Boldy v. McConnell's Fine Ice Creams

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Case: Boldy v. McConnell's Fine Ice Creams (1990)

Subject Category: Security, Franchise

Agency Involved: Private Civil Suit

Court: Ninth Circuit Court of Appeals

Case Synopsis: Boldy and others were franchisees of McConnell's who sued the company claiming that the franchise agreement constituted an unregistered security under federal securities laws. Although franchise agreements have not normally fallen under federal securities laws, Boldy claimed that the co-mingling of funds before start-up, and the application of the risk capital test brought this particular agreement under federal securities laws.

Legal Issue: Is the risk-capital analysis of an investment contract appropriate in determining the applicability of federal securities laws to a franchise agreement?

Court Ruling: The Ninth Circuit held that the risk capital approach was not the proper method to determine if a franchise agreement was also a security. The court upheld the active management standard of the Ninth Circuit. Boldy claimed that the franchise agreement was a unique case in franchising where the franchise agreement was actually a security because franchise fees were co-mingled with start-up capital and the franchisees did not have control over how those funds were spent, making their success as franchisees dependant on the franchisor's successful management of the franchisee's money. The Court rejected this application of the risk capital test because the franchise agreement placed the substantive managerial aspects of the franchise on the shoulders of the franchisee. The success of the franchise was based primarily on the activities of the franchisee in the actual operation of the business.

Practical Importance to Business of MLM/Direct Sales/Direct Selling/Network Marketing/Party Plan/Multilevel Marketing: When determining whether a franchise agreement should be regulated as a security, the Ninth Circuit looks to the actual managerial actions of the franchisee. If the success of the enterprise falls on them, then the agreement will not be found to be a security.

Boldy v. McConnell's Fine Ice Creams, No. 89-55424 (1990): The Ninth Circuit held that the risk capital approach was not the proper method to determine if a franchise agreement was also a security. The court upheld the active management standard of the Ninth Circuit. Boldy claimed that the franchise agreement was a unique case in franchising where the franchise agreement was actually a security because franchise fees were co-mingled with start-up capital and the franchisees did not have control over how those funds were spent, making their success as franchisees dependant on the franchisor's successful management of the franchisee's money. The Court rejected this application of the risk capital test because the franchise agreement placed the substantive managerial aspects of the franchise on the shoulders of the franchisee. The success of the franchise was based primarily on the activities of the franchisee in the actual operation of the business.

No. 89-55424

Helen BOLDY; Michael Boldy; MHRCC, Inc.; Esther Behnam; Ruth Lundgren,

Plaintiffs-Appellants,

v.

McCONNELL'S FINE ICE CREAMS, INC.; Thomas J. Bowerman; T.J.B. Development

Company, Inc.; Samuel Hale; Robert Ferro, Defendants-Appellees.

No. 89-55424.

United States Court of Appeals, Ninth Circuit.

Submitted June 7, 1990. [FN*]

Decided June 14, 1990.

Appeal from the United States District Court for the Central District of California; Ferdinand F. Fernandez, District Judge, Presiding.

C.D.Cal.

AFFIRMED.

Before ALARCON, BRUNETTI and O'SCANNLAIN, Circuit Judges.

MEMORANDUM [FN**]

**1 Helen and Michael Boldy and others, plaintiffs-appellants, filed suit against McConnell's Fine Ice Creams, Inc. and others, defendants-appellees, for securities fraud under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk, relating to the parties' execution of two contracts--a McConnell's Fine Ice Cream Store Franchise Agreement and a Contract for Turn-Key Ice Cream Parlor. The district court dismissed the action for failure to state a federal claim, ruling that "a simple, basically fast-food--franchise type of transaction" does not fall within the meaning of "security" as defined by federal securities law. [FN1] Appellants appeal this dismissal, and we affirm.

The trial court's dismissal for failure to state a federal claim presents a question of law that we review de novo. Miller v. United States, 587 F.2d 991, 994 (9th Cir.1978).

The Supreme Court has held that under the federal securities laws, a business transaction constitutes an investment contract, and hence a security under 15 U.S.C. § 78c(a)(10), where "the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." S.E.C. v. W.J. Howey Co., 328 U.S. 293, 301 (1946). More recently, we have held that "the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically." S.E.C. v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 (9th Cir.1973). Thus, we look to whether "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." Id.

In Bitter v. Hoby's International, Inc., 498 F.2d 183 (9th Cir.1974), we applied this analysis to a franchise agreement dispute similar to that in the present case, focusing on "the extent of participation the franchisee has under the franchise agreement." Id. at 184-85. We found that the agreement in Bitter required that the franchisee continuously operate the restaurant, produce and sell sandwiches and related products, purchase materials, merchandise, and supplies selected at his sole discretion, prepare monthly operating statements, and employ personnel to accomplish these tasks. Id. at 185. Therefore, we held that such a franchise agreement does not constitute a security under the federal securities laws because each franchisee's active management was essential to the success of his retail restaurant ... the individual restaurant operation was an integral economic entity ... its success was not dependent upon the success of the franchise system ... the failure of the franchisor would not necessarily doom the franchisee's investment."

Id. (citations omitted). Accord Meyer v. Dans un Jardin, S.A., 816 F.2d 533, 535-36 (10th Cir.1987); Nash & Assoc., Inc. v. Lum's of Ohio, Inc., 484 F.2d 392, 393 (6th Cir.1973). See also Mr. Steak, Inc. v. River City Steak, Inc., 324 F.Supp. 640, 646 (D.Colo.1970), aff'd, 460 F.2d 666 (10th Cir.1972).

**2 Appellants contend that this case presents "a unique factual scenario justifying a departure from those cases holding that a traditional franchise arrangement is not within the statutory definition of a security." Specifically, appellants contend that these transactions constitute securities because the invested funds were commingled as start-up capital for a single venture and they had no opportunity to contribute their managerial efforts to the success of the venture.

In the present case, the franchise agreement provided that appellants' duties as franchisees included:

(1) site selection and lease negotiations;

(2) interior construction, leasehold improvements, fixturization, and equipping of the franchise;

(3) timely franchise opening;

(4) required purchases of appellees' ice cream products;

(5) purchase of all other necessary equipment, supplies, and other materials sold or used in connection with the franchise from recommended suppliers;

(6) compliance with all applicable governmental laws;

(7) maintaining time and hours of operation;

(8) lighting of signs after dusk;

(9) authorization of franchisor inspection during normal business hours;

(10) personal full-time devotion of attention and best efforts to the management and operation of the franchise, including selection of managers and employees;

(11) payment of all operating expenses, taxes, and levies, including costs associated with supplies ordered for the franchise, all employee wages and salaries, and all taxes and assessments levied or imposed upon the franchise;

(12) local advertising totaling one percent of gross receipts;

(13) maintenance of the physical premises in good repair and appearance, including cost of periodic major refurbishing and redecorating;

(14) cooperation with franchisor in promotional programs or collective franchise activities;

(15) indemnification of the franchisor;

(16) carrying worker's compensation, liability, and business interruption insurance; and

(17) day-to-day operation of the franchise.

Furthermore, the agreement also provided:

A. RELATIONSHIP OF PARTIES....

It is specifically acknowledged that Franchisee is the independent owner of it business, shall be in full control thereof, and shall conduct such business in accordance with Franchisee's own judgment and discretion

* * *

Franchisor shall neither regulate nor be responsible for the hiring or firing of Franchisee's agents or employees or for the Franchisee's contacts with its customers ... [w]ith respect to all matters pertaining to the operation of the Franchised Store, Franchisee is, and shall be, an independent contractor.

In focusing on "the extent of participation the franchisee has under the franchise agreement" in this case, it is clear that "each franchisee's active management was essential to the success of his retail restaurant." See Bitter, 498 F.2d at 184-85.

Appellees' reliance upon Turner, S.E.C. v. Galaxy Foods, Inc., 417 F.Supp. 1225, 1242 (E.D.N.Y.1976), and Anspach v. Bestline Products, Inc., 382 F.Supp. 1083 (N.D.Cal.1974), is misplaced, as these cases did not involve franchise agreements where the franchisee's active management was essential to the success of the franchise. In Turner, a get-rich-quick scheme that did not involve franchising, the court found that the essential managerial efforts which affected the failure or success of the enterprise were those of the promoter, not the investor. Turner, 474 F.2d at 483. In the present case the essential managerial efforts were those of the investors, the appellants. Similarly, the court in Galaxy Foods found that the success of any one franchise was inextricably linked to the success of the whole operation, that the franchise was in fact almost entirely passive, and that franchisees received simply the opportunity to earn money if the efforts of others, the franchisor's management and salespeople, proved successful. Galaxy Foods, 417 F.Supp. at 1240, 1241. In the present case, the franchises are independent, active operations whose success stems from the efforts of the franchisees, not the franchisor. Lastly, in Anspach the plaintiffs alleged a pyramid scheme similar to that in Turner. Anspach, 382 F.Supp. at 1089. In the present case, there is no such allegation, nor evidence, of such a scheme.

**3 Appellees also rely upon several cases that apply a "risk capital" analysis, such as that employed by the California Supreme Court in Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 361 P.2d 906 (1961). However, this Court has specifically rejected such an analysis, instead choosing to focus upon whether the investor's active management is essential to the success of the business. Bitter, 498 F.2d at 185.

For the foregoing reasons, the district court's dismissal of appellants' action for failure to state a federal claim is AFFIRMED.

FN* The panel unanimously finds this case suitable for decision without oral argument. Fed.R.App.P. 34(a); Circuit Rule 34-4.

FN** This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Circuit Rule 36-3.

FN1. Because the district court held that appellants' failed to state a federal claim, the court also dismissed appellants' pendent state law claims. Appellants do not appeal the court's dismissal of these state law claims.