International Franchise Association
50th Annual Legal Symposium
May 7-9, 2017
JW Marriott
Washington, DC

We Broke the Law! Now What?

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1. Introduction

Complying with franchise laws in the U.S. is no easy task. One must consider federal law and regulation, as well as over a dozen different states laws. Each of these bodies of law allows enforcement by government agencies and regulators, and the state laws also allow other parties to enforce the laws.

Yet, for franchisors and franchisor counsel it is easy to put the enforcement sections of federal and state franchise laws to the back of their mind. Most franchisors try to comply with franchise laws, so why should they worry? They do their best to timely update their FDDs, to timely disclose prospective franchisees, and otherwise also comply with franchise laws. Yet, they should worry, because the most common franchise law violations arise out of inadvertent mistakes. While there are certainly those who intentionally skirt the laws, in most instances the violations can be summed up as more or less honest mistakes – ignorance of the law, ignorance of the specifics of the law, or ignorance of how the law will apply to one's set of facts.

And even innocent mistakes can have significant consequences on franchisors and franchise systems. At a minimum the discovery of a franchise law violation will mean that the franchisor must devote time and resources to understand what has happened, how to address the issue and how to avoid repeating the mistake in the future. The public disclosure of a violation may impact the franchisor's ability to sell additional franchises and even impact its relationship with existing franchisees.

In this paper we will follow the life of a franchise law violation, starting with how it may arise, to what potential legal actions may ensue, continuing to review typical actions taken by franchise examiners, then on to best practices for franchisors and their counsel in working with examiners to address violations, and finally providing some tips for how to avoid future mistakes and violations.

2. How problems arise

The reasons for why franchisors violate franchise laws are as manifold as the violations, but generally they can be divided into three categories: the franchisor who didn't realize it was a franchisor, or the "accidental franchise; the franchisor that is registered or exempt but mistook the scope of the law and unintentionally violated the law; and the fraudster who may or may not have been aware of franchise laws, but either way set out to reach their goals without regard for the law and the truth.

a. The Accidental Franchise

The federal and state franchise laws are consumer protection laws and as such cast a broad net to protect the unwitting consumer from fraud and deceit. Because of their broad scope, relationships that are not intended to be franchises may be covered by franchise laws. Add to this the multitude of state and federal franchise and business opportunity laws that must be reviewed for a complete analysis, and that many lawyers

may be unfamiliar with franchise laws or not understand their scope, and it is not so very surprising that accidental franchises abound.[1]

Even experienced franchise practitioners can easily stumble. Often they will use some type of mental shorthand when thinking about what type of relationship constitutes a franchise. The short hand likely follows the FTC Franchise Rule[2] definition and includes that there must be: (1) a trademark license; (2) the "franchisor" provides a marketing plan or has the right to control the "franchisee's" operations; and (3) the "franchisee" pays the "franchisor" a fee. This suggested definition is truly just a shorthand and insufficient in many ways. The franchise law definitions in various state statutes and the federal regulation are relatively similar, but still sufficiently different that one should not rely on one definition when analyzing the applicability of another statute to a potential franchise relationship. For example, the definition under the FTC Franchise Rule:

> (h) *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:
>
> (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
>
> (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
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> (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.[3]

is different from the definition under the New York statute:

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[1] For an in-depth review of how franchises are defined and a discussion of various models that may inadvertently be a franchise, *see e.g.* Rochelle B. Spandorf and Mark A. Kirsch, The Accidental Franchise, American Bar Association 24th Annual Forum on Franchising, and Kenneth R. Costello Beata Krakus and Kristy L. Zastrow, *From License Agreement to Regulated Relationships: The Accidental Franchise*, American Bar Association 32nd Annual Forum on Franchising.

[2] 16 CFR 436 (2007).

[3] 16 CFR 436.1(i) (2007).

> "Franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:
>
> (a) 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 the franchisee is required to pay, directly or indirectly, a franchise fee, or
>
> (b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchisee fee.[4]

which is also different from the Hawaii statute:

> "Franchise" means an oral or written contract or agreement, either expressed or implied, in which a person grants to another person, a license to use a trade name, service mark, trademark, logotype, or related characteristic in which there is a community interest in the business of offering, selling, or distributing goods or services at wholesale or retail, leasing, or otherwise, and in which the franchisee is required to pay, directly or indirectly, a franchise fee.[5]

As it is plain to see from these three definitions, what relationship is considered a franchise differs significantly depending on applicable law.[6] And the differences may be even more significant than the words of the definitions may at first imply, and even in statutes that use the same elements to define a franchise, each element may be subject to different interpretations. For example, under the California franchise statute,[7] the franchisee's business must be "substantially associated"[8] with the licensed trademark.

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[4] N.Y. Gen. Bus. Law § 681. The New York definition of a "franchise" is infamous for only containing two elements, when every other franchise definition under similar statutes has the Holy Trinity of trademark license, control/assistance/community of interest, and fee. In New York, it is sufficient that two of those elements are satisfied: a marketing plan plus the fee, or a trademark license plus a fee.

[5] Haw. Rev. Stat. Ann. § 482-E2. In Hawaii, instead of requiring that the franchisor provides the franchisee with a marketing plan or renders assistance or controls the franchisee's operation, the focus is on whether there is a "community of interest" between the franchisor and franchisee.

[6] The focus of this paper is on remedies available under franchise *disclosure* laws. If taking into consideration the franchise relationship statutes the definition of what relationship constitutes a franchise may be even more varied.

[7] Cal. Corp. Code § 31000 et seq.

[8] Cal. Corp. Code § 31005.

This appears to be a relatively high standard to meet, but in Release 3 F[9] the Commissioner explains that as long as a consumer associates the franchisee's business with the trademark, the trademark element of the California franchise definition is satisfied.

This inconsistency between franchise definitions rarely causes issues for companies who intend to franchise their concepts, but they may lead to significant issues for companies that are trying to avoid franchise laws. Some businesses may have a negative view of franchising as a business model, and in some cases these views extend to entire industries.[10] In other instances a faulty understanding of franchise laws may be prevalent in whole industries leading companies in those industries to believe that franchise laws may apply to them. This is often the case with multi-level marketing companies[11] and not-for-profit organizations.[12]

b. The Registered Franchisor

Just like accidental franchises happen by mistake, businesses that have decided they wish to franchise can accidentally violate franchise laws.

For example, for franchisors that are not registered in all the franchise registration states one common mistake is the offer or sale of franchises in states where it is not registered. Just like it is described above that franchise definitions vary by statute, so too do the scope of different franchise laws vary. The New York franchise statute is infamous for being extremely broad,[13] but more subtle differences in definitions may also cause issues. One example is the franchisee who lives in one state, but operates his or her franchise in another. A comparison between the California and Illinois

[9] Available at http://www.dbo.ca.gov/Commissioner/Releases/3-F.asp

[10] For example, in one of the authors' experience in the solar panel installers are generally unwilling to become franchisees, making it hard for solar panel manufacturers to structure their program as franchises.

[11] For example, multi-level marketing companies often believe that they are exempt from franchise laws as long as they offer a below $200 starter package to persons joining their networks. While this may generally be true, this analysis ignores that there are sometimes required purchases in addition to the cost of the starter package, or that not all franchise laws have an exemption for minimum franchise fees or that at least in the case of the Illinois franchise statute, the franchise fees paid over the length of the relationship are accumulated.

[12] Not-for-profits are regulated by the Internal Revenue Code and also by state laws that require registration before they can fundraise. Often they do not see themselves as being in business. However, both federal and state law guidance indicate that not-for-profits may very well be considered franchises. *See e.g. Girl Scouts of Manitou Council, Inc. v. Girl Scouts of the United States of America, Inc.*, No. 10-1986, 2011 U.S. App. LEXIS 10911 (7th Cir. May 31, 2011) for an application of the Wisconsin franchise statute to the Girl Scouts, and FTC Staff Opinions 02-2, issued April 26, 2002 and 00-4, issued April 7, 2000 for the applicability to not-for-profits in some situations.

[13] The New York statute, as opposed to other state franchise disclosure laws, does not limit its scope to franchises to be located in the state, or those sold by franchisors or prospective franchisees located there. N.Y. Gen. Bus. Law § 683. Generally speaking, any offer or sale of a franchise with a connection to New York, such as the parties meeting there to review the terms of the franchise, may be subject to the statute. The New York franchise examiners will even consider sales outside the U.S. by New York based franchisors as being subject to the New York franchise law and require an exemption filing to be submitted and approved before the offer or sale is undertaken.

franchise disclosure laws is illustrative. The California Franchise Investment Law has a relatively typical approach to jurisdictional scope: it applies to offers to sale franchises in California and encompasses situations when "an offer to sell is made in [the] state, or an offer to buy is accepted in [the] state, or if the franchisee is domiciled in [the] state, the franchised business is or will be operated in [the] state."[14] The statute excludes offers and sales of franchises to residents of other states if all franchised locations are physically located outside the state, thereby excluding the random meetings in California or other tangential contacts with the state.[15] The Illinois Franchise Disclosure Act[16] requires a franchisor to register in order to "sell or offer to sell a franchise in [the] State if (1) the franchisee is domiciled in [the] State or (2) the offer of a franchise is made or accepted in [the] State."[17] In most instances the difference between the California and Illinois statutes will be immaterial, but imagine the situation in which an out of state franchisor sells a franchise to an out of state prospective franchisee to open a location in Illinois or California, but they never meet in the state. It is clear that the Illinois statute will not apply, even though the franchise will be located in Illinois. *Likely*, the California statute also will not apply, but it is not nearly as clear and the cautious franchisor should consider registering before offering or selling the franchise. These issues occur all the time and occasionally lead to litigation. For example, in *Wine & Canvas Development, LLC v. Weisser*,[18] Indiana residents negotiated a "license agreement" with a licensor. The licensed location was to be located in California and the Indiana residents were moving there. They never received an FDD. When a lawsuit ensued between the parties, the licensees claimed that the license was a franchise and that the "franchisor" had violated the California Franchise Investment Law. The Indiana District Court dismissed the licensee's claims as the licensee was not domiciled in California at the time the agreement was negotiated and signed, and the negotiations took place in Indiana.

Another issue that often leads to unintentional franchise law violations is timely renewal of franchise registrations. Typically, a franchisor must be registered in a state not just to sell a franchise, but also to offer it. Franchisors that are actively selling franchises typically renew their state registrations timely, but with even slight differences in registration dates in different states it is easy to have certain gap periods. Some states, such as California and New York have special procedures in place to continue sales activities during gap periods, but in many states, it may not be as clear what you may do and what you may not.

A related issue is the failure to amend the FDD and the state registration in a timely fashion. The FTC Franchise Rule calls for quarterly updates, but state laws may require more frequent updates.

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[14] Cal. Corp. Code § 31013(a).

[15] Cal. Corp. Code § 31105.

[16] 815 Ill. Comp. Stat.705/1 et seq.

[17] 815 Ill. Comp. Stat.705/10.

[18] No. 1:11-cv-01598-TWP-DKL, 2013 WL 5965914 (S.C. ND. Sept. 11, 2013).

Yet another unintentional violation related to timeliness, and one of the easiest disclosure mistakes for franchisors to make, is the timely disclosure. Most franchisor are very familiar with the federally imposed 14 calendar day rule, which requires disclosure with the a franchisor's current FDD at least 14 calendar days before the franchisee signs a binding agreement with the franchisor (or its affiliates) or makes a payment to such parties.[19] However, since the FTC Franchise Rule only preempts state statutes that set forth lesser requirements,[20] it does not preempt the New York requirement to provide the FDD already at the first personal meeting between the franchisor and franchisee.[21] Likewise, the Michigan requirement that the FDD be provided 10 business days before execution of a binding agreement or the payment of any consideration may likewise not be preempted by the federal rule and as such may lead to inadvertent disclosure mistakes.[22]

And even when the franchisor does disclose timely, does it provide the prospective franchisee with the right document? Most franchisors strive to have one multi-state FDD that they can use throughout the U.S., but sometimes comments from the franchise examiners will make that impractical. In the situation where a franchisor has multiple FDDs it may be difficult to know exactly when to use which FDD. For example, if a franchisor based in Kansas had a separate Illinois FDD, and was selling a franchise to be located in Illinois to a prospect domiciled in Missouri, should the franchisor use its multi-state FDD or should it use its Illinois-specific FDD?[23] The variations are almost endless and again, it is not surprising that franchisors and their sales teams will occasionally stumble.

The human factor can play into the inadvertent franchise law violation on an even more basic level as well, for example by the sales team not being provided the latest version of the FDD after an annual renewal or material change amendment, leading to prospective franchisees receiving an old FDD.

Another common issue in franchise systems is the inherent conflict between complying with the legal limitations set by federal and state franchise laws, and the desire to grow the system as quickly as possible. Franchise sales teams are, not surprisingly, frequently evaluated and compensated based on the number of deals they close with new franchisees. The pressure on sales teams may lead to practices such as back dating FDD receipt pages to be able to sign deals before quarter end or year end, or by excessive puffery about the franchise system and the financial performance of existing franchisees.

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[19] 16 CFR 436.2(a) (2007).

[20] 16 CFR 436.10(b) (2007)

[21] N.Y. Gen. Bus. Law § 683 (8). Rhode Island until recently also had a first personal meeting rule.

[22] Mich. Comp. L. § 445.1508(1). The 10-business day requirement also remains in places in other statutes, such as in the California Franchise Investment Law.

[23] As discussed above, perversely, the answer depends on whether the offer of the franchise is made or accepted in Illinois. *See* 815 Ill. Comp. Stat. 705/10.

However, just as eager as the sales team may be to close a deal, the prospective franchisee may be equally eager to become a franchisee and start their development efforts. A common issue is the excited prospective franchisee who will send in a check for the initial fee, together with its signed franchise agreement, long before the 14-calendar day waiting period is over.[24]

c. Exempt Franchisor

Another group of compliant franchisors that may occasionally go astray are the exempt franchisors. Some franchisors choose to rely on exemptions throughout the U.S. and only close deals that fit within an applicable exemption. Others will use available exemptions in a more limited manner to avoid having to register in those states where exemptions would generally take them outside of the state registration requirements, or as a means to enter a state where they have not previously registered and an unexpected opportunity for a franchise sale has come up.

However, similar to how the franchise definition varies between various franchise laws and regulations, even similar exemptions differ between jurisdictions, making it easy to inadvertently make mistakes. For example, the fractional franchise exemption is favored by many franchisors because it exempts the franchisor both from registration and disclosure obligations and available in most states. It is a prime example of how slight differences may make a big difference and create a trap for the exempt franchisor. For example, under the FTC Franchise Rule, the fractional franchise exemption is defined as:

> a franchise relationship that satisfies the following criteria when the relationship is created:
>
> (1) The franchisee, any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business; and
>
> (2) The parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation.[25]

Compare this definition to the California fractional franchise exemption:

> (a) For at least the last 24 months prior to the date of sale of the franchise, the prospective franchisee, or if the

[24] To the extent the franchisor accepts the payment and the executed agreement it is likely that franchise examiners would consider this a mitigation circumstance if the same franchisee would later complain of disclosure violations by the franchisor.

[25] 16 CFR 436.1(g) (2007).

> prospective franchisee is not a natural person, an existing officer, director, or managing agent of the prospective franchisee who has held that position with the prospective franchisee for at least the last 24 months, has been engaged in a business offering products or services substantially similar or related to those to be offered by the franchised business.
>
> (b) The new product or service is substantially similar or related to the product or service being offered by the prospective franchisee's existing business.
>
> (c) The franchised business is to be operated from the same business location as the prospective franchisee's existing business.
>
> (d) The parties anticipated, in good faith, at the time the agreement establishing the franchise relationship was reached, that sales resulting from the franchised business will not represent more than 20 percent of the total sales in dollar volume of the franchisee on an annual basis.
>
> (e) The prospective franchisee is not controlled by the franchisor.
>
> (f) The franchisor files with the commissioner a notice of exemption and pays the fee prescribed in subdivision (f) of Section 31500 prior to an offer or sale of such a franchise in this state during any calendar year in which one or more of those franchises are sold.[26]

There are many easily noticeable differences between the two definitions, such as the California requirement that the fractional franchise be operated out of the same business location where the federal exemption has no location requirement and that the California exemption requires an annual notice filing. Most franchisors relying on this particular exemption are likely familiar with these differences. But there are also more subtle differences that can have a large impact. For example, where the federal exemption only looks to the financial impact on the franchisee during the franchisee's first year of operation of the fractional franchise, the California exemption requires the parties to take into consideration whether the fractional franchise will exceed 20% of the franchisee's revenue stream throughout the relationship. This relatively minor difference in wording makes a big difference in scope of the fractional franchise exemption.

[26] Cal. Corp. Code § Sec. 31108.

The fractional franchise exemption is just one of many exemptions and the issues are similar with other exemptions.[27] As mentioned above, there are businesses and even industries that strongly disfavor franchising as a model and believe that the use of franchising terminology and the use of an FDD will discourage people in their industry from joining their network of consultants/distributors/representatives. It is common for franchise lawyers to help these types of businesses to structure around the franchise laws, often at least in part by relying on exemptions. However, with franchise laws being broad and exemptions being narrow, typically the models developed by franchise lawyers are dependent on the would-be franchisor carefully following the proposed model, using carefully crafted agreements, and so on. But over time the details of the model developed are often forgotten, the business team enforcing it changes and institutional knowledge is lost about why the program was structured a certain way. The program is then tweaked, and not infrequently, what results is a franchise.

d. Intentional Violations

The final category of sources of franchise law violations is the one most of us likely think about first when thinking about in this context – the intentional violation. This is arguably the very root of why laws such as franchise and business opportunity laws were first adopted. It can be hard to draw the line between what is an intentional violation of franchise laws, as opposed to an accidental one. Are creative interpretations of the franchise laws intentional violations or inadvertent ones? How about when the franchisor relied on poor legal advice? Where ever on the scale from truly unintentional to clearly intentional a violation will fall, the authors would suggest that examiners will see through any subterfuge relatively easily and recourse and remedies sought by examiners will be meted out accordingly.

3. What can examiners do?/Sanctions and remedies

Franchisors and franchise counsel often see state franchise laws as one and expect that rights and obligations under different state laws will be the same. There are many similarities between the different statutes but it would be incorrect to assume that franchise examiners in all states have the same enforcement rights or the same remedies available to them.

a. FTC Actions

Most of this paper is devoted to discussing enforcement actions by state franchise examiners, as opposed to by federal examiners. Leaving aside the fact that there are simply more state franchise examiners than staff at the FTC to handle franchise-related complaints, the FTC also has limited resources available for pursuing such complaints. Consequently, while the FTC's powers are significantly broader, most investigations that the FTC undertake are those related to fraud and other intentionally misleading acts and omissions large groups of people.

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[27] For a review of federal and state law franchise exemptions, *see* Leslie Curran and Beata Krakus (editors), *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws*.

The FTC does, however, have significant investigative and enforcement powers under the FTC Act. The FTC may prosecute any inquiry necessary to its duties in any part of the United States.[28] The FTC can subpoena both witnesses and documents in investigations.[29] In addition to the subpoena powers, the Commission may also use civil investigative demands ("CIDs") to look in to allegations of unfair and deceptive practices. CIDs and subpoenas can to a large extent be used to achieve the same goals – to get witness testimony and documentation. CIDs give the Commission further reaching powers though. Through a CID, the FTC can also require written reports and responses to specific questions. The FTC also has the right to require annual or special reports or answers from businesses.

If based on an investigation the FTC has reason to believe that the FTC Act has been violated it can bring an enforcement action. Franchise-related violations of the FTC Act would be brought under Section 5(a) of the Act which prohibits unfair or deceptive acts or practices affecting commerce. "Unfair practices" are those that cause or are likely to cause substantial injury to consumers which are not reasonably avoidable by consumers themselves and are not outweighed by consumer benefit or competitive benefit.[30]

If the FTC's investigation leads it to believe that a party has violated the FTC Act it can issue a complaint and seek a consent agreement with the violating party. If the party agrees, the consent agreement is published for public comment for 30 days after which the FTC will determine whether to make the consent order final. If the party in question contests the complaint, the matter will be heard before an administrative law judge. The administrative law judge's decision can be appealed to a court of appeal, and then in turn to the U.S. Supreme Court.[31]

Instead of going through the administrative adjudicatory process, the FTC may also seek preliminary and permanent injunctions and civil penalties through court actions.[32] This type of action is taken under Section 13(b) of the FTC Act. The powers of the FTC under Section 3(b) have through practice been expanded to restitution, rescission, appointment of receivers and freezing of assets.[33]

While the FTC has broad enforcement rights, it has rarely used them against franchisors. In fact, a review of FTC enforcement actions for the last two years did not reveal a single enforcement action against a franchisor. The FTC has instead focused its consumer protection actions on FTC Act violations involving business opportunities, multi-level marketing plans/pyramid schemes and false and misleading advertising. In

[28] FTC Act Sec. 3, 15 U.S.C. Sec. 43.

[29] FTC Act Sec. 9.

[30] 15 U.S.C 45(n).

[31] 15 U.S.C. 45(c).

[32] 15 U.S.C. Sec. 53(b).

[33] *See e.g.* https://www.ftc.gov/about-ftc/what-we-do/enforcement-authority

allocating its limited resources, the FTC pursues violations that have affected a large number of consumers.[34]

b. Remedies Available To State Examiners

Exhibit A to this paper contains a summary of remedies that are available to examiner. The specific remedies available vary by state and the steps examiners must take to obtain them also vary. Below is a general discussion of remedies available to state examiners.

i. Stop orders/Cease and desist

Most states, as well as the FTC, can issue a stop order or cease and desist order to immediately prevent a franchisor from further selling franchises in their state (or in the U.S., in the case of the FTC) while an investigation is pending.[35] A stop order can be used by examiners if they discover a potential violation in a pending application, but can also be used to suspend or revoke a current registration. Depending on the state the order may be issued summarily, or there may be opportunity for a hearing before the order takes effect.

ii. Injunctive relief

Injunctive relief only comes into question if a civil action is brought against the franchisor. Examiners may seek both permanent and temporary injunctions, and may take other action to help prevent further wrong-doing, such as appointing receivers that can help manage the franchisor's assets.

iii. Fines and Investigative Cost

Civil or administrative fines can be imposed in most states. The fines are often measured per violation, so if there are multiple violations, they can be significant. The maximum per violation fine varies by state, but in several states a fine can be up to $10,000, and in some states, it can be as high as $50,000 or $100,000.[36] Typically, violations that have arisen out of ignorance or mistake will not generate high fines, especially when the violation is limited to one or two franchise sales. In those circumstances fines will often be limited to $2,000-$5,000. It is when the violation affects a large number of franchisees and when the parties' actions are more deliberate that the fines get higher.

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[34] FTC cases and proceedings can be found at https://www.ftc.gov/enforcement/cases-proceedings/advanced-search

[35] No such right exists in New York, North Dakota, Oregon and Wisconsin.

[36] For example, in California the per violation civil fine can be up to $10,000. In Rhode Island the per violation fine can be as much as $50,000. In Hawaii, a civil fine can be up to $100,000, but it is not clear from the statute if such a high fine would be imposed for a single violation.

California can issue administrative fines of up to $2,500 and obtain a civil fine of up to $10,000 per violation.[37] Hawaii can issue civil fines up to $100,000.[38] Michigan may issue fines up to $10,000.[39] Minnesota may issue fines up to $2,000 for violations, obtain fines up to $25,000 for failure to comply with judgment or court orders and up to $10,000 for willful violations of its Act. In New York, misdemeanor violations of its Act are subject to up to a $1,000 fine.[40] Rhode Island can issue fines up to $50,000 per violation and up to $5,000 for a violation of a stop order.[41] South Dakota can issue administrative fines up to $5,000 per violation of a stop order.[42] Violators of the Virginia franchise laws can receive a civil fine of up to $25,000 per violation and a criminal fine of up to $5,000.[43] Washington can obtain civil fines of up to $25,000 for violation of an injunction[44], $2,000 for violations[45] and up to $5,000 for willful violations.[46] Violators in Wisconsin will find themselves subject to fines up to $5,000.[47] The Federal Trade Commission has the authority to levy fines up to $16,000 for violations of the Franchise Rule or Commission orders.[48]

Some regulators may be amenable to negotiating the amount of the fine, and if the state's enforcement actions are available online it may be wise to review similar actions to get a feel for typical fines for the franchisor's violation. Factors that an examiner may take into consideration include what actions the franchisor and its management took once learning about the violation, whether any real harm resulted to franchisees, and whether the franchisor has been cooperative with the examiner throughout the investigation.

In addition to fines, it is also common that examiners will request reimbursement of investigation expenses and attorneys' fees. Investigation expenses are typically relatively modest amounts, but attorneys' fees can be significant.

iv. Rescission and Restitution

[37] Cal. Corp. Code §§ 31405, 31406, 31408(b), 31410, 31411

[38] Haw. Rev. Stat. Ann. §482E-10.5

[39] Mich. Comp. Laws §445.1535(1)

[40] N.Y. Gen. Bus. Law §692(2)

[41] R.I. Gen. Laws § 19.28.1-18(c)(3), 19.28.1-18(d)

[42] S.D. Codified Laws § 37-5A-66.1

[43] Va. Code § 13.1-569(B)

[44] Wash. Rev. Code § 19.100.210(2)

[45] Wash. Rev. Code § 19.100.210(3)

[46] Wash. Rev. Code § 19.100.210(6)

[47] Wis. Stat. § 553.54

[48] 15 U.S.C. § 45(l)-(m).

As discussed below in Section 4 a., rescission and restitution claims can be brought by franchisees and franchisors, and where brought by a franchisee or franchisor claims may be common law based or statutory. For purposes of rescission by franchise examiners, the basis for rescission and restitution claims would be the applicable franchise statutes.

The process that franchise examiners must follow to obtain rescission on behalf of aggrieved franchisees differ in different states. In California, Indiana and Virginia examiners can order rescission after only an agency hearing. In all other jurisdictions, the franchise examiners would have to bring a civil action to pursue rescission.

One may think that the need in most jurisdictions to go to court to obtain rescission is a deterrent for most examiners from seeking rescission. However, at least in some states the examiners will requires rescission as a required element of consent orders, so in practice offering rescission is a common remedy.

v. Criminal

Criminal actions are only available in the case of intentional violations of the franchise laws. Many state laws allow for significant fines and imprisonment. Criminal fines can be up towards $100,000 and in many states, intentional violation of the state franchise laws are categorized as felonies. Prison terms of several years – as long as 10 years[49] – are possible for intentional violations of the franchise laws.

vi. Other remedies

With most violations addressed by franchise examiners resulting from ignorance and inadvertent mistakes, rehabilitation, rather than penalizing is often the examiners' primary goal. Stop orders, fines and restitution certainly will get a franchisor's attention, but beyond that they do little to help ensure that the franchisor does not commit the same mistake again. Some states rely on other methods of helping prevent future violations.

One common method is to require that the franchisor's management get franchise law compliance training. The compliance training will at the very least educate the franchisor's management about what they should be doing to comply with franchise laws. Requiring compliance training is maybe the most common rehabilitative remedy and used almost as a matter of course in some states, such as California.

Other options that franchise examiners will sometimes revert to are to require that a franchisor hires competent franchise counsel to help prepare the franchisor's disclosure documents, hire franchise counsel to act as a monitor for the franchisor to supervise its franchise activities, or appoint somebody knowledgeable about franchise laws to act as the franchisor's compliance officer.

[49] Wash. Rev. Code § 19.100.191

Finally, while this is not necessarily a remedy imposed by state franchise examiners, a remedy implicit in the FTC Franchise Rule is the disclosure of ongoing and completed actions in Item 3 of the franchisor's FDD.[50] A pending administrative, criminal or material civil action involving the violation of franchise law must be disclosed, as must certain completed matters, such as franchise examiners' actions. For example, an injunctive or restrictive order resulting from an action by a public agency relating to a franchise must be disclosed.[51] Not all concluded enforcement actions will necessarily fall within this category, but many will. For example, if the franchisor is required to appoint a monitor for its business, or hire experienced franchise counsel, disclosure would likely be required.

c. Individual Responsibility

Maybe the most effective method of gaining the attention of anybody attending a franchise law compliance training program is to tell them that they may incur personal liability.

While the franchisor's management team is not held liable for franchise law violations nearly as often as the franchisor entity itself, it still common that individuals are held liable. For example, in California, the state franchise examiners can seek civil, administrative and criminal penalties against any person who violates the California Franchise Investment Law, and the examiners frequently seek such remedies.[52]

Franchisor's management can also be exposed to liability from suits brought by franchisees. For example, in *Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.* the 9th Circuit found that two franchisor executives were individually responsible despite ignorance of the law.[53] Likewise, in *Cherrington v. Wild Noodles Franchise Co., LLC*[54] the court found that the owner and COO of the franchisor could be held liable for violations of the Minnesota Franchise Act.

Personal liability may extend not only to the franchisor's management and employees, but attorneys assisting the franchisor may also be held liable. For example, a California court has found an attorney liable where he had drafted a deficient disclosure document that franchisees had relied upon.[55] Likewise, a Nebraska court found an attorney liable where he had held himself out as being experienced in franchise law and failed to do the necessary research to competently represent his client.[56]

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[50] 16 CFR 436.5(c) (2007).

[51] *Id.*

[52] *See e.g.* Desist and Refrain Order against Massetti, Shakesheff and Bike Caffee Franchising, Inc., dated August 31, 2016.

[53] 890 F.2d 165 (9th Cir. 1989).

[54] 2006 WL 1704301, U.S. District Court, D. Minnesota, No. 04-4572 (MCJ/JJG), June 15, 2006.

[55] *Courtney v. Waring*, 237 Cal. Rptr. 233 (Cal. Crt. App. 1987).

[56] *State v. Orr*, 759 N.W.2d (Neb. 2009).

4. What can others do?

Franchise examiners are not the only ones who can enforce state franchise law violations. Typically, state franchise laws will give franchisees the right to pursue damages and rescission claims against the franchisor.[57] Franchisees can bring action not only against the franchisor, but also against franchisor management, giving franchisee actions a significant, additional bite.[58]

a. Recession

Franchisees can seek rescission in most jurisdictions with franchise disclosure laws under the state's franchise disclosure statute. Anywhere in the U.S. common law claims for rescission could be brought by franchisees. It may be worth mentioning that rescission is a remedy that is available to both franchisors and franchisees. When franchisors seek rescission though it is typically as an offensive move to cut short the franchisee's ability to bring actions for franchise law violations. This type of offensive rescission is discussed further below.

To bring an action for common law rescission the plaintiff must show that there is a valid reason to rescind the franchise agreement. For common law rescission, the reason may be fraud in the inducement, a material breach of the agreement, mistake, impossibility of performance or frustration of purpose.[59] If instead the franchisee wants to rescind its franchise agreement pursuant to a franchise statute it will have to consult the specific franchise statute to determine what is necessary to bring an action, Typically, the franchisee must show that the franchisor (a) employed a device, scheme or artifice to defraud, (b) made an untrue statement of material fact or omitted a material fact necessary to make the statements made not misleading, (c) engaged in any conduct that operates as fraud or deceit, or (d) failed to timely disclose the franchisee. The list of grounds for rescission varies significantly by states though, and thus, franchisees' ability to seek statutory rescission will depend to a large extent on what state law applies.

Notification of franchisees once a violation is discovered and the offer of rescission can play an important strategic role. Many state statutes significantly shorten the statute of limitations once a rescission offer has been extended to the franchisee.[60] Typically, a multi-year statute of limitations period is cut down to only 90 days.[61]

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[57] *See e.g.* Cal. Corp. Code § 31300 (franchisee may seek damages and rescission for willful acts and omissions), 815 Ill. Comp. Stat. 705/26 (franchisee can seek damages); and Md. Code, Bus. Reg. §14-227 (rescission and restitution)

[58] *See e.g.* 815 Ill. Comp. Stat. 705/26, Md. Code, Bus. Reg. §14.-227, Minn. Stat. § 80C.17 and R.I. Gen. Laws §19-28.1-21.

[59] For an in depth review of rescission, *see* Rochelle Spandorf Julianne Lusthaus, Theresa Koller, *Rescission: The Annulment of a Franchise Marriage*, American Bar Association 38th Forum on Franchising.

[60] *See e.g.* 815 Ill. Comp. Stat. 705/23, RI 19-28.1-22 and Wis. Stat § 553.51.

[61] *Id.*

b. Examples of Franchisee Actions

When franchisees sue, the lawsuits are often not just limited to statutory franchise law claims for rescission or damages. Usually, common law claims will also be included. Because of the various causes of actions available to franchisees these lawsuits may appear like a veritable slush bucket. One example of such an action was *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*[62] In *Love of Food*, the franchisee, Love of Food, had purchased a franchise for the operation of a Maoz Vegetarian restaurant in Washington D.C. Love of Food had its principal place of business in Maryland and a Maoz Vegetarian sales person had emailed Love of Food from New York to discuss the franchise opportunity. Love of Food had been provided an FDD. The FDD was registered – just not in Maryland or New York. Love of Food's claims for damages and rescission were based on Maoz' failure to register in Maryland and New York, as well as its failure to timely disclose the FDD. Further, it also claimed that the initial investment information provided in the FDD was incorrect and that Maoz' had made illegal and inaccurate financial performance representations.

An example of a lawsuit involving an accidental franchise situation is *Chicago Male Medical Clinic, LLC v. Ultimate Management, Inc.*[63] In this case, Chicago Male had entered into a "consulting agreement" with Ultimate Management and paid a $300,000 initial fee. Even though there was no express right to use Ultimate Management's trademark, the District Court found that the addition of Chicago Male to Ultimate Management's website and providing Chicago Male with Ultimate Management's trademark for use was sufficient evidence of a trademark license. Because the other franchise definition elements were present, the court awarded Chicago Male rescission of its contract and payment of $300,000 of initial fees, plus the over $55,000 in royalties that had been paid during the term of the agreement.

Not all franchisee claims for breaches of the state franchise laws will be successful though and franchisees bringing action must evaluate what actions they have standing to bring. For example, in *Lofgren v. Airtona Canada*,[64] the franchisee alleged, amongst other things, that the franchisor's failure to file a notice under the Michigan Franchise Investment Law before selling a franchise to the franchisee was a violation of that statute. However, the court found that there is no private cause of action for this violation and dismissed the franchisee's claim.[65]

Another group that may be interested in enforcing franchise laws against a franchisor are its competitors. Typically, competitors do not have standing to pursue franchise law violations of other franchisors and businesses, competitors can play a role in enforcement through reporting violations to state and federal franchise examiners.

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[62] 70 F. Supp. 3d 376 (D.D.C. 2014).

[63] No. EDCV 13-00199-SJO (OPx), 2014 U.S Dist. LEXIS 174478 (C.D. Cal. Dec 16, 2014)

[64] No. 2:13-cv-13622, 2016 WL 25977 (E.D. Mich. Jan 4, 2016).

[65] The franchisee prevailed on other claims and permitted the franchisee's request for rescission of its agreement. *Id.*

5. What Action Do Examiners Typically Take?

Just like every motorist speeding does not get a speeding ticket, not every franchisor violating franchise laws will be penalized for the wrong doing. First, the violation must come to the attention of the federal or state examiners. There are many ways that examiners will find out about violations. Complaints from dissatisfied franchisees are a common source of information. Competitors may also complain about perceived unsavory or illegal practices of other franchisors. Not infrequently the violation may be apparent from the franchisor's own FDD, advertising materials, or the franchisor's website. For example, Item 20 of the FDD may show that there has been sales activity in a state where the franchisor was not registered. Or sales data included in Item 19 may be inconsistent with information included in franchise sales advertising materials. Franchisors should also be aware that state franchise examiners discuss matters with each other, so an investigation by one state may very well spread to include other states.

A survey, which is by now several years old, still stands as the best general review of how state franchise examiners prioritize enforcement actions and what factors they consider most important in determining whether to take action and what remedies to seek.[66] According to the survey, the state franchise examiners, as a group, ranked the factors in the following order: (1) franchisors self-reporting; (2) franchisor's and its management litigation and violation history; (3) plan of correction suggested by franchisor; (4) number of franchises sold in the state; (5) action taken by other state franchise examiners; (6) how long ago the violation occurred; (7) franchisor's good faith belief that it was not subject to the state's franchise law; (8) amount of franchise fees the franchisor collected; (9) franchisee's investment; (10) franchisor's reliance on bad advice from counsel; and (11) number of franchises sold in other states.[67] The above factors were the ones that the survey questions had asked about. Examiners also responded that they were influenced by the seriousness of the violation, the financial sophistication of the franchisees who were harmed, the degree of harm caused, if disclosure was provided (and its completeness), the results of discussions with the franchisees and if fraud was involved.[68] The examiner's perception of the franchisor's candor also contributed to the action taken by the examiners.[69]

Before jumping to the conclusion that a franchisor should always confess error and self-report it should be noted that examiners' responses to self-reporting are not uniform.[70] Self-reporting may be very beneficial in some states, but in others it will not have any

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[66] Leonard Vines, Gina Bishop and Rupert Barkoff, *Damage Control for Violations of Registration and Disclosure Obligations*, Franchise Law Journal, Vol. 24, No. 3, Winter 2005.

[67] *Id*.

[68] *Id*.

[69] *Id.*

[70] *Id.*

material impact on the examiners' actions, and as such a franchisor may be better off not reporting.

The same survey also asked state franchise examiners about what actions they were most likely to take. According to the survey, examiners are most likely to seek a consent decree that, in addition to requiring the franchisor not to sell any more franchises before registering, also requires rescission to the affected franchisees. Notifying franchisees of the violation was also a popular action, as was imposing a fine.[71] Least popular was instituting a civil or criminal action. These results are hardly surprising. Most of the violations that are addressed by franchise examiners are unintentional mistakes. They do not warrant more serious steps, such as bringing a civil or criminal action.

a. An Example: The Enforcement Process in Washington

How does an examiner with the Washington State Department of Financial Institutions-Securities Division become aware that the state franchise laws have been broken? As discussed in the introduction to this paper, there are many ways examiners learn about franchise law violations. The most common way is the receipt of a complaint from a franchisee. Other sources include registration filings, franchisors self-reporting violations, competitor complaints, referrals from other regulators, advertisements in local media sources, and monitoring of online sites such as Craigslist.

The Securities Division has two kinds of examiners: one is doing registration work, reviewing franchise applications and issuing comment letters. The registration examiners are assisted by two administrative staff persons who do some limited review of registration filings. The second kind of examiner does enforcement work, reviewing complaints, conducting investigations, initiating enforcement actions and negotiating resolutions to those actions. Currently, all of the Washington State examiners are attorneys or "financial legal examiners."

A registration examiner may become aware of a registration violation during the review of a franchisor's FDD Item 20 or the franchisor's webpage, in which case the examiner would inquire of the applicant if an exemption is being claimed for sales prior to the filing of the application. If a franchise applicant cannot establish an exemption for prior sales, the registration examiner will refer the matter to enforcement for investigation. If a franchisor self-reports the sale of an unregistered franchise when filing its franchise registration application, the examiner will also refer it to enforcement for investigation. A franchisor can also self-report a registration violation directly to the Securities Division's Enforcement Unit. A registration examiner may also issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of any registration application, if sufficient grounds exist, such as a registration application is incomplete in any material respect or contains false or misleading statements. Registration examiners generally will request that a registrant submit a waiver of the automatic effectiveness of

[71] Id.

the application in order to avoid the entry of a stop order and enable the parties to resolve any deficiencies or problems without a formal administrative proceeding.

When the Enforcement Unit receives a complaint or referral, the matter is assigned a case number and given to an enforcement examiner/attorney for follow up. The Washington Franchise Act (the "Franchise Act") provides an enforcement attorney broad jurisdiction to investigate an offer or sale of a franchise. An offer to sell a franchise is made in this state when: (a) the offer is directed by the offeror into this state from within or outside this state and is received where it is directed, (b) the offer originates from this state and violates the franchise or business opportunity law of the state or foreign jurisdiction into which it is directed, (c) the prospective franchisee is a resident of this state, or (d) the franchise business that is the subject of the offer is to be located or operated, wholly or partly, in this state.[72] A sale of any franchise is made in this state when: (a) An offer to sell is accepted in this state, (b) an offer originating from this state is accepted and violates the franchise or business opportunity law of the state or foreign jurisdiction in which it is accepted, (c) the purchaser of the franchise is a resident of this state, or (d) the franchise business that is the subject of the sale is to be located or operated, wholly or partly, in this state.[73]

Depending on the source and nature of the complaint, the enforcement examiner will generally speak with any complaining parties, potential witnesses, and respondents. Interviews are typically done by telephone, but may be done in person and, in the case of a respondent, interviews may be done under oath and recorded by a court reporter. An enforcement examiner may send a "warning letter" to potential respondents advising them that their conduct appears to be in violation of the Franchise Act and that they should cease and desist from the offending activity. The warning letter typically includes a request for information and documents relevant to the potential violation. A warning letter may also be accompanied by a subpoena for documents, testimony or both. After the enforcement examiner has completed the review of the information and documents obtained in the inquiry, a determination is made whether a violation of the Franchise Act has occurred.

Registration and enforcement examiners may resolve violations informally, that is without formal enforcement action taken, depending on the nature and extent of the violation.

Typically defects associated with the filing of a franchise registration application can be addressed through the filing of an amended application. However, as stated above, if the registration examiner discovers that an unregistered franchise has been sold in the state, a referral to the enforcement section will follow.

In certain circumstances where a violation is believed to have occurred, an enforcement examiner may not file an enforcement action. This could be due to a statute of

[72] Wash. Rev. Code § 19.100.020(2)

[73] Wash. Rev. Code § 19.100.020(3)

limitations concern, whether the examiner's caseload precludes adequate investigation of the violations or the Securities Division's competing enforcement priorities.

If violations are found, the examiner typically prepares a "Statement of Charges" that is issued to the respondent(s) along with an application for an administrative hearing, should a respondent wish to contest the allegations before an administrative law judge. Hearings are conducted by the state Office of Administrative Hearings ("OAH"), an agency independent of the Department of Financial Institutions. The examiner also has the option of issuing a "Summary Order" to cease and desist if the Securities Administrator finds that a respondent's continued violations of the Franchise Act necessitates emergency action. Recipients of a Summary Order may also request a hearing through the OAH. If a respondent fails to request a hearing within twenty days of receiving the Statement of Charges or Summary Order, the examiner will prepare a "Final Order" to be entered. In certain cases, such as when a franchisor self-reports the sale of an unregistered franchise, the examiner may forego issuing a statement of charges and negotiate a consent order with the respondent(s).

Typical violations found by the Securities Division are: (1) sale of unregistered franchise[74], (2) failure to provide a franchise disclosure document[75], (3) incomplete or misleading information within or outside the FDD[76], and (4) unregistered franchise broker[77].

The majority of cases in which an examiner decides to take enforcement action are ultimately resolved through a consent order or consent agreement. The consent order frequently provides that the respondent does not admit or deny the allegations made against him or her, but that he/she agrees to cease and desist from further violations of the Act. The Securities Division does not have the ability to impose administrative fines, but typically requires a respondent to reimburse it for its investigative costs. If it is a financial hardship for a respondent to pay costs of the investigation, the respondent may file a financial declaration form provided by the Division and request that all or part of the costs be waived. Other provisions that have appeared in consent orders include the requirement to provide rescission and to provide copies of the consent order to officers, directors, certain franchisor employees, brokers, and franchisees.

While the Securities Division has the authority to initiate a civil action to obtain a temporary injunction, restraining order, or writ of mandamus and request that a receiver or conservator be appointed[78], it has typically relied on its administrative powers to enforce the Franchise Act. Civil fines of up to $2,000 per violation of the registration, disclosure and anti-fraud provisions of the Act may be obtained in a civil action[79]. The

[74] Wash. Rev. Code § 19.020

[75] Wash. Rev. Code § 19.080(1)

[76] Wash. Rev. Code § 19.170

[77] Wash. Rev. Code § 19.140

[78] Wash. Rev. Code § 19.210(1)

[79] Wash. Rev. Code § 19.210(3)

Securities Division is also authorized to make criminal referrals to the Attorney General's Office and local prosecuting attorneys. A person who willfully violates any provision of the Franchise Act or who willfully violates any rule is guilty of a class B felony and can be fined not more than five thousand dollars or imprisoned for not more than ten years or both if convicted[80].

From 2014 through February, 2017, Washington took formal enforcement action against twenty franchisors. All twenty franchisors were alleged to have offered or sold unregistered franchises. Eleven were alleged to have failed to provide franchisees with a current franchise disclosure document. Five were alleged to have made misrepresentations or material omissions in the offer and sale of franchises. Nineteen of the franchisors resolved their investigations through Consent Order settlements in which they neither admitted or denied the allegations, but agree and were ordered to cease and desist from future violations. A Final Order to Cease was entered against the remaining franchisor. As of the date of this paper, in 2017 the Securities Division has issued two orders in franchise related investigations.[81]

During this period, the Securities Division alleged that three individuals acted as unregistered franchise brokers and made misrepresentations or material omissions in the offer and sale of franchises. One of the individuals entered into a Consent Order in which he neither admitted or denied the allegations, but agreed and was ordered to cease and desist from future violations. Final Orders to Cease and Desist were entered against the other two individuals, who did not contest the Statements of Charges that were filed against them. The Franchise Act does not provide for fines, but the Securities Division recovered approximately $45,000 in costs of the settled investigations. The lowest amount recovered was $500 where a franchisor submitted a financial declaration to establish that it would be a substantial financial hardship for it to pay the full costs of the investigation. The highest amount recovered was $12,000.

When your client has broken the law, you should consider contacting the Securities Division to discuss how it might view the violation(s) and how it has handled similar violations in the past. Although no assurances can be given by the Securities Division as to the ultimate outcome of any investigation of the client, you may gain useful information regarding the possible steps involved in resolving the matter and the range of possible sanctions that your client may face.

The Securities Division can be contacted at 360-902-8760 or POB 9033, Olympia WA 98507-9033. The Division's messenger only delivery address is 150 Israel RD SW, Tumwater WA 98501.

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[80] Wash. Rev. Code § 19.210(6)

[81] *In the matter of EquipLinx Sales & Service, LLC*, Order No.: S-17/2116-17-CO01; *In the matter of Champs Chicken Franchising, LLC*, Order No. S-16-2008-17-CO01, dated January 18, 2017. Information about Security Division enforcement actions can be found at http://dfi.wa.gov/securities-enforcement-actions/securities2017

b. Enforcement Actions By Other States

Below is a review of some enforcement actions taken by franchise examiners in other states. It is intended to provide a general feeling for the level of regulatory activity in different states, and the types of remedies sought by examiners. However, there are significant differences between the accessibility of information about enforcement in different states. Some states maintain information in easily searchable online databases, while others have databases that are hard to search without having information about the specific franchisor subjected to enforcement. Other states do not make their enforcement action publicly available at all. Consequently, the lack of information in the below list about a state does not mean that the state is not actively enforcing its franchise law. Likewise, a description of only a few actions taken in a state does not mean that those are the only actions taken.

i. California

California examiners are very active in pursuing franchise law violations. Just in 2016, the Department of Business Oversight reported more than a dozen enforcement actions.[82] The actions range from situations where a franchisor has sold a sole franchise in California without having first registered, to more involved violations where the franchisor and its executives appear to have been either extremely sloppy or lacked any regard for compliance with franchise laws. The remedies against the various franchisors, and their executives, are meted out accordingly: A cease and desist order to sell additional franchises until the franchisor is registered was issued for the franchisor who sold one franchise without first registering;[83] and administrative fines up towards $20,000, reimbursement for attorney's fees, restitution of initial franchise fees and remedial education where the violations are more severe and affect several franchisees.[84] An over-reaching theme of the penalties sought is ensuring that the franchisor and its management do not repeat past mistakes. To that end, the Commissioner may order the franchisor to appoint an attorney to act as monitor for its franchise law matters, appoint an internal compliance officer and require that management participate in franchise law compliance training.

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[82] Information about California enforcement actions can be found at www.dbo.ca.gov/ENF/Chron/Default.asp and specific actions can be searched at: www.dbo.ca.gov/ENF/search.asp

[83] *See e.g.* Desist and Refrain Order against Valiant Healthcare Services, Inc., dated August 24, 2016, available at http://www.dbo.ca.gov/ENF/pdf/2016/Valiant%20Healthcare%20Services%20Inc%20DR.pdf

[84] *See e.g.* Desist and Refrain Order against PCJV USA, LLC, dated December 13, 2016 (Franchisor disregarded financial assurance requirement over 50 times and was ordered to pay a $20,000 penalty, hire an attorney to act as a monitor for 3 years and submit to in-person franchise law compliance training); and Desist and Refrain Order against Massetti, Shakesheff and BikeCaffee Franchising, Inc., dated August 31, 2016 (Franchisor sold franchises during black out period, required franchisees to sign agreement not included in the FDD, had incomplete Item 2 disclosure, and violated financial assurance requirements and was ordered to pay administrative penalties of $15,000, pay restitution to franchisees amounting to close to $70,000. In addition, several executives were ordered to pay administrative penalties of about $12,500).

ii. Minnesota

Like in Washington, most actions involve selling unregistered franchises in the state. Frequent remedies include fines and rescission. In at least one instance, a repeat offender was fined as much as $50,000[85]

iii. Virginia

Virginia maintains information about enforcement actions online, but it is hard to find franchise cases without reviewing all cases because you can only search by case name or case number.[86] The authors were able to find two relatively recent settlement orders against franchisors. In one case, the franchisor had sold one franchise in Virginia without first having registered. It is unclear from the order if no FDD was provided at all, or simply not one approved by the state. The franchisor was fined $2,000 and also had to pay $500 to defray investigative expenses.[87] The second order involved misleading financial performance representations being made in franchise sales advertisements. The advertisement did not subtract various fees that franchisees would have to pay and was therefore incorrect and misleading. The franchisor had to pay $25,000 in monetary penalties, and in addition also had to pay $4,000 to defray the cost of the investigation.[88]

iv. Wisconsin

In 2016 Wisconsin issued a Summary Order of Prohibition against two California entities and a California resident for the sale of an unregistered franchise and a misrepresentation in the offer and sale of the meal delivery franchise.[89] The franchisor, who was not exempt under the Wisconsin franchise law, had not registered, yet held out to prospective franchisees that it was registered.

6. What can franchisors/counsel do to limit exposure & best practices

a. Avoiding the problems in the first hand - educate your client

As the saying goes - an ounce of prevention is worth a pound of cure. This is true for franchise compliance as well. The best remedy to violations of franchise laws is to avoid them in the first place by ensuring a solid, up to date FDD, and that franchisors

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[85] Minnesota Department of Commerce enforcement actions are searchable at https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showSearchParameters&searchType=new

[86] Orders can be found at http://www.scc.virginia.gov/docketsearch#search

[87] Settlement Order, Commonwealth of Virginia v. The Brothers Franchising Corp., Settlement Order, Case No. SEC-2015-00056, dated January 6, 2016.

[88] Settlement Order, Commonwealth of Virginia v. C&C Franchising, Inc., Settlement Order, Case No. SEC-2015-00008, dated March 27, 2015.

[89] Wisconsin administrative orders are available at: https://www.wdfi.org/newsroom/admin_orders/dos_default.htm

and their staff are well educated on basic franchise law requirements and aware of the many nuances.

Typically, franchisor legal departments will themselves, or with the help of outside counsel, do periodic franchise law compliance training with their sales teams. The topics reviewed often cover timing requirements under federal and state franchise laws, limitations on financial performance representations, and sometimes also the content of the FDD. It may be worthwhile to have not just the sales team participate in these types of presentations, but also franchisor executives and other staff whose work relates to the information disclosed in the FDD. The focus of franchise law compliance training will change depending on the group. For example, high-level executives need to understand generally how franchise laws affect their business and the consequences of non-compliance. Other members of the franchisor's team should understand how changes that they make to the franchise system may require FDD changes.

For franchisor counsel, it is important to take the FDD-preparation seriously. On annual renewal there is often a temptation to avoid an in-depth dive into the FDD. The franchisor does not want to read every word of the lengthy document and counsel has many clients who typically all need help renewing their FDD about the same time. Especially for franchisors with limited sales activity the focus may be on updating the few items that by default always require updating, such as Item 19 and Item 20 disclosures. Another short-cut may be to simply review the FDD and see if any information has changed. While this approach is better than just focusing on a few key items, the parties still risk missing adding information to the FDD that may be relevant and required to be disclosed.

Franchisors and their counsel should consider how the FDD will be used in the sales process. While it is primarily a legal compliance document and not in itself a sales tool it is worth considering how information is presented to help avoid inadvertent mistakes. For example, it makes sense to involve the sales team in discussion about how Item 19 is put together. What is the key financial data they are asked for by franchisees? How do competitors present their financial data? Does it make sense to include certain subsets of locations in the FDD if prospective franchisees often ask about them?

Franchisors should also review when in the sales process disclosure happens. For example, with electronic disclosure it is both easy and cheap to disclose prospective franchisees early in the sales process, later avoiding potential violations of the 14-calendar day rule. For franchisors with many multi-unit franchisees it may even make sense to distribute each new FDD as soon as it is approved by the state examiners.

b. When you discover the issue yourself

Franchisors tend to find out about many more franchise law violations than ever get reported to franchise examiners. What franchisors should do when they discover an issue depends on many factors, such as the timing of the discovery, the type of violation, the seriousness of the violation, the jurisdictions involved, and the future plans of the franchisor.

i. Pre-sale discovery

When the violation is discovered early on and the parties have not yet entered into a franchise agreement there is typically no need to inform any franchise examiners. Typically, the franchisor's first issue will be whether to sell the prospective franchisee a franchise. If the violation is relatively minor – for example the failure to register in an applicable state, the franchisor may halt the sales process, pursue registration, and only continue the sales process once it is registered to offer and sell franchises. In that situation, there is of course a small risk that the franchisee would later claim that it was sold the franchise illegally, but given that there should be little harm done to the franchisee the likelihood of regulatory action is limited.

If the violation instead is an unlawful financial performance representation being shared with the prospective franchisee most franchisors will likely decide not to pursue the sale and take action to ensure that the problem does not arise again. Franchisors typically consider an unlawful FPR to be an uncurbable mistake – the prospect cannot forget the information provided.

ii. Post-sale discovery

When the violation is not discovered until after a sale has been completed the situation is significantly more complex than in the pre-sale scenario. It is no longer an option to take defensive measures such as not selling a franchise to the affected prospect, or to fix a pre-sale violation by registering and thereby minimizing the impact of any violation.

1. To Self-Report or Not?

The first question when a franchise law violation is discovered post-sale is whether the franchisor should do anything. Should the franchisor let sleeping dogs lie, or should it fix the problem? The answer will depend on many factors. For example, how serious is the violation? Is it a technical violation that likely has little impact on the affected franchisees? How wide-spread is the issue? Another issue to consider is whether any of the franchise registration states are implicated. While the FTC has broad investigatory powers, it has limited resources and franchisees do not have a private cause of action under the FTC Act.[90] And if franchise registration states are implicated the franchisor may also want to consider which ones and how likely the examiners are to find out about the violation. For example, if the violation will be evident on the face of the FDD, but it occurred in a notice filing state, there is still a low risk that the violation will come to light. On the other hand, if the violation involves a state that reviews the FDD the franchisor can expect that the state examiner from that state will raise the issue. Finally, the franchisor may wish to consider its future plans. If the franchisor is

[90] Franchisors should consider that some states have so called "Little FTC Act" which provide private persons with a cause of action in state courts for violations of the FTC Act. *See* John G. Parker & Angela M. Fifelski, *Claims Under Little FTC Acts*, American Bar Association 28th Annual Forum on Franchising, for more information about Little FTC Act claims.

only selling few franchises or is switching from a franchise model to another distribution model, it may not wish to make a big deal of the violation.

Against the arguments that may support sticking one's head in the sand and hoping that the violation will not see the light of day weighs the significant benefits of self-reporting a violation.

Examiners are likely to be more benevolent towards the franchisor who relatively promptly inform them of a violation and is willing to address the issue (though not always, as mentioned above). Self-reporting also allows the franchisor to do its due diligence and lay out its plan for how to address the problem before informing the examiners, as opposed to resorting to reactionary behavior that likely results from being informed by an examiner about an issue.

If the franchisor decides to self-report it may be wise to start with an anonymous inquiry with the state franchise examiner. Franchisor's outside counsel should be able to make this first inquiry.

2. Notify the franchisee?

Whether or not the franchisor decides to notify any franchise examiners the franchisor should also consider whether to notify the affected franchisees. If for no other reason, notifying the franchisees would start the statute of limitations running setting a deadline for when the franchisee could bring a future claim.[91] Where the relationship with the franchisee is good notifying the franchisee is a low-risk proposition, in particular if the franchise law violation is relatively minor.

If the franchisor determines to notify the franchisee it should consider raising the issue with the appropriate state franchise examiner first. Examiners will often require that the franchisor offers the franchisee rescission and may have specific requirements regarding how the rescission offer is worded or provided to the franchisee. Coordinating the matter with the examiner will allow for a smoother solution of the matter.

c. When you receive an inquiry

The approach to a franchise law violation will be quite different when it is discovered by a franchise examiner, as opposed to when a franchisor itself discovers that a violation has occurred. There is obviously no opportunity to stick one's head in the sand and hope that it will go away.

[91] Statutes often cut the statute of limitations significantly when a franchisee has been offered rescission.

i. Analyze the facts and applicable law and impact on franchise system

Before jumping to conclusions, the franchisor should thoroughly investigate the facts. Depending on what the examiner's inquiry is based on, the examiner may not have complete facts available to him or her. The franchisor should determine if the facts as presented by the examiner are correct and if they are, whether the examiner is aware of all relevant facts.

Assuming the facts seem to indicate there is indeed a potential violation of state franchise laws, the next step would be to carefully review the applicable statute. As discussed above in Section 2 a., the franchise laws are not identical. Their jurisdictional scope can vary significantly and the specific facts of the alleged violation should be reviewed carefully against the jurisdictional definition to determine if the statute applies. The franchisor should also review the definition of a "franchise" under the statute, element by element to determine if the relationship that is subject to the alleged violation is truly a franchise in the relevant state.

Even if the relationship in question falls within the scope of the applicable franchise law and is indeed within the scope of the franchise definition, the franchisor should still look at available exemptions under the statute. Most franchise law exemptions are only exemptions from registration and not disclosure. As such, they may not be a defense against a violation of the statute. However, exemptions are included in statutes to ease the regulatory burden from franchisors in situations where the legislator determined prospective franchisees may not need the same level of protection as a typical prospective franchisee requires. Viewed from that perspective, a violation resulting from a transaction that is exempt is likely to garner less attention from a state examiner, and the franchisor may have a good argument in the discussion with examiners about appropriate remedies.

Franchisors should also review the procedural aspects of the applicable statute as they apply to the alleged violation. For example, has the statute of limitations expired? Are there other procedural blocks to the examiner proceeding with its investigation of the violation? In the same vein, are there other reasons the examiner should not be pursuing this particular violation? For example, has the affected franchisee provided a waiver or release that would exclude their claims? Was there lack of reliance on the franchisee's part?

The last thing the franchisor may want to do before responding to an inquiry is to familiarize itself with the remedies that are available to the examiner and develop a plan for how to address the violation.

d. Work with the examiner

Whether a franchisor self-reports a violation or is responding to an investigative demand or subpoena, there are some important do's and don'ts to consider. Thinking about these do's and don'ts in the interaction with the franchise examiners will likely help a

franchisor reach a resolution to the issues it is facing sooner, and frequently with lesser remedies being imposed against it. Hopefully this list will appear rather common-sensical:

- Treat the examiner in a courteous professional manner.
- Anticipate the information and documents that an examiner is likely to want from the client.
- Don't fail to produce information or documents if requested or required to be produced without adequate grounds.
- Tell the examiner what is not being produced and the basis for why it is not.
- If self-reporting a violation, report all the known violations.
- Don't overlook discussing with the client all possible violations and analyzing all of the facts and issues that may culminate in an enforcement action.
- Provide the examiner with all of the documentation supporting the factual and legal basis for any exemptions, defenses or mitigating factors available to your client.
- Check with the examiner to determine the preferred method of communications, whether it is by phone, email, fax, or file sharing service.
- Respond to phone calls or other communications from the examiner in a timely way. Don't let deadlines pass without communicating with the examiner the reason(s) they might be missed.
- Remember that the examiner is going to have a say in the sanctions and remedies imposed on your client.
- Don't make the settlement negotiations more difficult by not working with the examiner from the beginning to the finish of the investigation.
- Consider contacting the regulators where there may be a potential violation to try and gain insight into how they may perceive and act on the discovery of a violation.

The above list could be called the "common sense and common decency list." Developing a good working relationship with an examiner is generally not difficult. An examiner can be a good resource for explaining the agency's investigative policies and processes. An examiner may able to explain how the agency has handled similar violations and provide you with insight into the probable resolution of your client's matter. However, an examiner who believes the franchisor is hiding information from the

examiner is likely going to develop a negative view of the franchisor and consequently suspect there may be additional violations that have not been disclosed. Consequently, the relationship between the franchisor and the examiner may be difficult and the examiner less likely to show leniency towards the franchisor.

7. Conclusions

As with most every aspect of franchise laws, compliance is not easy. Between the multitude of laws and regulations involved, the almost never ending variations of relationships that may fall within the scope of some of these laws, and the different situations that may arise, it is not surprising that violations occur. The remedies available to examiners are far reaching and franchisors should take violations seriously. However, working with examiners to resolve the issues, as opposed to considering them adversaries, is likely to yield a better, and speedier result.

Exhibit A

Statutory Reference List

Abbreviation key: (examiner) – state examiners may bring action; (fee) – franchisee may bring action; yr/yrs – year/years.

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
California Cal. Corp. Code § 31300 et seq.	§31402 – desist franchise offer §31403 – desist selling under exemption §31406 – desist after violation of order	§31400 (examiner)	§31405 civil: $10,000/violation – assessed through civil action §31406 administrative: $2,500/violation – through citation.	§31300 (fee) only for willful violations §31408 rescission, restitution, damages on behalf of injured party (examiner) §31400 restitution (examiner)	§31300 (fee) §31400 (examiner)	§31302, §31400.	§31404 commissioner can refer to DA §31410 willful violation $100,000, imprisonment 1 yr or both §31411 fraud $100,000, imprisonment 1 yr or both	§31400 receiver	§31303: §31300 actions: 4 yrs from act or 1yr from discovery, 90 days after notice of disclosure or registration violation.
Hawaii Haw. Rev. Stat. §482E-1 et seq.	§482E-8 – stop sell franchises §482E-10.7 – cease and desist unlawful action	§482E-10.7	§482E-10.5 $100,000 max (examiner)	§482E-9 (fee)	§482E-9 (fee)	§482E-9	§482E-10.6: Class B felony	§482E-10.7 receiver	§482E-10.5 For civil damages: 5 yrs from violation or 2 yrs discovery. §482E-10.6 5 yrs for criminal penalty
Illinois 815 Ill. Comp. Stat. 705/1 et seq.	§705/23 – stop order if in public interest		§705/24 $50,000/violation	§705/26 rescission (fee) §705/22 restitution	§705/26 (fee)	§705/26	§705/25 class 2 felony		§705/24 For civil penalty: 3 yrs §705/27 3 yrs, but 90 days from f-or's notice
Indiana	§§14 & 34 – for registration violations or other	§32		§34 rescission and	§28	§29	§36 – refer to		§30 3 yrs

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
Ind. Code § 23-2-2.5-1 et seq.	violations §35 – exemption violations			restitution			DA §37 Class C felony		
Maryland Md. Code, Bus. Reg. §14-201 et seq.	§14-210 cease and desist, receiver §14-221 stop order (summarily)	§14-210 injunction, dissolution (court)	§14-228 (willful actions) $10,000	§14-210 restitution (court) §14-227 rescission and restitution (fee)	§14-210 damages (court) §14-227 (fee)	§14-227 (fee)	§14-211 §§14-228 – 14-232 $10,000, 5 yrs imprisonment	§14-210 receiver	§14-210 3 yrs §14-211 3 yrs
Michigan Mich. Comp. Laws §445.1501 et seq.		§445.1535 injunction, receiver (court action)	§445.1538 $10,000	§445.1531 (fee) rescission §445.1535 restitution	§445.1531 (fee)	§445.1532	§445.1537 fine $10,000, 7 yrs imprisonment		§445.1533 4 yrs
Minnesota Minn. Stat. §80C.01 et seq.	§80C.12		§80C.16 $2,000/violation, failure to comply with final order $25,000	§80C.17 (fee) rescission	§80C.17 (fee)	§80C.17 (civil liability)	§80C.16 willful violation $10,000, 5 yrs imprisonment		
New York N.Y. Gen. Bus. Law §680 et seq.				§691 (fee) rescission §692 restitution			§690 class A misdemeanor, $1,000 fine	§689 receiver	§691(4) 4 yrs
North Dakota N.D. Cent. Code §51-19-01 et seq.	§51-19-09, §51-19-13 (cease and desist)	§51-19-13, injunction, receiver	§51-19-13 $10k/violation	§51-19-12	§51-19-12 (fee)	§51-19-12 (civil liability)	§51-19-14 Class B felony	§51-19-13 receiver	§51-19-12 5 yrs, or offer before action §51-19-13 5 yrs

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
Oregon Or. Rev. Stat § 650.050 et seq.		§650.065		§650.020 (fee) rescission	§650.065	§650.020		§650.065 receiver	§650.020 3yrs
Rhode Island R.I. Gen. Laws § 19-28-1-1 et seq.	§19-28.1-18 stop order, cease and desist	§19-28.1-18 injunction	§19-28.1-18 $50,000 (action), administrative fine $5,000/violation	§19-28.1-21 (fee) rescission	§19-28.1-21 (fee)	§19-28.1-21 (civil liability)	§19-28.1-20 - felony	§19-28.1-18 receiver	§19-28.1-18 (for admin fines 4 yrs) §19-28.1-22 4 yrs, 90 days rescission offer
South Dakota S.D. Codified Laws §37-5B-1 et seq.	§37-5B-41 and §37-5B-42 cease and desist		§37-5B-43 $5,000/violation	§37-5B-49 (fee)	§37-5B-49 (fee) treble	§37-5B-49 (fee)			§37-5B-50 (1-2 yrs)
Virginia Va. Code §13.1-557 et seq.		§13.1-568	§13-.1-570 $25,000 civil penalty	§13-1-570 restitution (examiner)	§13.1-571 (fee)		§13.1-569 Class 4 felony		
Washington Wash. Rev. Code §19.100.010 et seq.	§19.100.248	§19.100.191, §19.100.248	§19.100.191 $2,000/violation	§191.100.190 (fee)	§19.100.190 (fee)		§19.100.191 $5,000, 10 yrs imprisonment	§19.100.19 1 receiver	
Wisconsin Wis. Stat. §553.01 et	§553.28	§553.54		§553.51 rescission (fee) §553.54 restitution	§553.51 (fee)	§553.51 (fee)	§553.52 $5,000, 5 yrs imprisonment		§553.51 (fee) 3yrs/90 days rescission notice

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
seq.									

Exhibit B

State Examiner Addresses and Where to Find Enforcement Actions

State Examiner Address	Website
California Department of Business Oversight 1515 K Street Suite 200 Sacramento, CA 95814-4052 (866) 275-2677	See www.dbo.ca.gov/ENF/Chron/Default.asp for an overview of actions. Search for actions at: www.dbo.ca.gov/ENF/search.asp
Hawaii Department of Commerce & Consumer Affairs Division of Business Regulation 335 Merchant Street Room 203 Honolulu, HI 96813 (808) 586-2744	
Illinois Attorney General's Office Consumer Fraud & Franchise Bureaus 500 South Second Street Springfield, Illinois 62706	
Indiana Office of the Secretary of State Securities Division 302 West Washington, Room E-111 Indianapolis, IN 46204 (317) 232-6681	
Maryland Office of the Attorney General Division of Securities 200 Saint Paul Place	

Baltimore, MD 21202-2020 (410) 576-6360	
Minnesota Department of Commerce 85 East 7th Place Suite 500 Saint Paul, MN 55101 (651)539-1638	https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showSearchParameters&searchType=new
New York Office of the Attorney General Investor Protection Bureau 120 Broadway 23rd Floor New York, NY 10271 (212) 416-8222	
North Dakota Securities Commission 600 East Boulevard State Capitol, 5th Floor Bismarck, ND 58505-0510 (701) 328-2910	
Rhode Island Department of Business Regulation 1511 Pontiac Avenue John O. Pastore Complex Bldg. 69-1 Cranston, RI 02920-4407 (401) 462-9527	
South Dakota Division of Securities 124 South Euclid Avenue Suite 104 Pierre, SD 57501-3185 (605) 773-4823	
Virginia State Corporation Commission Division of Securities &	http://www.scc.virginia.gov/docketsearch#search

Retail Franchising 1300 East Main Street 9th Floor P.O. Box 1197 Richmond, VA 23218 (804) 371-9051	
Washington Department of Financial Institutions Securities Division 150 Israel Rd, SW P.O. Box 9033 Tumwater, WA 98507-9033 (360) 902-8760	http://www.dfi.wa.gov/securities-enforcement-actions/securities2017
Wisconsin Department of Financial Institutions Division of Securities 201 W. Washington Avenue Suite 300 P.O. Box 1768 Madison, WI 53701-1768 (608) 266-1064	https://www.wdfi.org/newsroom/admin_orders/dos_default.htm