorcycle, Ferguson was struck by an auto driven by John Jenkins. Ferguson filed a suit in a Tennessee state court against Jenkins, who was underinsured with respect to Ferguson's medical bills, and Consumers. The insurer argued, among other things, that because the motorcycle was bought and titled in Ferguson's own name, and he was riding it at the time of the accident, it was his personal vehicle and thus was not covered under the dealership's policy. What is the relationship between a sole proprietor and a sole proprietorship? How might this status affect the court's decision in this case? [*Ferguson v. Jenkins*, 204 S.W.3d 779 (Tenn.App. 2006)]

35-10. A QUESTION OF ETHICS

*In August 2004, Ralph Vilardo contacted Travel Center, Inc., in Cincinnati, Ohio, to buy a trip to Florida in December for his family to celebrate his fiftieth wedding anniversary. Vilardo paid $6,900 to David Sheets, the sole proprietor of Travel Center. Vilardo also paid $195 to Sheets for a separate trip to Florida in February 2005. Sheets assured Vilardo that everything was set, but in fact no arrangements were made. Later, two unauthorized charges for travel services totaling $1,182.35 appeared on Vilardo's credit-card statement. Vilardo filed a suit in an Ohio state court against Sheets and his business, alleging, among other things, fraud and violations of the state consumer protection law. Vilardo served Sheets and Travel Center with copies of the complaint, the summons, a request for admissions, and other documents filed with the court, including a motion for summary judgment. Each of these filings asked for a response within a certain time period. Sheets responded once on his own behalf with a denial of all of Vilardo's claims. Travel Center did not respond. [*Vilardo v. Sheets, *__ Ohio App.3d __, __ N.E.2d __ (12 Dist. 2006)]*

(a) Almost four months after Vilardo filed his complaint, Sheets decided that he was unable to adequately represent himself and retained an attorney who asked the court for more time. Should the court grant this request? Why or why not? Ultimately, what should the court rule in this case?

(b) Sheets admitted that "Travel Center, Inc." was a sole proprietorship. He also argued that liability might be imposed on his business but not on himself. How would you rule with respect to this argument? Why? Would there be anything unethical about allowing Sheets to avoid liability on this basis? Explain.

LAW ON THE WEB

For updated links to resources available on the Web, as well as a variety of other materials, visit this text's Web site at

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To learn how the U.S. Small Business Administration assists in forming, financing, and operating businesses, go to

www.sbaonline.sba.gov

For information about FTC regulations on franchising, as well as state laws regulating franchising, go to

www.ftc.gov/bcp/franchise/netfran.htm

A good source of information on the purchase and sale of franchises is Franchising.org, which is online at

www.franchising.org

Legal Research Exercises on the Web

Go to **academic.cengage.com/blaw/clarkson**, the Web site that accompanies this text. Select "Chapter 35" and click on "Internet Exercises." There you will find the following Internet research exercises that you can perform to learn more about the topics covered in this chapter.

Internet Exercise 35–1: Legal Perspective
Starting a Business

Internet Exercise 35–2: Management Perspective
Franchises