BEFORE THE
DEPARTMENT OF CORPORATIONS
STATE OF CALIFORNIA

In the Matter of the Desist and Refrain Order Issued to: WILLIAM M. MORAN, JR., WILLIAM M. SHANER, MORAN FOODS, INC., dba SAVE-A-LOT, LTD., Respondents.	Case No. 7194 OAH No.: 2007120040

DECISION

The attached Proposed Decision of the Administrative Law Judge of the Office of Administrative Hearings, dated December 4, 2008, is hereby adopted by the Department of Corporations as its Decision in the above-entitled matter with the following technical and minor changes pursuant to Government Code Section 11517(c)(2)(C).

On page 1, paragraph 1, line 1, of the Issue Statement, delete "Department of Corrections" and replace with "Department of Corporations".

On page 7, paragraph number 3, line 1, of the Legal Conclusions, delete "Section 31110" and replace with "Section 31011".

This Decision shall become effective on 20 March 2009.

IT IS SO ORDERED this 19th day of March 2009.

CALIFORNIA CORPORATIONS COMMISSIONER

Preston DuFauchard

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PROPOSED DECISION

Karl S. Engeman, Administrative Law Judge, Office of Administrative Hearings, State of California, presided over the administrative hearing in the above captioned matter in Sacramento, California, on May 29 and 30, 2008.

Lindsay B. Herrick, Corporations Counsel, represented Complainant California Corporations Commissioner.

Scott W. Pink and Steven G. Churchwell, Attorneys at Law, represented respondents.

At the close of evidence on May 30, 2008, the record was left open for the preparation of the reporter's transcript and submission of written argument. Complainant's final argument was received on October 10, 2008. Both parties cited to the transcript in their closing arguments so the Administrative Law Judge requested a copy of the transcript which was received on October 29, 2008. The matter was then submitted.

ISSUE STATEMENT

Department of Corrections has issued a Desist and Refrain Order against respondents based on the contention that the "license" agreement offered by respondents in the State of California meets the statutory definition of a franchise and no registration of such franchise offering has been obtained. The parties, at least for purposes of this matter, agree that the first two of the three statutory criteria defining a franchise have been met. The remaining question is whether the transaction at issue requires the payment, either directly or indirectly, of a franchise

fee. The Department asserts that fees paid for goods, required equipment, and other services constitute direct and indirect payment of franchise fees. For the reasons set forth below, it is determined that no franchise fees are required. Thus, the Desist and Refrain Order should be rescinded.

FACTUAL FINDINGS

1. Respondent Moran Foods, Inc., doing business as Save-A-Lot, Ltd., is a Missouri corporation with a registered California address of 818 West 7th Street, Los Angeles, California. Moran Foods, Inc. is a subsidiary of SUPERVALU, Inc., a publicly traded Delaware corporation. Respondent William M. Moran, Jr., is President, Chief Executive Officer, and a Director of Moran Foods, Inc., and respondent William M. Shaner is an Executive Vice President and the Chief Operating Officer of Moran Foods, Inc. None of the respondents holds a franchise registration with the Department.

2. Save-A-Lot is the fifth largest "single banner" retail grocery chain in the country and operates in 39 states. Moran owns approximately 300 corporate Save-A-Lot grocery stores. It also has entered into contractual relationships with approximately 873 independent Save-A-Lot grocery store owners. Save-A-Lot averages approximately 4 million shoppers each week. In addition to wholesale sales to independently owned Save-A-Lot stores, Moran Foods, Inc., sells approximately 20 million dollars of wholesale grocery items outside the Save-A-Lot system. Purchasers include wholesale grocers in Miami and Alaska, the Kentucky prison system, and Dollar Tree stores. Twelve to fifteen million dollars of wholesale sales are made to Dollar Tree.

3. The typical supermarket carries approximately 30,000 items and occupies approximately 100,000 square feet. Save-A-Lot stores are much smaller in size, approximately 15,000 to 18,000 square feet, and offer approximately 1250 items. These items consist of those which Moran regards as the most popular grocery store items in the most popular sizes. Moran distributes product to its stores, both corporate and independently owned, through 16 distribution centers. The products include Moran's approximately 400 private label grocery items and national brand name products. A typical store's inventory turns over approximately every two weeks.

4. An independent owner wishing to do business as a Save-A-Lot grocery store must execute a series of documents. The first two are typically provided to "prospective retailers" during preliminary discussions. These are the Receipt Waiver and Disclaimer Agreement and the Confidentiality Agreement. At the point at which the prospective retailer and Moran determine to enter into a business relationship, the retailer executes a Security Deposit Agreement, a Save-A-Lot Payment Policy, a Guaranty, a Supply Agreement, and the License Agreement.

5. In so far as the issues to be resolved in this matter are concerned, the critical

documents are the License Agreement and the Supply Agreement. The License Agreement is a 17 page document defining the rights and obligations of Moran and the retailer. The agreement grants a nonexclusive license to the retailer to use the trademarks, service marks, copyrights and logo types (Marks) associated with Save-A-Lot in connection with the operation of a "limited assortment discount" grocery store. The agreement also grants the retailer the right to use Save-A-Lot's "program." Paragraph 7 of the agreement reads, in pertinent part:

> This agreement shall not be construed as creating a relationship of employer and employee, franchisor and franchisee, partners, joint venturers, or profit sharing or loss agreement between the parties, or any other relationship between the parties other than that of Licensor and Licensee permitting Licensee to operate a limited assortment discount food store pursuant to the Save-A-Lot Program in connection with the Marks. Licensee is not obligated to, and shall not be required to, make any payment of any fee, charge or other amount to Licensor or its affiliates in consideration for the right to enter into or maintain this Agreement, other than payment for inventory at bona fide wholesale prices purchased from Licensor or its affiliates, which obligations may be set forth in a Supply Agreement entered into by and between the parties hereto.

6. Paragraph 9, subparagraph A, of the agreement requires the licensee to adhere to the Save-A-Lot "standards and specifications as provided for herein, and as may be announced periodically by Licensor." The agreement requires that the licensee "comply with the operating standards of Licensor as set forth below and as such standards may be changed or amended in writing from time to time by Licensor." Subparagraph A includes the parties' acknowledgement that:

> [The] Save-A-Lot Program consists of certain general standards which contribute to the overall image portrayed by the Marks and the goodwill associated therewith. These general standards include (a) primary emphasis on high quality private/control label products distributed by Licensor, (b) no generic or salvaged products, (c) product stocked in cases on approved fixtures, (d) high standards of cleanliness, appearance and sanitation, (e) exterior and interior signage, including item price signs, as approved by Licensor, and (f) courtesy and friendliness toward all customers, but with services generally limited to redemption of manufacturer's coupons, redemption of food stamps, and limited cash checking. Fresh meat and produce departments, if offered, must be consistent with and reinforce the Save-A-Lot concept of limited assortment, high quality and discount prices.

7. Subparagraphs B and C of paragraph 9 of the License Agreement require the parties to agree on an interior layout and design of the grocery store, including equipment and fixtures. The parties must also adopt a merchandising plan. These must be completed

within time limits established by the parties and inserted into the agreement.

8. Paragraph 11 of the License Agreement permits either party to terminate the agreement, without cause, upon 90 days notice. Licensor may terminate the agreement at any time that licensee violates the provisions of the agreement, including non compliance with the Supply Agreement and with the Save-A-Lot Program (the latter after reasonable time not to exceed 60 days to cure non-compliance.) Licensee is given similar rights regarding licensor's violation of the agreement.

9. In response to a request by the Department, Moran submitted on October 31, 2006, a document entitled "Exhibit A Save-A-Lot Store Guidelines." The body of the document is titled "OPERATING STANDARDS." The last page includes an acknowledgement that the retailer (licensee) has received a copy of the guidelines and understands that "these guidelines are part of the Save-A-Lot license agreement." The Operating Standards include site requirements, including "an attached lighted Save-A-Lot sign approved by Save-A-Lot." Minimum size graphic striping on each side or a canopy type sign are "recommended" for the sign. The specific type and placement of the store sign must be approved by Save-A-Lot. Building Layout and Design standards are also included and the store layout must also be approved by Save-A-Lot. Also included are standards for equipment and fixtures in the store's various departments, e.g., produce, meat, etc. As noted above, a merchandising plan must be completed by the retailer and approved by Save-A-Lot. The standards include maximum numbers or types of products like fresh meat and bread. The standards also address products which are not supplied by Save-A-Lot. Any such product which is duplicative of a Save-A-Lot item must be approved by Save-A-Lot and must be included in a list of such products completed and approved by Save-A-Lot.

10. The Supply Agreement reaffirms that licensee will buy grocery items "at bona fide wholesale prices on terms to be established from time to time by Save-A-Lot." The licensee agrees to purchase all its requirements from Save-A-Lot except for those items which are specifically approved for purchase elsewhere. Save-A-Lot may terminate the agreement for cause without the normal 90 day notice if the licensee fails to purchase food items exclusively from Save-A-Lot or with authorization to buy them elsewhere. There is no mention in the Supply Agreement, or in any of the other contractual documents required to establish an independently owned Save-A-Lot store, of any minimum purchase of grocery items either to start the store or replenish inventory.

11. The document entitled Save-A-Lot Payment Policy describes the various methods by which the licensee may pay for inventory purchased, as well as additional services which the licensee elects to purchase. An open account requires a security deposit equal to one week's average inventory purchase with interest to accrue to licensee. A written "Guaranty" is also required to secure credit extended by Save-A-Lot to the licensee. The Payment Policy includes that Save-A-Lot's weekly statement to the licensee will include the inventory purchased by the licensee, "which may include a separately stated 2.5 % service

charge." Respondent explained that until in or about the end of February or start of March in 2007, it was common practice in the wholesale grocery industry to "break out" the charges for goods attributable to warehousing and handling. More recently, the wholesale grocery industry generally includes the amount in the wholesale price for goods and Save-A-Lot has adopted that practice as well. At the time that Department issued its Desist and Refrain Order, Save-A-Lot was no longer isolating the "service charge." Rather, the amount attributable to warehousing and handling has been included in the wholesale priced charged to licensees since early 2007 and the 2.5 % surcharge is no longer charged.

12. Other than the standards described above, the licensing agreements do not address the manner in which the licensee will outfit the grocery store. The average cost of doing so in 2007 was approximately $765,000, excluding the cost of purchasing or renting the store structure. This includes approximately $100,000 for initial inventory. Other typical grocery store costs include refrigeration equipment, shelving, and the check out equipment described below.

13. A successful grocery store today requires various electronic components to facilitate the sale of products. This system is referred to as the "front end" system and includes cash registers, scanners, credit and debit card processing devices (pin pads), and printers. There are a number of companies which offer such equipment. Save-A-Lot prefers the ICL (Fugitsu) system because of its open architecture (ability to mix and match various computer components) and recommends this system to licensees. Save-A-Lot has no ownership interest in ICL. Licensees may purchase the ICL system from Save-A-Lot or buy it from a dealer. If the latter option is elected, the licensee can take advantage of a price negotiated by Save-A-Lot for its licensees or attempt to obtain a better price on its own. Other systems are available from NCR, IBM and others. If a licensee purchases the ICL system from Save-A-Lot, Save-A-Lot requires an approximately two week on site training course for cashiers and other store personnel. Save-A-Lot charges a fee of approximately $2,000 to cover part of the travel costs and wages for the one or two employees it sends to the store from its St. Louis, Missouri headquarters. If the licensee obtains the equipment elsewhere, the training is not required.

14. Save-A-Lot also offers other optional services and equipment to its licensees. One such system electronically transmits weekly suggested retail price changes for goods to licensees to avoid having to make manual changes in the registers. This system also assists stores and individual cashiers balance accounts. A hand held device is offered to facilitate checking existing inventory and reordering product. Other grocery store essentials offered include refrigeration equipment, shelving, pallet jacks, meat department knives, aprons, uniforms and name tags. Save-A-Lot also offers freight service for delivery of products from the distribution centers. The purchase of the described equipment and services from Save-A-Lot is optional and Save-A-Lot provides the licensees with alternative providers in their areas. If licensees do purchase equipment or services, they are charged accordingly. Approximately half of the independent owners/licensees have purchased front end systems other than ICL.

15. As noted, the licensee must provide signage which is approved by Save-A-Lot. They may purchase the sign or materials from anyone. The typical cost of the large lighted store front sign is approximately $14,000 to $15,000. Licensees are also required to attach the name Save-A-Lot to grocery carts. This is typically done with a cart handle insert.

16. Save-A-Lot charges a wholesale price to its licensees which it believes provides it a fair profit and still assures that retail licensees are competitive in the limited assortment, discount grocery market environment. Save-A-Lot purchases products which are at least comparable to national brand items.[1] Save-A-Lot produced a chart listing approximately 36 randomly selected grocery items. The chart compares the wholesale price charged by Save-A-Lot with that charged by United Western Grocers and name brand suppliers for comparable products. United Western Grocers is the largest wholesale supplier of grocery items in California. In Fresno alone, United Western Grocers sells wholesale groceries to approximately 26 retail entities. United Western Grocers also sells many products under its own private label brands and the comparisons were made using such private label brands. Virtually all of the wholesale prices charged by Save-A-Lot were lower than those charged by United Western Grocers and the national brands.

LEGAL CONCLUSIONS

Applicable Statutes

1. Corporations Code section 31110 reads:

> On and after April 15, 1971, it shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered under this part or exempted under Chapter 1 (commencing with Section 31100) of this part.

2. Corporations Code section 31005, subparagraph (a), reads:

> (a) 'Franchise' means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:
>
> (1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and
>
> (2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the

[1] This assertion was made by Save-A-Lot executives who have considerable experience in the grocery field. There was no other evidence presented by either side to either corroborate or refute the assertion.

franchisor or its affiliate; and

(3) The franchisee is required to pay, directly or indirectly, a franchise fee.

3. Section 31110 of the Corporations Code reads:

> 'Franchise fee' means any fee or charge that a franchisee or subfranchisor is required to pay or agrees to pay for the right to enter into a business under a franchise agreement, including, but not limited to, any payment for goods and services.
>
> However, the following shall not be considered the payment of a franchise fee:
>
> (a) The purchase or agreement to purchase goods at a bona fide wholesale price if no obligation is imposed upon the purchaser to purchase or pay for a quantity of the goods in excess of that which a reasonable businessperson normally would purchase by way of a starting inventory or supply or to maintain a going inventory or supply.
>
> (b) The payment of a reasonable service charge to the issuer of a credit card by an establishment accepting or honoring that credit card.
>
> (c) Amounts paid to a trading stamp company under Chapter 3 (commencing with Section 17750) of Part 3 of Division 7 of the Business and Professions Code by a person issuing trading stamps in connection with the retail sale of merchandise

4. Business and Professions Code section 20009 reads:

> The regulations, releases, guidelines and interpretive opinions of the Commissioner of Corporations under the Franchise Investment Law (Division 5 (commencing with Section 31000) of Title 4 of the Corporations Code) regarding whether or not an agreement constitutes a 'franchise' within the meaning of that law shall be prima facie evidence of the scope and extent of coverage of the definition of 'franchise' under this chapter; provided, however, the burden of proving an exemption or an exception from a definition is upon the person claiming it.

Applicable Commissioner's Guidelines

5. The Commissioner of Corporations has issued detailed guidelines to provide guidance in determining whether an agreement constitutes a "franchise." These are found in Commissioner's Release 3-F, entitled "WHEN DOES AN AGREEMENT CONSTITUTE A 'FRANCHISE'?" The Guidelines were issued on June 22, 1994. The provisions which are applicable to this matter follow and are identified by the paragraph and subparagraph designations found with the guidelines. The underlined emphasis of certain language has been added. The bold print is original.

6. **Franchise Fee**

For the agreement to constitute a franchise, the agreement must call for the payment of a franchise fee by the franchisee.

a. Definition

Section 31011 of the Law contains a broad definition of 'franchise fee.' That section includes in the definition any fee or charge that a franchisee is required to pay or agrees to pay for the right to enter into a business under a franchise agreement. In accordance with this definition, any fee or charge which the franchisee is required to pay to the franchisor or an affiliate of the franchisor for the right to engage in business is a franchise fee regardless of the designation given to, or the form of, such payment.

Whether or not a fee or charge is 'required' and whether it is made 'for the right to enter into a business,' is a mixed question of fact and law.

b. Types of Franchise Fees

A franchise fee may be payable in a lump sum or in installments. The amount of the installment payments may be made to depend on gross receipts or net profits in the form of a royalty, or it may be charged on units of merchandise ordered or sold by the franchisee. Thus, the franchise fee may be contained in the price charged by the franchisor or an affiliate of the franchisor for goods or services supplied to the franchisee or in the rental fee payable by the franchisee for business premises or equipment rented from the franchisor or an affiliate of the franchisor.

c. Bona Fide Wholesale Price of Goods

Under Section 31011, there is an exception from the definition of franchise fee for a payment on account of the purchase of goods in an amount not exceeding the bona fide wholesale price of such goods. This exception is based on the rationale that no substantial prejudice will come to a person buying a business and paying only the bona fide wholesale price for merchandise which that person proposes to sell in the business. Under these circumstances, such a payment is not deemed to be made for the right to enter into the franchised business. (Comm. Op. No. 73/20F.)

In line with this rationale, 'bona fide wholesale price' means the price at which goods are purchased and sold by a manufacturer or wholesaler to a wholesaler or dealer where there is ultimately an open and public market in which sales of the goods are effected to consumers of the goods. 'Bona fide wholesale price' does not include the price of goods for which there is no such open and public market, and where the goods are sold primarily to a person engaged in their redistribution. (PL/20F; Comm. Op. Nos. 71/52F, 73/1F, 74/2F.)

e. Quantity of Goods

Under Section 31011, the bona fide wholesale price exception is further limited to apply only if no obligation is imposed upon the purchaser to purchase or pay for a quantity of such goods in excess of that which a reasonable business person normally would purchase by way of a starting inventory or supply, or to maintain a going inventory or supply. Since a payment for such purchases is made by the franchisee not because the franchisee has a need for the goods, it is reasonable to conclude that the purchases are only to secure the right of selling the goods under the franchise agreement, and for that reason the payment constitutes a franchise fee. (Comm. Op. Nos. 73/1F, 73/10F.)

f. Question of Fact

Whether the price which the franchisee under the agreement is required to pay for goods exceeds their bona fide wholesale price (or exceeds it by an amount in excess of that allowed by Rules 310.011 and 310.011.1) is a question of fact. Also a question of fact is, whether the quantity of goods the franchisee is required to purchase or pay for exceeds what a reasonable business person normally would purchase as a starting inventory or supply, or to maintain a going inventory or supply. The Commissioner will not resolve these questions in an interpretive opinion since such opinions are limited to the interpretation and determination of legal questions arising under the Law. (See, Commissioner's Release No. 61-C.)

However, there are some legal considerations applicable to the determination of the bona fide wholesale price as follows:

i. The bona fide wholesale price of goods which are sold under a trademark or other commercial symbol may vary depending on the degree to which such trademark or symbol has attained public acceptance. The price charged for trade-marked articles does not necessarily exceed their bona fide wholesale price when non-trade-marked articles of equal or comparable quality are wholesaled at a lower price because products with little or no market identification usually have a lower bona fide wholesale price than items, though of comparable quality, which have a marketing history and a ready identity in the market place. Therefore, if, as a matter of fact, at the time of the franchise agreement the trade-marked articles command a premium price in the market place by virtue of the trademark, the premium is not necessarily a franchise

fee. (Comm. Op. No. 71/2F.) However, sales to distributors who are all within the common enterprise or marketing system is not sufficient to substantiate the ultimate marketability and market identification of the product and, consequently, do not serve to support the bona fide wholesale price of the product being sold. (Comm. Op. No. 73/1F.)

iv. Under Section 31153 of the Law, the franchisor has the burden of proving that the price at which goods are sold to the franchisee does not exceed the bona fide wholesale price of such goods. Similarly, the franchisor must prove the facts to support any other exemption, such as those under Rules 310.011 and 310.011.1.

g. 'Required' to Pay

The Law does not include in the definition of 'franchise fee' payments which the franchisee is not required to make but which are optional and required only if the franchisee elects to purchase, lease or rent merchandise, equipment or other property from the franchisor or an affiliate of the franchisor. In the absence of an obligation or a condition in the franchise agreement compelling action on the franchisee's part, or the necessity for undertaking such obligation in order to successfully operate the business, voluntary payments are not "required" under the agreement and, therefore, are not included within the statutory definition of 'franchise fee.' Also, voluntary payments, presumably, are not made for the right to enter into a franchised business and for that reason do not come within the definition. However, while a truly optional payment is not a franchise fee, a payment by a franchisee, though nominally optional, may in reality be essential; this is especially so if the franchisor intimates or suggests that the payment is essential for the successful operation of the business.

h. Payments to Franchisor or Others

Payments which the franchisee is required to make under the franchise agreement for the account of the franchisor are equivalent to payments made to the franchisor. Thus, it makes no difference whether payments for the rental of premises are required to be made by the franchisee to the franchisor as the owner and lessor of the premises, or to a third-party owner where the franchisor is the lessee and the franchisee the sublessee.

Also, payments required in the franchise agreement to be made by the franchisee for advertising and promotion to enhance the good will of the franchisor's business, even though the advertising and promotion also benefit the franchisee's business, may be deemed made for the account of the franchisor, especially where the agreement gives the franchisor discretion to determine the manner and content of the publicity. (PL/38F, PL/43F.) A payment to, or for the account of, third parties not affiliated with the franchisor is not a 'franchise fee' within the meaning of Section 31011, even though the franchisee is required by the agreement to make such payment and even if the franchisor

collects it from the franchisee on behalf of the third party; provided that such payment is not made for the right to enter into the business. However, under Section 31101(c)(1)(G) of the Law, if the agreement is a franchise as a result of other payments required of the franchisee amounting to a franchise fee, the obligation to make payments to the franchisor, in whole or in part, on behalf of third parties must be disclosed in writing by the franchisor.

Applicable Case Law

7. *Thueson v. U-Haul International, Inc.* (2006) 144 Cal. App. 4th 664 is the only California published appellate case which has addressed the issue of what constitutes a "franchise fee." (*Thueson*, p. 673.) The Court noted the existence of the Commissioner of Corporations guidelines (recited above) and observed that the Department's interpretation of its law is entitled to great weight.[2] The Court observed that the Guidelines confirm that the payment of a franchise fee is a necessary element of a franchise and the definition includes "any fee or charge which the franchisee is required to pay to the franchisor or affiliate of the franchisor for the right to engage in business."

8. *Thueson* involved a U-Haul dealership in McKinleyville, California, which claimed to have entered into a franchise with U-Haul corporation. The trial court found that no franchise fee had been imposed by U-Haul as a condition of the dealership contract. The First District Court of Appeal affirmed the trial court ruling. In addition to consideration of the Commissioner's Guidelines, the appellate court also considered the holdings of the other courts interpreting identical or very similar statutory definitions of a "franchise." The Court noted that those other courts have emphasized that the purpose of most franchise laws is to protect franchisees that have unequal bargaining power once they have made an unrecoverable "firm-specific investment" in the franchisor. In the absence of such investment, the concern does not exist. Moreover, payment of ordinary business expenses is not regarded as indirect franchise fees. (Citing *Wright-Moore Corp. v. Ricoh Corp.* (7th Cir. 1990) 908 F.2d 128 in which the federal 7th Circuit was applying Indiana's franchise law; *Watkins & Son Pet Supplies v. The IAMS Company* (E.D.Mich.1995, No. 94-70379) in which federal District Court applied Michigan law; *The Bryant Corporation v. Outboard Marine Corporation* (W.D.Wash. 1994, No. C93-1365R) holding that ordinary business expenses are not franchise fees under Washington State's franchise law; *Schultz v. Onan Corp.* (3d Cir. 1984) 737 F.2d 339, 345, interpreting Minnesota's franchise law in the same way.)

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[2] Respondents argue in this matter that the reference in Business and Professions Code section 20009 to "this chapter," refers exclusively to the California Franchise Relations Act found in the Business and Professions Code and not the California Franchise Investment Law which is the basis for the Desist and Refrain Order. However, *Thueson* was brought under both Acts and the Court drew no distinction between the two bodies of law in its expression of deference to the Commissioner's guidelines (*Thueson*, at p. 673.)

9. The *Thueson* Court rejected the dealer's contention that sums paid during the course of the business relationship were indirect franchise fees. These included a monthly fee for a local telephone line and directory listing, the cost of a local computer terminal, and other business expenses. The appellate court held that the trial court's decision that such expenses were ordinary business expenses was supported by substantial evidence. The court summarized its conclusion on page 676 of the decision:

> Appellant invested nothing in return for the right to enter into business with or for U-Haul. He made no required contribution of capital, made no unrecoverable investment in the franchisor, was not required to purchase any inventory, and was not required to purchase services from U-Haul in order to become a dealer. He placed none of his own funds… at risk in exchange for the dealership. Our statutes define a franchise fee as a fee paid for the right to do business, not ordinary business expenses paid during the course of business.

Determination Of Issues

10. As respondents have conceded[3] in their closing brief, the License Agreement and related documents grant the right to engage in the business of offering, selling or distributing goods and services under a marketing plan or system prescribed in substantial part by respondents and that plan is substantially associated with the respondent Save-A-Lot's trademark, service mark, and trade name. Therefore, the first two requirements for a "franchise" under California law are satisfied.

11. The remaining question is whether respondents require licensees to pay a "franchise fee" for the right to operate a Save-A-Lot grocery store. Section 31011 defines "franchise fee" broadly to include any fee or charge that the franchisee is required to pay or agrees to pay "for the right to enter into a business…including, but not limited to, any payment for goods and services." The wording of the License Agreement disavows the intent to create a franchise, but while such verbiage may convey respondent's intent, the question is whether the agreement nonetheless includes the direct or indirect payment of franchise fees.

12. First, apart from the clear obligation to purchase food exclusively from respondents (or to seek authorization to go elsewhere), there are no direct fees required of licensees for the right to do business with respondents. There are certainly considerable capital expenditures required to enter into the limited assortment discount grocery business which may approach $800,000 if the licensee begins with little more than a building. However, these are normal business expenses which are not required to be paid to respondents and not payments for the "right to enter into a business" authorized by respondents.

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[3] The concession is conditional, in that it is limited to the resolution of this matter.

13. The License Agreement, and the incorporated Supply Agreement, do contemplate that licensees will purchase food and other grocery products from respondents and licensees do expressly agree to pay the charges for such goods. However, neither agreement specifies either a minimum amount or dollar value of goods which must be purchased by licensees. Thus, the purchase of goods from respondents might be regarded as voluntary or optional; but the Commissioner's Guidelines include as "required" payments those goods which are necessary "to successfully operate the business." This includes those payments which the 'franchisor intimates or suggests .... [are] essential for the successful operation of the business." Here, the centerpiece of respondents' enterprise is the licensee's purchase of virtually all of its grocery store inventory from respondents to take advantage of the lower costs for such goods. Therefore, under the Commissioner's Guidelines, licensees are required to pay a direct fee for grocery items as a condition of engaging in business with respondents.

14. This is not the end of the inquiry as the Legislature has exempted such required payments for goods, if (a) the agreement is to purchase goods at a bona fide wholesale price; and (b), there is no obligation to pay for a quantity of goods in excess of a normal starting inventory or to maintain a going inventory. As noted, the agreement does not require any specific dollar amount for inventory or even a minimum amount to be purchased, either initially or thereafter to replenish inventory, so the remaining question is whether the goods will be sold to licensees at a "bona fide wholesale price."

15. The Commissioner's Guidelines (4, C) express that the rationale for this exception is that no substantial prejudice will come to a person buying a business and paying only the bona fide wholesale price for merchandise which that person proposes to sell in the business.[4] The guidelines add that the phrase only includes those situations in which "there is ultimately an open and public market in which sales of the goods are effected to consumers" and does not include situations in which no such market exists and "where the goods are sold primarily to a person engaged in their distribution." In this matter, the goods are initially sold to licensees at wholesale prices, but the ultimate consumers are the Save-A-Lot grocery store customers who purchase the goods in a retail "open and public" market. Moreover, respondents have established by the comparison of their wholesale prices with those of the largest wholesale grocer in California and name brand wholesale prices, that the price charged licenses is a bona fide wholesale price.[5] Finally, the very quick turnover of inventory minimizes the risk that the licensee will be left with an "illiquid" investment in the event that the parties part company. (See, e.g., *Wright-Moore Corp. v. Ricoh Corp.,* 908 F.2d 128, 136

[4] An alternative, and perhaps more persuasive, rationale is the Legislature's attempt to prevent a franchisor from hiding the franchise fee in inflated costs for wholesale goods (See, e.g., *Blanton v. Mobil Oil Corp.* 721 F.2d 1207, 1220 (9th Cir.1983.)

[5] Black's Law Dictionary defines "bona fide" as made in good faith; without fraud or deceit. (Black's Law Dictionary (8th ed. 2004.) Michigan's definition of a franchise contains language nearly identical to California and has defined "bona fide" as: "a price that constitutes a fair payment for goods purchased at a comparable level of distribution, and no part of which constitutes a payment for the right to enter into, or continue in, the franchise business." (§445.101(6), Mich. Admin. Code R.)

(C.A.7, 1990) noting that, under Indiana law, excess inventory requirements may constitute an indirect franchise fee if the inventory is illiquid, but a normal sales quota will not be a franchise fee under the bona fide wholesale price exception.)

16. Complainant also asserts that other fees paid by licensees are indirect franchise fees. These include the 2.5 % service fee previously charged by respondents, the security deposit, cost of signage, fees paid for marketing support, and the required costs for litigation including arbitration. These will be addressed in order.

17. The 2.5% service fee was not in effect at the time the Desist and Refrain Order was issued which calls into question its very relevance to this proceeding. Apart from that consideration, the evidence established that the break out of the cost of warehousing and handling was standard practice in the wholesale grocery industry. There is no question that when the charge was imposed, the licensees were required to pay the surcharge in connection with their purchase of inventory, but the issue was then, and remains, whether the total wholesale price reflected a bona fide wholesale price. The price comparisons among respondent, United Western Grocers and brand name producers establishes that with the inclusion of the service fee in the wholesale price, respondents' products were still considerably lower in price than brand name producers and United Western Grocers.

18. The next listed item is the security deposit. The Security Deposit Agreement requires the licensee to deposit with respondents a sum which the parties agree represents their best estimate of a one week's average total charges including inventory, service fees, transportation, and basic charges. If that amount turns out to be inadequate, respondents may require additional amounts. The licensee retains ownership of the deposit and is entitled to interest, but respondents have the right, without notice, to "set off" accounts receivable or other indebtedness of licensees. The security deposit is only required if the licensee elects to have an open account with respondents. In summary, the Security Deposit is not a payment required for the right to do business with respondents.

19. Licensees are required to provide signage, including a fairly elaborate large sign at the front of the grocery store and adequate product signage in the facility. This includes Save-A-Lot identification on the shopping carts. The cost of the signage can be, as the findings reflect, significant. Respondents' facility standards require that such signs be approved by respondents. They do offer to sell approved signage to licensees, but licensees may elect to purchase them elsewhere including from the alternative suppliers listed by respondents. Paragraph 6 h of the Commissioner's Guidelines provide that the payment of fees to third parties, even if required by as a condition of doing business, do not constitute franchise fees so long as they are not "made for the right to enter into the business." As the language of the License Agreement reflects, these aesthetic guidelines are designed to protect the image of the Save-A-Lot Marks and promote a successful business model. Such expenses also fall with the category of normal business expenses which the *Thueson* court determined not to be franchise fees for the same reason- they are not imposed for the right to enter into the business.

20. Respondents do offer a Marketing Subscription Agreement. However, this agreement is optional and licensees are not required to participate in the marketing program. Only if they do are they assessed a fee.

21. The last in the series of Department's contentions that licensees are required to pay a franchise fee involves the language in the License Agreement which requires the parties to submit any disputes regarding the agreement to mediation. If mediation is unsuccessful, the dispute proceeds to binding arbitration. The costs of arbitration are to be shared, but if a party fails to proceed with arbitration or unsuccessfully challenges the arbitration award, or fails to comply with the award, the other party is entitled to costs including reasonable attorney fees for having to compel arbitration or enforce the award. The License Agreement also provides that upon expiration of the agreement or earlier termination, the licensee shall pay the expenses of collection and reasonable attorney fees if it becomes necessary for licensor to employ an attorney to collect any amounts due from licensee or to enforce licensor's rights or licensee's obligations. The second provision appears at odds with the agreement to resolve all disputes in mediation and arbitration, but neither provision can reasonably be construed as requiring the licensee to pay a fee for the right to enter into business with the franchisor.

ORDER

1. Respondents' appeal from the Desist and Refrain Order is granted.

2. The Desist and Refrain Order issued September 25, 2007, against respondents is rescinded.

Dated: December 4, 2008

KARL S. ENGEMAN
Administrative Law Judge
Office of Administrative Hearings