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Control without Responsibility: The Legal Creation of Franchising 1960-1980*

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Abstract

While the first business organizations to reach large size in the late nineteenth-century did so through the route of vertical integration—formal ownership of assets and direct employment of workers—mid-twentieth-century franchising firms pioneered a new path to bigness, relying on restrictive contracts rather than formal integration to control their business organizations. Franchised chains replaced formal ownership and employment with contractual mechanisms known as vertical restraints (contractual controls on separate firms, such as price and supplier restrictions) to achieve uniformity and control over their outlets, without directly owning them. While most existing accounts of franchising focus on efficiency reasons for the evolution of the business form, this paper identifies a policy and legal mechanism: the relaxing of antitrust prohibitions on vertical restraints. These policy and legal changes were heavily lobbied for by franchising firms themselves. Whatever the efficiency implications of franchising, the increasing legalization of vertical restraints also had the benefit for franchising firms of allowing them to pull in the legal boundaries of the firm, leaving workers and other stakeholders outside. At the same time that they pursued franchising as a kind of vertical integration by other means, franchisors lobbied to preserve the legal benefits of having franchisees considered separate firms under a variety of laws, such as access to Small Business Administration Loans and exclusion of workers at franchised establishments from access to collective bargaining and other rights against them.

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1 Introduction

While the first capitalist firms to reach large size in the late nineenth and early twentieth century did so through the mechanism of vertical integration—formal ownership of assets and employment of workers—a group of entrepreneuers in the 1950s, concentrated especially in the emerging industry of fast food, pioneered a different route to bigness. This new path deployed highly restrictive "franchise" contracts rather than formal property ownership and employment relationships to bind subordinate units into coherent, centrally controlled business organizations. Under franchise contracts, a large franchisor like McDonald's, rather than owning and operating its retail business operations, licensed legally independent franchisees to do so. Franchisees typically paid a percentage of their sales to the franchisor and signed long-term contracts that gave franchisors substantial control of unit operations.[1] In 2012, the most recent year for which data are available, franchising firms accounted for 7.9 million jobs in the United States, compared to 13.4 million jobs in manufacturing. Franchisors accounted for more than 450,000 establishments, 10.45 percent of all establishments. Sales of franchised chains were about 1.3 trillion dollars in 2007, or 9.2 percent of total U.S. GDP (Kosová and Lafontaine, 2012).

The economic history and business history literature on franchising is surprisingly thin.[2] This paper begins to deepen that history by delving into the concrete struggles franchisors undertook to establish their unique business form. On one hand, franchisors fought against broad antitrust prohibitions on vertical restraints—controls on legally separate firms like price, supplier and customer restrictions. Their eventual victory on this front allowed them

[1]The term franchising is sometimes also used to refer to exclusive dealing relationships between manufacturers and distributors. In this paper I use "business format franchising" to refer to the former type, and "product distribution franchising" to refer to the second type. Since business format franchising is the focus of this paper, the term "franchising" when used alone refers also to the former type.

[2]Several profiles of successful franchisors have been published, including Love (1995) and Shook and Shook (1993). Luxenberg (1986) is a (highly critical) journalistic account of the history of franchising. However, Dicke (1992) is to my knowledge the only scholarly history of this business form. Through case studies of five firms from 1840 to 1980, he explores the form's history by a comparative analysis of the challenges faced by representative franchisors in five industries. Blair and Lafontaine (2010) provide a good overview of the main legal and economic issues involved in franchising.

to follow an alternative path to giant size than that pursued by the vertically integrated firms of the nineteenth and early twentieth century. On the other hand, they persuaded courts and a wide range of regulators that, despite tight control exercised through vertical restraints, franchised chains should not be considered single organizations under labor, tax and other laws. Rather, franchised chains should be understood under these laws as loose constellations of dozens, hundreds or thousands of legally separate organizations, with the central franchisor not ultimately responsible or liable for activity at any of the individual branches.

Franchising thus in a sense redefined the legal boundaries of the firm. What did franchisees gain by pulling in the legal boundaries of the firm? As Nelson Lichtenstein (2017) has argued, twentieth century policymakers created the regulatory law holding firms accountable for the activity they oversaw and controlled with the archetype of the large vertically integrated firm in mind. This meant that the tied legal responsibility and accountability to the formal characteristics of vertical integration: the ownership of assets and employment of workers. While Progessive and New Deal-era regulation worked reasonably well for as long as the relevant economic activity took place within the legal boundaries of such firms, subsequent vertical dis-integration undermined the ability of the public to subject corporations to social control. For example, vertical dis-integration created what David Weil (2014) has called "fissured workplaces," in which the legal boundaries of the firm acted as barriers excluding workers outside it from gaining access to higher wages paid by large firms, internal career ladders, and legal protections (whose coverage remains largely limited to the firm in which the worker has formal employee status).

In litigating and lobbying to pull in the legal boundaries of the firm, franchisors pursuing vertical dis-integration ironically followed in the footsteps of the nineteenth-century manufacturers that created the first vertically integrated large industrial firms. Most economic studies of vertical integration, dis-integration and franchising emphasize technological changes or efficiency considerations as driving the movement to one business structure over

the other (Williamson, 1985; Lamoreaux et al., 2003; Blair and Lafontaine, 2010). However, far from merely responding to technological changes making mass production possible, the first vertically integrated large manufacturing firms actually created, through lobbying and litigation, the very national US market that made it profitable for them to invest in those mass-production technologies in the first place (McCurdy, 1978). Similarly, twentieth-century franchisors, with help from increasingly sympathetic antitrust policymakers, the dynamic Law and Economics movement, and somnolent labor law, used lobbying and litigation to transform an innovative legal structure of fragile legality into an accepted staple of American business.

Franchising allowed firms to escape the legal and regulatory costs and risks that constrained vertically integrated corporations of the earlier era, and many contemporary observers therefore felt that franchisors were unfairly avoiding the law. Donald Conley, the first franchising vice president for McDonald's, who left that position to become a franchisee, testified that "the franchise relationship is so sophisticated that it is not presently regulated by any traditional state or federal law, and has basically become a vehicle for getting around traditional law" (Committee on Commerce, 1976, pp. 390-391). Franchisors had to persuade regulators, legislators, and courts that their business form was new, unique and valuable, and should not be regulated according to existing conceptions of legal relationships.

Franchisors relied on their trade association, the International Franchise Association (IFA), as their main public voice and lobbying vehicle. It has remained the official voice of franchisors from its founding in 1960, as franchisors have grown into some of the largest corporations in the United States. The IFA is the only consistent presence across the two decades of public hearings, litigation, and legislative action over the years 1960-1980. While opponents of the IFA, in particular the various short-lived franchisee associations, appear in the public record one year and disappear the next, the IFA is still active today. Its activities have included lobbying, filing amicus briefs, engaging in public relations, mobilizing its members to lobby state and federal legislators and agencies and, starting in 1978, becoming

one of the early business associations founding a Political Action Committee (PAC). As one journalist reported,"the IFA in its own limited area is an unchallenged force"(Luxenberg, 1986, [p. 243).

2 Vertical Restraints: An Alternative Route to Bigness

According to a study commissioned by the Small Business Administration in 1963, "[t]he legal status of franchising is the dominant problem affecting the future of this method of distribution" (Lewis and Hancock, 1963, 72). To put it bluntly, franchising as we know it in 2018 was not legal in the 1960s. The history of the creation of franchising is in large part the story of the loosening of antitrust restrictions on what are known as *vertical restraints*. These contractual controls on independent franchisees such as price, supplier, and customer restrictions, were the mechanisms franchisors relied on to create the uniform chain-store appearance of their far-flung operations in the absence of formal vertical integration. Without vertical restraints, franchisors would have been forced to directly own and operate outlets to achieve similar chain store levels of uniformity.

In important ways, however, franchising represented, rather than true vertical dis-integration, an alternative path to centralized vertical control. Franchising firms like Burger King sought to tightly control their production networks, setting prices, products, suppliers, menus, recipes and hours of operation, dictating everything from the process for making french fries to the manner in which employees greet customers. They aimed to achieve this, however, without taking title to productive assets or employing workers. As Earl Pollock, a former Antitrust Division attorney and then-Chairman of antitrust programs for the American Bar Association put it in 1973, "integration by contract is a substitute for integration by ownership" (International Franchise Association, 1973, p. 49). From this perspective, *franchising was vertical integration by other means.*

The minute control franchisors sought to impose on franchisees could be intense. As Ray Kroc, the founder of franchisor *par excellence* McDonald's, put it, "the only way we can positively know that these units are doing what they are supposed to do ... is to give them no alternative whatsoever. You can't give them an inch" (Love, 1995, p. 144). To enforce this control, franchisors required franchisees to follow detailed operations manuals incorporated into the franchise contract. These manuals often left little to franchisee discretion.As one bemused regulator complained to an IFA audience in 1976, a certain Mexican food chain's operations manual opened with the three lines, "Put the key in the door," "Open the door," and "Turn on the light" (International Franchise Association, 1976, p. 3).

Franchisors soon faced a problem in replacing property and employment with contract as a means of vertical integration, however: while traditionally antitrust laws allowed centralized control and coordination *within* firms, they prohibited many types of control and coordination *between* them, including vertical price-fixing and other vertical restraints.[3] In particular, many antitrust policymakers believed antitrust laws should protect the independence of small business from domination and control by larger firms through vertical restraints. For example, when Monte Pendleton, President of the IFA, argued in 1965 before the Senate Subcommittee on Antitrust and Monopoly that franchisors should have the *same* ability to impose constraints through contract that vertically integrated corporations could impose through administrative fiat, Jerry Cohen, Chief Counsel to the Subcommittee, was incredulous:

> Then what would be the difference between a franchise operation and an integrated corporation? The argument we get here for franchising is that it allows an independent businessman to be independent. But if he is told what product he has to buy, what prices he has to charge, what operation he has to operate in, then he is no longer independent is he? He is part of an integrated franchisor's operation (Subcommittee on Antitrust and Monopoly, 1965, p. 55).

[3] The function of antitrust law in "allocating economic coordination rights" is developed in much greater detail in Paul (2018)

Cohen, articulating a widely held antitrust principle of the time, felt that franchisors violated the antitrust laws when they constrained the independence of smaller firms through vertical restraints.

Throughout the 1960s and 1970s, antitrust policy moved away from the goal of preserving the independence of small business and towards a consumer welfare standard focused narrowly on maintaining low consumer prices, as economists replaced lawyers as top staffers in the Antitrust Division of the Department of Justice and the Federal Trade Commission in the 1960s (Eisner, 1991). Meanwhile, the Law and Economics movement, which applied anti-regulation University of Chicago economic theories to law, grew increasingly influential within the judiciary. According to Law and Economics doctrines, the proper role of law, especially antitrust law, was to promote economic efficiency rather than social goals like restraining corporate power (Posner, 1973). Law and Economics antitrust theory was especially helpful to franchisors by providing scholarly ammunition to their arguments about vertical contracts, which Law and Economics scholars like Bork (1978) argued should be presumed efficient because firms would not adopt them if they were not. In particular, franchisors (Subcommittee on Antitrust and Monopoly, 1965, written submission of IFA President Monte Pendelton, pp. 456-458) and Law and Economics (Bork, 1966) both argued that vertical restraints, including price-fixing contracts, promoted efficiency by enhancing competition *between* brands even if it hampered competition between franchisees *within* brands.

However, franchisees, many of whom had been lured to franchising by the promise of independent business ownership, often rebelled against vertical restraints. Franchisee frustration with franchisor controls ultimately fueled litigation, in which the courts judged the various vertical restraints in terms of their compliance with antitrust laws. The courts struggled to come to terms with franchising in its initial two decades. In *White Motor* in 1963, the Supreme Court said it did not have enough information about franchising to issue a blanket rule on the legality non-price vertical restraints. This ruling initiated a period of confusing

and sometimes conflicting judicial rulings.[4]

Judicial rulings over vertical restraints reflected a deep divide in legal thinking about antitrust that ran all the way back to the debates over the passage of the Sherman Act itself. Was its goal keeping consumer prices low (the "consumer welfare standard"), as staff economists at the Antitrust Division and FTC, as well as University of Chicago Law and Economics scholars, argued? Or was it meant to restrain the power of big business, including protecting the independence of small business from control by larger corporations, as the antitrust tradition associated with Louis Brandeis held? In the early years of franchising this divide had not yet been resoloved in favor of the consumer welfare standard. At the beginning of the first Congressional hearings addressing the new business form, Senator Philip Hart declared, "About the only area of agreement is that there is disagreement about how the antitrust laws should be applied in this area" (Subcommittee on Antitrust and Monopoly, 1965, p. 2). It would take two decades for franchisors to comfortably establish the legality of their business form under antitrust law.

The courts initially applied antitrust law to franchising in a confused manner, exemplified by the bombshell US Supreme Court decision in *United States v. Arnold, Schwinn & Co* in 1967.[5] *Schwinn* struck down vertical restraints in in bicycle manufacturer Schwinn's contracts with its franchisees that barred franchisees from selling Schwinn bicycles outside their assigned territories. The Court ruled that such vertical restraints were *per se* violations of Section 1 of the Sherman Act, meaning that such contract terms were always illegal no matter the circumstances, and courts would not even listen to evidence justifying them on a case-by-case basis. Nothing dominated the International Franchise Association's annual legal meeting agendas from that date through the 1970s as much as the fallout from *Schwinn* and the IFA's strategy to overturn it. *Schwinn* struck at the heart of franchising by refusing to grant broad antitrust approval to franchisor vertical restraints on franchisees.[6]

[4] *White Motor Co. v. United States*, 372 U.S. 253 (1963).

[5] *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

[6] Price restraints will be addressed in more detail below. Maximum vertical price restraints were *per se* illegal from 1968 to 1997. Minimum vertical price restraints were *per se* illegal from 1911 to 2007.

The ruling put franchising on uncertain legal ground. Over the course of ten years following the *Schwinn* decision, franchisors agonized over whether and how *Schwinn* might apply to them. The Supreme Court created confusion by grounding its decision in the fact that Schwinn franchisees took title to the bicycles, and thereby as the owner had the right to dispose of them free from franchisor vertical interference. According to a narrow interpretation of the majority opinion, the *per se* rule in *Schwinn* only applied to cases where franchisees took title to the franchisor's goods, and did not apply to business format franchisors like Burger King or Jiffy Lube that provided services under a licensed trademark.

The Federal Trade Commission's Ad Hoc Committee on Franchising concluded that the reasoning of *Schwinn* probably did not apply to service or business format franchisors (Ad Hoc Committee on Franchising, 1969). However, others warned that *Schwinn* was the first step in a movement by the courts to protect small business franchisees from large franchisors. Robert Grossman, Chief of Evaluation for the Antitrust Division, warned that the Court "left little doubt as to its desire to preserve the business prerogatives of independent distributors," and was likely to rule against franchisors in future business format franchising cases (International Franchise Association, 1970, p. 73). During this era of antitrust jurisprudence, before the consumer welfare standard and the Law and Economics movement attained ascendancy, the idea of a large corporation controlling and dominating a smaller company still evoked the whiff of antitrust violations. As IFA Chairman Jerrold Van Cise lamented, "Easier for camel to go through the eye of a needle than for a fat franchisor to comply with the antitrust laws when he seeks to control the franchisee" (International Franchise Association, 1968, p. 25).

Some types of vertical restraints attracted virtually no legal scrutiny. Minimum hours requirements were rarely challenged, and when they did, franchisors won soundly.[7] Vertical restraints upholding quality standards such as sales quotas and controls over service standards, layout and design, and advertising also attracted little antitrust scrutiny (Inter-

[7]For example, *Gordon v. Crown Central Petroleum Corp.*, 423 F. Supp. 58 (N.D. Ga. 1976).

national Franchise Association, 1970, p. 11). For other types of vertical restraints franchisees pursued innovative strategies in devising workarounds to adverse antitrust rulings, such as partial vertical integration (operating company-owned shops in competition with franchisee-owned locations), franchisor advertising of prices, or using the threat of termination or nonrenewal against franchisees who did not comply with "suggested" prices, products, and so on (Subcommitte on Minority Small Business Enterprise and Franchising, 1973, p. 96); (Committee on Commerce, 1976, pp. 26-28). For example, when *Siegel v. Chicken Delight* prohibited forcing franchisees to buy inputs from the franchisor as a condition of using the franchise trademark, franchisors largely stopped requiring mandatory purchases. Instead, they adopted lists of "approved suppliers" and quality standards, and earned income from franchisees by charging them royalties rather than selling them inputs.[8]

In other instances franchising firms engaged in litigation to change the courts' interpretation of the laws. In key cases the IFA's lawyers represented franchisors, and the IFA itself filed *amici* briefs in support of franchisors beginning with *Susser v. Carvel* in 1965.[9] Franchisors benefited from the lack of an organized opposition: in most cases, only the IFA and industry-specific franchisor trade associations filed briefs. Supplier restrictions, in particular, faced difficult challenges under antitrust law.

For franchisors, maintaining uniform appearance and quality equivalent to an integrated chain was essential. However, a major obstacle was antitrust law's prohibition against tying—requiring a buyer to buy a second, undesired item as a condition of buying a first, desired item. Early court decisions found that the trademark license was a separate product from the other inputs to a franchise, and could therefore be considered a tying item under antitrust law. This opened up franchisors to challenges from franchisees who did not want to buy other inputs or lease real estate from franchisors, or from suppliers designated by franchisors.[10] At

[8] *Siegel v. Chicken Delight, Inc.,* 311 F. Supp. 847 (N.D. Cal. 1970)

[9] *Susser v. Carvel Corp.*, 381 U.S. 125 (1965). Others include *Nichols v. Arthur Murray, Inc*, CA Court of Appeals Civ. 8198 (1967)), *Ungar v. Dunkin Donuts* 531 F. 2d 1211, Court of Appeals, 3rd Circuit (1976), *Siegel v. Chicken Delight* 448 F.2d 43, Court of Appeals, 9th Circuit (1971), *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

[10] *Siegel v. Chicken Delight*, *FTC v Brown Shoe Co., Inc.*, 384 U.S. 316 (1966); *Perma Life Mufflers v.*

the extreme, an FTC Bureau of Competition staffer warned IFA members against exclusive deals with name-brand ketchup and soft drink providers, asking, "[is there] a substantial difference in quality catsups between Heinz, Hunts, and Ritters?" (International Franchise Association, 1971, pp. 114-115)? Today we take our inability to get a Pepsi at McDonald's or a Coke at Taco Bell for granted, but at least some in the FTC questioned the legality of such vertical restraints in the early years of franchising. Franchisor attorney Harvey Applebaum noted five years later, "Virtually every major national, and sometimes even local, fast food or 'business package' franchisor is presently or recently has been under some form of antitrust treble damage attack with respect to required purchases of products" (International Franchise Association, 1975, p. 64). In 1975 the Federal Trade Commission required seventy-five fast food franchisors to answer a questionnaire pertaining to whether they required franchisees to purchase products or services from designated suppliers, and to justify any such requirements (Federal Trade Commission, 1975, p. 12).

Thus, in the mid-1970s franchisors were not certain whether the logic of *Schwinn* would be pushed further into business format franchising. Would they be able to impose sufficient control on franchisees to project a chain store image and achieve vertical integration by contract, or would the regulators and courts block their efforts and preserve the independence of franchisees? Until the mid-1970s, franchisors felt the momentum of judicial reasoning was against them and moving in the direction of "expanding the applicability of the *Schwinn* doctrine" (Zeidman, 1976, p. 11).

The fortunes of franchisors took a decisively positive turn, however, with the outcome of the *Sylvania* case. GTE Sylvania, a product distribution franchisor, restricted the geographical areas in which its franchised distributors could sell its products. Its franchisees sued, and the case made its way to the Supreme Court. While considered a watershed in antitrust jurisprudence today, only the IFA and two industry-specific franchisor groups filed *amici* briefs. The Court, in language very similar to that in the IFA's amicus brief, over-

Int'l Parts Corp., 392 U.S. 134 (1968); *Chock Full ONuts Corp.*, FTC Docket No. 8884 (1973).

turned *Schwinn*.[11] The decision all but terminated any uncertainty surrounding non-price vertical restraints, ending a decade of confusion as to the legality of a key pillar of the franchising business form. Zeidman celebrated the importance of the case for business format franchisors:

> For those operating service franchises or business format franchises, the haunting question of the applicability of Schwinn in the absence of a sale and resale context ... has now presumably been rendered academic (Zeidman, 1977, pp. 15-16).

Zeidman was not exaggerating when he beamed of Sylvania, "With that holding, one era of franchise litigation comes to an end" (ibid, p. 11).

While the time period of the analysis in this paper ends in 1980, it is worth noting that the permissive logic of Sylvania with respect to vertical restraints did not end with that case. Eventually the courts extended their blessing even to vertical *price* restraints. With *State Oil Co. v. Khan*, the Supreme Court found that maximum vertical price restraints could be pro-competitive, since they kept consumer prices low.[12] Finally, the the Supreme Court in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* overturned the 96-year old *per se* prohibition on minimum vertical price restraints.[13] There is no more fundamental business decision than what price to charge. Post-*Leegin*, franchisors were free to control even this aspect of their "independent" franchisees' operations.

3 The Benefits of Vertical Separation

At the same time that franchisors sought to achieve centralized economic control through vertical restraints, they also lobbied and litigated to escape the consequences of that economic control, by convincing government agencies and courts that economic control through contracts should not entail the same kinds of legal responsibilities that control through own-

[11] *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).
[12] *State Oil Co. v. Khan*, 522 U.S. 3 (1997).
[13] *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

ership traditionally entailed, especially responsibilities to workers under employment law. In seeking economic control without legal responsibilities, franchisors sought to pull in the legal boundaries of the firm, taking advantage of the differential legal and regulatory treatment of activites occurring inside vs. outside the legal boundaries of the firm.

While franchisors fought to expand the economic control of franchised organizations through legalization of vertical restraints, they also sought to establish franchisees' legal status as independent contractors outside the firm. Franchisors' first success in this arena came when the Small Business Administration (SBA) changed its definition of "small businesses" eligible for SBA assistance to include franchisees. Prior to the 1966 rule change, the SBA considered franchisees, due to vertical controls, to be part of franchisor organizations and not independent businesses at all.[14] As SBA Administrator Eugene P. Foley testified in 1965, any requirement that a small business person "conduct his business in strict conformity with an operating manual issued by the franchisor," or establishment by the franchisor of "standards of quality, service, protection and advertising" rendered the franchisee ineligible (Subcommittee on Antitrust and Monopoly, 1965, pp. 9-10). According to Foley, "the major decision for the Small Business Administration is this: Are we financing the distribution outlets of large businesses or are we financing independent small businesses as the Congress intended us to" (ibid, p. 19)?

Shortly after Foley's testimony, the SBA decided to revisit the issue of franchising. In early 1966, the SBA invited academics and businesspeople to present information and opinions on whether the SBA should change its definition of small business to include franchisees. The IFA advised SBA on whom to invite. The IFA's General Counsel, President, and Chairman all received inviations to attend.[15] Very few, if any, franchisees participated, however. As then-SBA General Counsel Philip F. Zeidman wrote to the SBA Administrator, "It must be conceded that the hearing was inadequate in that most of those participating were either

[14] Title 13, Part 121, Code of Federal Regulations.

[15] Small Business Administration Archive. Record Group 309, National Archives Building, College Park, MD [hereafter SBA Archive]. Administrative Subject Files 1953-1972. Box 290, File 18 FY 66.

franchisors or associations representing franchisors."[16]

Zeidman recommended that the agency completely abandon any consideration of franchisor control in approving SBA loans. The SBA followed his advice. The new standard for independence under the Small Business Act would be that the franchisee had the "right to profit" from effort and bore the "risk of loss or failure," regardless of the level of control of its business by a larger firm. The rule change opened up an important new source of financing to franchisors that remains important to this day: in 2014, forty-three percent of first time franchisees obtained financing from SBA loans (Johnson, 2015). The SBA rule change was also the first federal response to the uncertainty released by *White Motor*, and an early ruling in favor of a more permissive approach to franchising. Henceforth, for purposes of receiving SBA financing, franchisees would be considered legally separate businesses, despite the control exerted by franchisors. The SBA went from skepticism of big business controlling small business through franchise agreements to being the advocate for franchising it remains to this day, as foreshadowed by Zeidman's note to SBA Administrator Boutin that "SBA will endeavor to influence the shaping of antitrust enforcement policy with respect to franchising as well as otherwise into directions legitimately and appropriately beneficial to small business concerns."[17] Zeidman went on to serve as Washington Counsel to the IFA from 1970 to 2016.

Throughout this period, franchisors also expressed intense anxiety that their control over franchisee operations might create a legal employment relationship between themselves and their franchisees, or between themselves and their franchisees' employees. While franchisors sought to create an alternative path to large size than traditional vertical integration by imposing vertical restrictions on franchisees, they desperately wanted to keep franchisees and franchised employees outside the legal boundaries of the firm under employment law. At the

[16] Action Memorandum for the Administrator, Subject: Hearing on Franchisee Size Standards; Philip F. Zeidman to Bernard L. Boutin, July 1, 1966, p. 9. SBA Archive: Administrative Subject Files 1953-1972, Box 290, File 18 FY 66; Box 290.

[17] Action Memorandum for the Administrator, Subject: Hearing on Franchisee Size Standards; Philip F. Zeidman to Bernard L. Boutin, Administrator, July 1, 1966, p. 5. SBA Archive: Administrative Subject Files 1953-1972, Box 290, File 18 FY 66.

1971 IFA Legal and Government Affairs Symposium, for example, IFA attorney Jerome Fels chastised McDonald's for accepting the legal standard of employer/employee relationships in litigation of a post-termination covenant not to compete,[18] warning that "[a]ccepting any theory that the franchisor/franchisee relationship is an employment relationship or similar to it might have some unfortunate consequences"(International Franchise Association, 1971, p. 85).

Those "unfortunate consequences" were that workers at franchised establishments would have legal rights against franchisors. Of particular concern was the possibility that workers could unionize and gain the right to bargain directly with the *franchisor*, not just the franchisee that formally employed, under the "joint employer" doctrine. As a law professor invited to the IFA's 1972 legal symposium explained,

> If the [National Labor Relations] Board does not assert jurisdiction, those employees do not have the protection of the National Labor Relations Act. They can be fired for union activity, and ... the employees have few legal rights with respect to union organizing. So it is in the immediate interest of the McDonald [sic] Corporation to assert the the franchisee is the sole employer of those employees (International Franchise Association, 1972, p. 41).

IFA General Counsel Harry L. Rudnick sounded the alarm in 1967 after the National Labor Relations Board ruled that a Mister Softee franchisee's truck drivers were employees rather than independent contractors under the definition of the National Labor Relations Act. The Board ruled that while formally the drivers' contracts were those of independent contractors and not wage workers, the substance of the controls enforced by the franchisor and franchisee removed them from independent contractor status and put them under the jurisdiction of the National Labor Relations Act as employees. The relevant test, according to the Board, was a "right of control" test: who controlled the means and manner by which the output

[18] *McDonalds v. Sandys*, 45 Ill App 2d 57 (1963).

was generated?[19] While the ruling did not challenge the franchise relationship itself, focusing only on the relationship of ice cream truck drivers to a franchisee, Rudnick warned that "It is not difficult to project the application of this line of analysis and reasoning to a great many franchise systems" (Rudnick, 1967a, p. 29).

Franchisors must have breathed a sigh of relief, then, when two years later the NLRB refused to use franchisor control over franchisees as a reason to expand its jurisdiction to franchising relationships. In *Southland Corporation v. Retail Store Employees Union*, the Board ruled that Southland, the franchisor of 7-11 stores, was not the joint employer of a franchisee's employees, because the franchisor did not *directly* control the labor relations of the franchised store. According to the Board, "We have long held that the critical factor in determining whether a joint employer relationship exists is the control which one party exercises over the labor relations policy of the other."[20] If franchisors avoided interfering directly in the labor relations of franchisees, such as by telling them whom to hire and fire or setting shift schedules, they would avoid triggering NLRB jurisdiction, even if they indirectly controlled labor conditions by controlling the work process, equipment used, hours of operation, franchisee prices and countless other aspects of the business through contractual restraints.

Franchisors' concerns with the Fair Labor Standards Act (FLSA), which regulates minimum wages and overtime, echoed their anxieties about the National Labor Relations Act. In a 1978 article in the *IFA Current Legal Digest*, Lewis Rudnick and John Dickens, citing a recent Department of Labor interpretive bulletin, highlighted the risk that the Wage and Hour Division of the Department of Labor would find franchisors to be joint employers under the FLSA (Rudnick and Dickens, 1978), making them liable for wage and hour and overtime violations at franchised establishments. As it happened, the courts ultimately defined the meaning of "employer" narrowly in interpreting the FLSA, relying on a physical control test

[19] *Mister Softee Inc. and Curb Service of Indianapolis, Inc. and Oil, Chemical and Atomic Workers International Union, AFL-CIO,* 162 NLRB 22 (1966).

[20] *Southland Corporation v. Retail Store Employees Union, Local 428,* 170 NLRB 159 (1968).

similar to that of the NRLB (Power, 2016).

In retrospect, franchisor fears seem misplaced, since the NLRB and Department of Labor would stick to the "right to control" test and refuse to consider the indirect ways in which one firm could control the labor relations of another firm by controlling production processes and other aspects of the firm's operations that determine labor relations. But for franchisors in the 1960s and 1970s, fighting to establish their organizational form as a relationship of vertical integration for antitrust purposes and independent contracting under employment, tax and other law, franchising's legal status did not *feel* secure just yet.

While the legal interpretation of franchising under the NRLA and FLSA was taking place, franchisors were also apprehensive about courts and regulators finding franchisees to be inside the boundaries of the firm under other legal regimes. A major concern was that courts would find franchisors liable for the actions of franchisees under principal-agent law, under which courts could rule that the franchisor's control over the freanchisee meant that the franchisee was legally acting on behalf of the franchisor, making the franchisor responsible for the franchisee's actions undertaken on its behalf. As Lewis Rudnick cautioned in 1967, "[t]he courts will not unlikely say that the franchisor has guided and controlled its franchisee to the extent necessary to make him the franchisor's agent (Rudnick, 1967b, pp. 255-256).

Throughout the 1970s, the IFA fought back attempts by state legislatures to tie franchisors to franchisees under a variety of laws. After intense lobbying from the IFA, New Jersey in 1976 restricted an indemnification and warranty bill holding franchisors responsible for actions taking place within their chains to the automobile industry, excluding business format franchisees from its jurisdiction (Zwisler III, 1976). In 1978 the IFA lobbied against attempts in two states to include franchised chains under chain store tax regimes (International Franchise Association, 1978, p. 81). 1978 also saw Arizona and Massachusetts consider laws to impose joint tort liability on franchisors by statute. IFA persuaded the Arizona Senator who introduced the law to withdraw it, and the Massachusetts legislature rejected a similar bill (ibid, 83).

4 Fighting Off Alternative Regulations

Then-Director of the Federal Trade Commission's Bureau of Consumer Protection Robert Pitofsky grappled with the danger of franchising falling into an unregulated gap between antitrust antitrust and labor law in 1972:

> If the relationship is viewed as one between independent businessmen or businesses ... then it makes sense to apply the public policies of the antitrust laws, with the prime objective of preserving the franchise as an independent competitive unit. ... On the other hand, one may view the relationship as essentially characterized by vastly unequal bargaining power and access, in which the franchise is ... virtually indistinguishable from the position of employees or agents. Given this view, it makes sense to apply the public policies of the National Labor laws (International Franchise Association, 1972, p. 3).

Pitofsky was uneasy with franchisors' attempt to create a new kind of status, franchisee, that was neither a truly independent competitor protected by antitrust laws, nor an employee protected by labor laws.

As franchisors succeeded in avoiding regulation of franchising under antitrust or employment law doctrines, federal and state lawmakers stepped into the breach to propose regulations to control this new business form, which had escaped the grasp of traditional doctrines. Their main concern was the gross power imbalance between the parties. Franchisees were small businesses who signed restrictive, one-sided contracts offered on a take-it-or-leave it basis from franchisors who were often large corporations. Indentured servitude and feudal metaphors abounded: franchising, for example, was "feudal in concept—the lord and the serf" according to a Senate Antitrust Subcommittee lawyer (International Franchise Association, 1973, remarks of Donald A. Randall, p. 60). As Timothy H. Fine, General Counsel of the National Franchisee Association Coalition put it, "if franchisees are to be more than branch managers taking orders from a parent corporation, such power must be curbed"

(Subcommittee on Consumer Protection and Finance, 1976, p. 189).

Laws that equalized bargaining power by prohibiting certain onerous contract terms soon emerged as an alternative to both labor law and the regulation of vertical restraints as means of regulating franchising. Franchisees advocated laws that regulated the substance of the franchise relationship itself, in particular termination and non-renewal clauses. The IFA strongly opposed these efforts, and sought to channel franchise regulatory efforts into laws regulating the sale of franchises, particularly favoring pre-contract disclosure laws (International Franchise Association, 1967). The first skirmish was fought over the Franchise Competitive Practices Act, introduced in 1967 by Senator Philip Hart, Chair of the Subcommittee on Antitrust and Monopoly, to regulate termination and nonrenewal of franchises. A revised version of Hart's bill introduced in 1969 prohibited terminations and failures to renew without cause. The bill did not pass, and the IFA took credit for killing it (International Franchise Association, 1972, Philip Zeidman, p. 88). Franchising bills continued to be introduced in subsequent years. with Representative Abner Mikva's Franchising Practices Reform Act in 1976 garnering an "an almost unheard of" 109 co-sponsors, according to Zeidman (International Franchise Association, 1976, p. 9). Ultimately, however, like the Hart Bill, Mikva's legislation came to nothing. Franchise relationship laws were also introduced in a number of state legislatures in the early 1970s, and the IFA played an extremely active role in lobbying and shaping state legislation, with considerable success. As of 2004, only eighteen states had relationship laws. Of these, most did not regulate the franchisor's right to terminate contracts, requiring only advance notice of termination. Only eight states (Arkansas, Hawaii, Illinois, Iowa, Michigan, Minnesota, Washington, and Wisconsin) required that franchisors give franchisees an opportunity to cure defaults before terminating a franchisee (Barkoff and Seldern, 2004, p. 325).

From the franchisor's perspective, all this talk of unequal bargaining power was completely beside the point. Philip Zeidman declared during one hearing, "In fact, all men are not equal, nor does anything in our law or our history require that they be so" (Committee

on Commerce, 1976, p. 189). The IFA sought to keep franchising firmly within the domain of contract law, where "buyer beware" governed agreements between consenting parties, no matter the balance of power between them. The IFA accordingly pushed pre-contract disclosure rather than post-contract regulation as the remedy for the alleged abuses in franchising. They argued that as long as franchisees were warned beforehand about the contents of the contract they signed, there could be no complaint afterward about the unfairness of any contract term. The IFA drafted model disclosure legislation and worked closely with lawmakers to introduce and pass it around the country. The IFA also urged the FTC to adopt a disclosure approach when the agency announced its intention to regulate franchising in 1971. In 1970 Lew Rudnick declared the IFA-developed California Franchise Investment Law to be the IFAs "model act," and optimistically predicted that in ten years federal legislation along the lines of that law would be enacted (International Franchise Association, 1970, p. 115). He was almost right—but it would be a Federal Trade Commission regulation, not a federal statute, that applied the principles of the California law to the whole country.

While the FTC discussed, but never aggressively pursued, taking action against dominant franchisors under its Section 5 authority to prohibit unfair methods of competition, it ultimately took the path favored by the IFA and implemented a disclosure rule. The IFA's allies in advocating for this approach included the Nixon White House.[21] When the FTC announced its intention to promulgate a trade rule regulating franchising in 1971, the IFA was there from the beginning, lobbying the FTC to attack fraud and misrepresentation in franchise sales, but to leave the franchise relationship alone.[22] Disclosure regulation was favored by franchisors because it attacked the "fast buck artists" and frauds who gave franchising a bad name, while leaving the basic power imbalance at the heart of franchising unchallenged. Disclosure, moreover, actually protected franchisors in litigation with franchisees:

[21] Federal Trade Commission Public Records, request made by the author [hereafter FTC Public Records]. Folder 398394087, Document 04, Memo dated March 31, 1972 from the White House Director of Policy Analysis to FTC Bureau of Consumer Protection.

[22] FTC Public Records: Folder 398394088, Doc 01. Statement on Behalf of International Franchise Association before the Federal Trade Commission Hearing on Proposed Trade Regulation Rule, 10 A.M., February 14, 1972, Presented by Philip F. Zeidman.

after mandatory full disclosure, franchisees could no longer claim franchise contracts were adhesion contracts that they were forced to sign (International Franchise Association, 1975, pp. 2-3). A disclosure rule would thus sanctify franchise contracts as purely private, bilateral, arms-length transactions between equal parties in the marketplace, cementing franchisees' status as outside the firm.

Franchisees, for their part, never supported and were dismayed by the FTC's embrace of disclosure rather than regulation. Franchisee lawyer and head of the American Association of Franchised Dealers Robert Purvin argued during the FTC's 1995 review that the rule "has achieved a situation of legitimizing what I call systematic fraud."[23] As franchisee attorney Harold Brown remarked, "with the adoption of this rule in 1979, the FTC has, for almost all practical purposes, withdrawn from the conduct regulation activity in which it previously was occupied."[24] The FTC rule was finally enacted in 1979. With *Sylvania* and the FTC rule, franchisors ended the 1970s with their regulatory agenda largely achieved.

5 Conclusion

By 1980, franchisors had succeeded in establishing their organizational innovation under the law, giving them rights to coordination and control consistent with vertical integration without triggering the responsibilities, under employment and other laws, that traditionally accompanied integration. The Supreme Court gave franchisors the right to vertically integrate by contract rather than direct ownership through non-price vertical restraints. The FTC, meanwhile, abandoned any attempt to reduce the power imbalance between franchisees and franchisors, adopting the International Franchise Association's preferred policy of pre-contract disclosure rather than post-contract regulation. The IFA simultaneously beat back

[23]FTC Public Records: Folder 296701583, Doc 02. In the Matter of: Periodic Review of Franchise Rule, Docket No. P954402, Tuesday, September 12, 1995, Crown Sterling Suites 901-34th Ave, Bloomington Minnesota, p. 16.

[24]FTC Public Records: Folder 296701583, Doc 02, Federal Trade Commission, In the Matter of: Periodic Review of Franchise Rule, Docket No. P954402, Thursday, September 14, 1995, Crown Sterling Suites 901-34th Ave, Bloomington Minnesota.

most attempts at the federal and state level to regulate the franchise relationship beyond disclosure requirements. Finally, employment and other laws that New Deal-era policy had used to socially control corporations did not adapt to changing legal forms and remained fixated on narrow, formalistic definitions of the boundaries of the firm.

This article shows how the creation of franchising entailed a political and legal struggle to shrink the legal boundaries of the firm relative to its economic boundaries. Franchisors persuaded regulators, courts, and legislatures to allow them to pursue de facto vertical integration by contract (imposing vertical restraints such as customer and price restrictions on their franchisees), while simultaneously claiming benefits of vertical separation, such as eligibility for Small Business Administration assistance and avoidance of tax, labor, and other laws that would apply if franchisees were not legally separate entities. Franchisors transformed business practices that rested on shaky legal ground in the 1960s into legal components of a new business form.

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