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Keeping the Enforcers at Bay – Handling an FTC or
State Franchise Investigation

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# TABLE OF CONTENTS

I. INTRODUCTION .............................................................................................................1

II. FTC INVESTIGATIONS ..................................................................................................1
   A. Section 5 of the FTC Act / FTC Franchise Rule ..................................................1
   B. Why, How and When? ..........................................................................................2
   C. The Investigational Process/Procedures ...............................................................5
      1. Non-Compulsory Procedures ...........................................................................5
         a. Access Letters ............................................................................................6
         b. Questionnaires and Surveys .........................................................................7
         c. Interviews .....................................................................................................8
         d. Trade Show “Shops” and Other “Sting” Operations ....................................8
      2. Compulsory Procedures .....................................................................................8
   D. Disposition of Investigations ................................................................................11
      1. Consent Order Agreement ...............................................................................11
      2. NFC Alternative Rule Enforcement Program .............................................13
      3. Commencement of an Enforcement Action ..................................................14

III. HANDLING A STATE FRANCHISE INVESTIGATION ...........................................15
   A. Initiation Of A State Franchise Investigation .....................................................15
   B. State Investigative Tools ....................................................................................17
   C. Suggestions For Responding To A State Franchise Investigation ...................18
      1. Respond Fully and Promptly to all Requests for Information ..................18
      2. Once a Franchisor Becomes Aware of a State Law Violation, Immediately Bring the Violation to the Attention of the State Franchise Enforcement Agency .................................................................19
3. After the Franchisor Becomes Aware of a State Franchise Law Violation, Take Adequate Steps to Ensure That the Violation is Not Repeated ................................................................. 20

4. Review the Provisions of the State Franchise Law Under Which the Investigation is Proceeding ................................................................. 20

D. The Forum For Franchise Enforcement Actions ............................................. 21

E. Circumstances When Franchisees And Their Counsel Should Turn To Their State Franchise Authorities For Assistance ......................................... 22

1. Informal Attempts to Mediate Complaints .................................................. 22

2. States Franchise Agencies as a Source of Information ................................. 23

3. Amicus Briefs and Serving as Expert Witnesses ......................................... 23

4. Formal Enforcement Action ....................................................................... 24

F. Likely Future Trends In State Franchise Enforcement Actions ................. 26

IV. CONCLUSION ............................................................................................. 27
I. INTRODUCTION

The process by which the Federal Trade Commission (the “FTC” or “Commission”) and comparable state authorities evaluate, commence and undertake an investigation of a franchisor’s alleged wrongdoing is the subject of much speculation and misperception. The purpose of this article is to shed some light on the process and provide constructive suggestions on what to do if your franchisor client is the subject of an investigation or your franchisee client believes that its franchisor violated the Federal Trade Commission Act (the “Act” or “FTC Act”) or a state equivalent.¹

II. FTC INVESTIGATIONS²

A. Section 5 of the FTC Act / FTC Franchise Rule

The FTC was created in 1915 pursuant to the FTC Act, 15 U.S.C. §§ 41 et seq. The Commission is responsible for administering a number of statutes that are generally intended to promote fair competition and protect the public from “unfair and deceptive acts or practices” in or affecting the advertising and marketing of goods and services. Unfair and deceptive acts or practices are deemed “unlawful” pursuant to Section 5(a)(1) of the FTC Act (15 U.S.C. § 45(a)(1)) and, in appropriate circumstances, may give rise to equitable remedies, consumer redress and/or civil penalties. See 15 U.S.C. § 45(m) -- civil penalties; § 53(b) -- equitable relief, including a permanent injunction and ancillary remedies (e.g., monetary damages); and § 57b(b) -- consumer redress, including rescission and restitution.

The Commission is comprised of a number of units, including the Bureau of Consumer Protection which is responsible for, among other things, investigating and prosecuting franchisors for potential violations of Section 5 of the FTC Act. Pursuant to the authority granted to it under the FTC Act, the Commission has promulgated a number of trade regulation rules, including the FTC Franchise Rule (16 C.F.R. § 436.1, “the Franchise Rule” or “the Rule”).³ The Franchise Rule governs pre sale disclosures by a franchisor and prohibits a franchisor from making an earnings claim unless it is (i) set forth in its disclosure document or Uniform Franchise Offering Circular, and

¹ This article represents the collective views and opinions of the authors, and does not in any way represent the opinions of the Federal Trade Commission or any individual Commissioner, the office of the Attorney General of Maryland, the North American Securities Administrators Association, Inc., or Bartko, Zankel, Tarrant & Miller.

² This article includes excerpts from and expands on a previously published article regarding issues confronting a franchisor when it is the target of an FTC investigation. See C. Towle, Representing a Franchisor in an FTC Investigation, 16 Franchisor L.J., Spring 1996.

³ These trade regulation rules are found in the first volume of Title 16 of the Code of Federal Regulations. See 16 C.F.R. §§ 0-999.

The trade regulation rules found in Title 16 of the Code of Federal Regulations and various provisions of the FTC Act set forth the general policies and procedures which guide the Bureau of Consumer Protection in its investigation and prosecution of franchisors. Additional guidance is provided by the FTC Operating Manual.4

B. Why, How and When?

Franchisors, franchisees and lawyers alike often ask why, how and when does the FTC initiate an investigation of the business practices of a franchisor. An investigation may be commenced for any number of reasons, including complaints from current/former franchisees or employees of the franchisor, or upon the request of a governmental agency (federal or state), the Attorney General's office, Congress or the President. The Commission may also commence an investigation on its own initiative. In addition to targeted investigations, the FTC may -- and periodically does -- undertake industry-wide investigations.

Historically, there were two levels to an FTC investigation -- an "initial phase" and, if warranted, a "full phase." As a matter of practice, however, the Commission has done away with the distinction.

Decisions to initiate an investigation of a franchisor are typically made at the Division level, with the filing of a Matter Initiation Notice, which is approved by the Associate Director of the Division of Marketing Practices. Among other things, the notice identifies the franchisor to be investigated, as well as the potential law violation.5 The overriding consideration in determining whether to open an investigation is whether the alleged wrongdoing falls within the Commission's jurisdiction and, assuming that it does, whether pursuing the matter would be in the public interest.

Not every complaint submitted to the Commission involves an alleged violation of the FTC Act or the Franchise Rule. For example, franchisee complainants often raise issues such as the failure of the franchisor to register in a particular state, or the interpretation of a specific agreement term or condition. Similarly, other complainants

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4 The Operating Manual is in the process of being substantively revised. At this time, there is no expected completion date.

5 Industry-wide investigations and investigations involving First Amendment issues (such as an investigation of a publisher) must be approved by the Commission.
express dissatisfaction with franchise purchase and seek to cancel the franchise agreement or to obtain a refund. These types of complaints fell outside the FTC’s purview.

Once it is decided that a complaint or other information presented to the Commission raises a potential violation of the FTC Act and/or Franchise Rule, the Commission staff must then determine whether an investigation would be in the public interest. In making this determination, the FTC staff may consider, among other things, (i) the subject matter of the complaint; (ii) whether the subject matter of the complaint appears to be an isolated event or part of a pattern or practice; (iii) the potential level of injury; and (iv) whether there is likely to be a meaningful remedy.

In determining whether to initiate an investigation, the FTC staff will, of course, consider the subject matter of the complaint. Because FTC investigations are nonpublic, the Franchise Program Review does not provide any statistical data on the type of alleged wrongdoing that is most likely to lead to an investigation. However, certain inferences can be drawn about what type of conduct the FTC is most likely to investigate based on the allegations made in enforcement actions. As part of the Franchise Program Review, the Commission staff analyzed allegations raised in both franchise and business opportunity law enforcement actions. The most common Rule violation allegation (127 allegations) was the making of earnings claims without substantiation or without providing the required earnings claims document (i.e., a violation of Item 19). The failure to provide any disclosure document was the second most common, with 113 complaint allegations. Where a disclosure document was furnished, the most common deficiency was the failure to disclose complete and accurate franchisee statistical or background information (11 allegations), followed up by the failure to disclose complete and accurate litigation history (6 allegations).

See generally Franchise and Business Opportunity Program Review 1993-2000: A Review of Complaint Data, Law Enforcement and Consumer Education (June 2001)(“Franchise Program Review”). A copy of the Franchise Program Review is attached to this article and is also available on the FTC’s website (www.ftc.gov). Among other things, the Franchise Program Review reveals that there were many instances where complainants either did not state a specific allegation or made allegations that did not violate any law enforced by the Commission. For example, 37 franchise complaints submitted to the Commission contained no specific allegation; 11 complaints raised state law (and not FTC) issues; 14 complaints alleged contractual issues; and 39 complaints sought cancellation of the franchise agreement. See Franchise Program Review at p. 43.

The Commission’s Sentinel database, as discussed below in section III(B), is an increasingly important source of data that is considered by the FTC in determining whether to initiate an investigation.

See Franchise Program Review at p. 38.

Id.
For law enforcement actions filed under Section 5 of the FTC Act, the making of false earnings claims generated 94 allegations.\textsuperscript{10} This was by far the most common Section 5 allegation. The next most prevalent false or deceptive representation pertained to testimonials and references (28 allegations), followed by profitability and availability of locations for vending machines or other devices (24 allegations) and support and assistance claims (17 allegations).\textsuperscript{11}

Because the Commission is charged with acting in the public interest, it typically looks for patterns or practices of violations of the FTC Act and/or Franchise Rule. As a matter of policy, the Commission does not represent individual consumers. While a number of franchisee complaints regarding a particular franchisor is likely to draw the Commission’s attention, a single, well-documented complaint setting forth a pattern of Rule violations, for example, may suffice to trigger an investigation. The Franchise Program Review reveals that the Commission opened an investigation regarding every franchisor that was the subject of at least five complaints. No franchisor received more than eight complaints. The staff opened an additional 11 investigations in which the franchisor was the subject of four or fewer complaints, including eight investigations of companies with only one complaint.\textsuperscript{12}

The number of complaints and the level of injury will also guide the Commission staff in determining whether to initiate an investigation. The Franchise Program Review shows that 30\% of business opportunity and franchise complainants allegedly suffered injuries of less than $1,000, while 5\% allegedly suffered injuries of $20,000 or more. The most frequent level of reported injury was between $2,500 and $20,000, making up more than 50\% of the known total.\textsuperscript{13}

The FTC staff also considers whether there is likely to be any meaningful remedy as a result of the investigation. Specifically, the staff may consider whether the franchisor has gone out of business, or whether the franchisor is likely to have assets with which to pay consumer redress or a civil penalty.

Finally, the staff may take into account other practical considerations in deciding whether an investigation is warranted. These may include whether the alleged law violation is within the applicable statute of limitations; whether franchisees are able to

\textsuperscript{10} Id. at p. 39.

\textsuperscript{11} Id.

\textsuperscript{12} See Franchise Program Review at p. 42. The FTC staff also noted that 74\% of the complaints it analyzed represented a single, isolated complaint against a company. Less than 6\% of the companies analyzed were the subject of six or more complaints. Id. at p. 13.

\textsuperscript{13} See Franchise Program Review at p. 15. For franchises specifically, the $2,500 to $20,000 range of injury is predominant, but there are more instances of injury exceeding $20,000 than reported for business opportunities. Id. at p. 16.
resolve their dispute through state common law, fraud, misrepresentation, or breach of contract actions; and whether the same matter is being pursued by other law enforcement agencies.

C. The Investigational Process/Procedures

Like most government investigations, FTC investigations are nonpublic. See 15 U.S.C. § 57b-2(f); 16 C.F.R. §§ 4.9, 4.10 and 4.11. Thus, the FTC may not reveal to the public that a particular franchisor is the subject of an ongoing investigation.\textsuperscript{14} Nor, with certain limited exceptions, may the Commission disclose the identity of any person who provides information to the FTC before or during an investigation without the permission of such person. 5 U.S.C. § 552(b)(7)(D); 16 C.F.R. § 2.2(d). Accordingly, the identity of a complaining party (e.g., a franchisee) will not be disclosed to a franchisor under investigation. One exception to the confidentiality of an FTC investigation is a request for information or documents from a committee or subcommittee of Congress. 15 U.S.C. § 57b-2(b)(3)(C); 5 U.S.C. § 552(d). In addition, in the event an action in a United States district court is commenced -- or in the unlikely event that an administrative action is commenced -- some, but not all, of the information gathered by the FTC during an investigation may be obtained by the defendant(s) through discovery or otherwise disclosed in connection with such proceedings.

Having made the decision to initiate an investigation, the Commission may undertake to gather information by so-called “non-compulsory” and/or “compulsory” procedures. The “non-compulsory” investigational procedures -- to the extent they are utilized to affirmatively obtain information from a party under investigation or a potential witness -- are, as the name suggests, voluntary. The “compulsory” investigational procedures are, on the other hand, mandatory and may be enforced in federal court.

1. Non-Compulsory Procedures

The FTC has available to it a variety of “non-compulsory” investigational procedures, including (i) a letter to the franchisor requesting that it voluntarily provide the Commission with documents, materials and information regarding various aspects of the franchisor’s operations (a.k.a. as an “access letter”); (ii) informal or formal surveys or questionnaires sent to prospective, current or former franchisees, and/or other persons; (iii) interviewing persons with knowledge of the areas of the franchisor’s business that are being investigated; or (iv) “shops” of the franchisor’s trade show presentations or other “sting” operations.

\textsuperscript{14} The Commission may publicize that it is conducting an industry-wide investigation. However, the identity of the individual industry members being investigated generally remains nonpublic.
a. Access Letters

Typically, a franchisor discovers that it is the subject of an FTC investigation by receiving an access letter. In such cases, the Commission is required to include in the access letter a statement notifying the entity and/or person(s) under investigation of the “purpose and scope” of the investigation, as well as the general nature of the “conduct constituting the alleged violation which is under investigation and the provision of law applicable to such violation.” 16 C.F.R. § 2.6. For better or worse, the “notice” that must be provided by the FTC may not be particularly illuminating. For example, the access letter may simply indicate that the purpose of the Commission’s inquiry is to determine whether or not the franchisor and one or more of its employees has engaged in “unfair or deceptive acts or practices” in connection with the sale of franchises. Given that a broad spectrum of conduct rises to the level of an “unfair or deceptive act or practice” within the meaning of Section 5 of the FTC Act -- including a violation of any of the provisions of the Franchise Rule -- this provides little meaningful information to the franchisor. In certain instances, the nature of the documents and information being sought by the Commission may shed some light on the principal focus of the investigation. However, in the event the FTC is seeking documents and information on a number of subjects, it may be difficult to discern what really is at issue. Needless to say, this makes it extremely difficult for a franchisor to either assess its potential exposure or develop a strategy for dealing with the investigation.

After receiving an access letter, one of the first issues that a franchisor will need to grapple with is whether it must or should disclose in its Uniform Franchise Offering Circular the fact that it is the subject of an investigation by the Commission. This issue is potentially more complicated than it might seem at first blush. Neither the Franchise Rule nor the Uniform Franchise Offering Circular Guidelines adopted by the North American Securities Administrators Association (“NASAA”) require that a franchisor disclose that it is the subject of a FTC investigation. A compelling case can be made that a franchisor is under no obligation to disclose the fact that it is the subject of an FTC investigation. For example, depending on the stage of the investigation, the franchisor may not know what specific “act(s)” or “practice(s)” are being investigated. Alternatively, the franchisor may simply be part of an industry-wide investigation and the FTC has no evidence or even complaints of wrongdoing by the franchisor. Nonetheless, an attorney representing a franchisee may argue that the existence of an FTC investigation is “material” and that the franchisor was obligated to disclose the pendency of such an
investigation during the pre-sale process under the common law or "antifraud" provisions contained in a state's franchise laws.15

The franchisor is not required to provide information to the FTC in response to an access letter. That being said, it is difficult to think of any legitimate reason not to cooperate with the FTC's investigation. A refusal to cooperate or respond to an access letter is simply inviting heightened scrutiny and will likely cause the Commission to seek documents, information, etc., through one or more of the available compulsory procedures. However, in the event the FTC is seeking a large number of documents regarding a variety of subjects, the franchisor should consider seeking to narrow the scope of the documents and information it is being asked to provide. In addition, the franchisor may also want to ask for additional time in which to produce the requested materials. If the documents requested by the FTC are particularly voluminous or the FTC is gathering information as part of an industry-wide investigation, the franchisor should also consider requesting that it be reimbursed for all or part of its copying costs.

b. Questionnaires and Surveys

Although not as common as access letters, the FTC regularly utilizes questionnaires and/or surveys to gather information as part of an investigation. The information sought by way of a questionnaire is typically general in nature (e.g., background). Questionnaires may be sent to (i) potential respondents (e.g., a franchisor under investigation); (ii) prospective, current or former franchisees; and/or (iii) prospective witnesses, competitors and/or customers. Surveys, on the other hand, are typically sent to current or former franchisees and are more likely to be used to develop evidence for use in litigation. As such, it is important that the survey be prepared and undertaken in accordance with generally accepted survey techniques.

During the pendency of an investigation, the questionnaire and survey results obtained by the Commission are nonpublic and, thus, not available to the franchisor. See 15 U.S.C. § 57b-2(f); 16 C.F.R. § 410(a)(8). However, should the FTC initiate an

15 See, e.g., Cal. Corp. Code § 31201 ("It is unlawful or any person to offer or sell a franchise in this state by means of any written or oral communication not enumerated in Section 31200 which . . . omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."); N.Y. Gen. Bus. Law § 687.2 ("It is unlawful for a person, in connection with the offer, sale or purchase of any franchise, to directly or indirectly . . . omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.").
enforcement action, such documents should be discoverable in the event the Commission
seeks to rely on them in meeting their evidentiary burden.\footnote{For example, in order to obtain injunctive relief based on a franchisor’s oral and unsubstantiated earnings claims, the FTC must affirmatively establish that such claims were “widely disseminated.” The Commission may attempt to meet its burden, in whole or part, by the results of a survey. In such event, the franchisor should be permitted to discover the completed surveys.}

c. Interviews

As in any investigation, the FTC regularly conducts interviews of potential
witnesses as part of an investigation of a franchisor. There are no set procedures for
when or how such interviews may be conducted. However, it is the policy of the
Commission that any interview be memorialized in a written report summarizing the
interview.

Interview reports, like questionnaires and survey results, are also nonpublic.
Furthermore, even if the FTC has initiated an enforcement action, interview reports are
generally immune to discovery pursuant to the work product privilege. However, the
work product privilege is qualified and may, in certain circumstances, be overridden by
the respondent’s demonstrated “need” for the information set forth therein.

d. Trade Show “Shops” and Other “Sting” Operations

Additionally, the Commission may -- on its own or in conjunction with other
federal or state governmental organizations -- “shop” a particular franchisor or conduct a
“sweep” if the franchisor falls within an industry that is the subject of an investigation. In
these situations, an FTC investigator or attorney may pose as a prospective franchisee and
attempt to determine if a franchisor is, for example, making impermissible earnings
claims or otherwise violating Section 5 of the FTC Act or the Franchise Rule. These
“shops” and “sting” operations are often taped. The Commission staff may also review
trade show promotions, newspaper advertisements, as well as surf franchisor websites.

2. Compulsory Procedures

In addition, or as an alternative, to the voluntary means of gathering information
in connection with a pending investigation, the FTC may also resort to so-called
“compulsory” procedures. However, prior to resorting to compulsory process, the
Commission must first authorize such procedure by an investigational resolution.
\footnote{16} 16 C.F.R. § 2.7(a). The resolution may take the form of (i) a special resolution
authorizing an investigation into the acts or practices of a particular entity(ies) and/or
individual(s); (ii) an omnibus resolution providing for an industry-wide investigation to
ascertain whether corrective enforcement proceedings by the FTC are warranted; or (iii) a
blanket resolution directed at the investigation of certain types of practices in

\footnote{16} For example, in order to obtain injunctive relief based on a franchisor’s oral and unsubstantiated earnings claims, the FTC must affirmatively establish that such claims were “widely disseminated.” The Commission may attempt to meet its burden, in whole or part, by the results of a survey. In such event, the franchisor should be permitted to discover the completed surveys.
general -- *e.g.*, a general investigation of unfair or deceptive acts or practices in violation of Section 5 of the FTC Act (rather than of a particular entity or industry).

The only type of compulsory process available in an investigation regarding potential violations of Section 5 of the FTC Act by a franchisor -- *i.e.*, unfair or deceptive acts or practices on the part of a franchisor -- are civil investigative demands ("CID"). 15 U.S.C. § 57b-1(b); 16 C.F.R. § 2.7(b). The authority to issue an investigational CID rests with the Commission or a Commissioner and cannot be delegated to, for example, a Regional Director or even the Director of the Bureau of Consumer Protection. 16 C.F.R. § 2.7(a). There are four types of CIDs: (i) a request for production of documents; (ii) a request for production of tangible things; (iii) written reports or answers to questions (*i.e.*, interrogatories); or (iv) the giving of oral testimony (*i.e.*, a deposition). *Id.* The CID must specifically state the "nature of the conduct constituting the alleged violation which is under investigation and the provision of law applicable to such violation." 15 U.S.C. § 57b-1(c)(2).

The receipt of an investigational CID raises several important issues that a franchisor should consider. In the event the franchisor has already voluntarily provided information to the Commission, it is reasonable to conclude that the FTC believes that it has discovered at least some evidence of wrongdoing on the part of the franchisor and, more importantly, believes that any harm to the public caused by such wrongdoing is sufficiently egregious so as to warrant a more comprehensive investigation. If the franchisor or its counsel has not previously done so, this is the time to engage in a serious discussion with the FTC attorney responsible for the investigation. If possible, the franchisor should attempt to learn what specific acts or practices are being investigated and what, if any, concrete evidence of wrongdoing the Commission has discovered. Although this may seem both relatively obvious and only fair, the FTC is not required to disclose this information to a franchisor. In the appropriate circumstances, the franchisor may also want to consider broaching the subject of settlement by way of a negotiated cease and desist order (if warranted) and/or consent agreement.

In addition, the franchisor must decide whether it wishes to challenge the CID. In the event the franchisor believes that the CID is burdensome or overbroad, it should first attempt to narrow the scope of the information it is being required to provide and/or extend the time it has in which it must produce documents or respond to the questions. If these efforts are unsuccessful, the franchisor may elect to petition to limit or quash the CID. See 15 U.S.C. § 57b-1(f); 16 C.F.R. § 2.7(d).

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17 The other compulsory procedures available to the FTC -- (i) subpoenas; (ii) access orders, and (iii) so-called special Section 6b FTC Act reports -- cannot be used in investigations involving alleged unfair or deceptive acts or practices. 15 U.S.C. § 57b-1(b); 16 C.F.R. §§ 2.7(b), 2.11(a) and 2.12(a). The FTC can also hold investigational hearings. 16 C.F.R. § 2.8. However, such hearings are rarely, if ever, conducted.
A petition to limit or quash a CID must be filed with the Secretary of the Commission within 20 days after service of the CID. Similar to a motion for a protective order, the petition must set forth the factual and legal reasons why the CID should be limited or quashed, as well as a statement by counsel confirming that he/she conferred with counsel for the Commission in a good faith effort to resolve the dispute. Provided that the petition was filed in a timely manner, the time for complying with the portion of the CID is stayed pending a ruling on the petition. 15 U.S.C. § 57b-1(f)(2); 16 C.F.R. § 2.7(e). An individual Commissioner is designated by the Commission to consider petitions to limit or quash CIDs and will rule on the matter unless he/she refers the petition to the full Commission for determination. One downside to seeking to limit or quash a CID is that the petition is part of the public record. The franchisor’s right to appeal the designated Commissioner’s decision is restricted to asking the full Commission to review the ruling.

Should a franchisor fail to comply with the CID, the Commission may petition a district court of the United States for an order that the CID be enforced. 15 U.S.C. § 57b-1(e). If the district court orders that the franchisor comply with the CID and the franchisor fails or refuses to do so, the Commission may initiate a civil contempt proceeding. 16 C.F.R. § 2.13(b)(4). The franchisor is also subject to criminal prosecution. 15 U.S.C. § 50.

The procedural and substantive rules regarding a CID are, for all intents and purposes, virtually identical to those governing discovery in civil litigation. For example, each CID for the production of documents or answers to questions must be sufficiently definite and certain so that it is clear what information is being requested. 16 C.F.R. § 2.7(b). Similarly, the responding party must confirm in writing and under oath that all applicable information in its possession, custody, control or knowledge is being submitted in response to each CID. See 15 U.S.C. §§ 57b-1(e)(11), (12) and (13); 16 C.F.R. § 2.7(b). However, in appropriate circumstances, the franchisor may withhold documents or information on the basis of a privilege. 16 C.F.R. § 2.8A. In such case, the franchisor must provide the Commission with a privilege log. The Commission is required to pay for the reasonable cost of copying any documents being produced pursuant to a CID, but it is not required to pay for the cost of searching for and gathering the documents. Any person required to appear pursuant to a CID for the giving of oral testimony may be represented and advised by an attorney. As in a deposition, the attorney may object to questions and instruct his or her client not to answer any question on the grounds of privilege. However, notwithstanding a refusal to answer a question on the grounds of self-incrimination, a person may be compelled to provide such testimony under a grant of immunity pursuant to 18 U.S.C. § 6004. See 15 U.S.C. § 57b-1(c)(14)(D)(iii); 16 C.F.R. § 4.16.

The Commission may, but is not required to, consider requests for an extension of time in which the petition must be filed. 16 C.F.R. § 2.7(d)(3).
D. Disposition of Investigations

After having obtained whatever information it deems necessary, the Commission may dispose of an investigation in one of several ways. If an investigation reveals that the franchisor has not violated Section 5 of the FTC Act or the Franchise Rule, or for other good reason(s), the investigation will be closed. Ordinarily, the Associate Director of the Division of Marketing Practices (or Regional Office Director) has the authority to close an investigation, unless the investigation was originally authorized by the Commission or compulsory process was authorized. In such cases, the Commission must authorize the closing of an investigation. Once a determination has been made to cease an investigation, the staff may, but are not required to, send a letter to the franchisor under investigation advising it of this fact. Unlike the information gathered in connection with the investigation, the “closing” letter is part of the public record. See 16 C.F.R. § 4.9(b)(4)(ii). In some cases, an investigation may be closed despite some evidence of a technical violation of the Franchise Rule or other wrongdoing. For example, an investigation may be closed because the cost of continuing the investigation is prohibitive, other investigations are of a higher priority, or the practice being investigated has been discontinued.

In the event the investigation establishes that there has been one or more violations of Section 5 and/or the Franchise Rule and the Commission believes that corrective action is appropriate, the FTC may either: (i) offer the franchisor an opportunity to enter into a consent order agreement;\(^\text{19}\) (ii) refer the franchisor to the Alternative Rule Enforcement Program administered by the National Franchise Council (“NFC”); (iii) initiate adjudicative proceedings before an Administrative Law Judge;\(^\text{20}\) or (iv) file a complaint in a United States district court seeking civil penalties, injunctive relief and/or consumer redress.\(^\text{21}\) Where a franchisor has been notified of an investigation through an access letter, FTC staff will almost always provide the franchisor with an opportunity to enter into a consent order agreement before recommending to the Commission that it commence an adjudicative proceeding or an action in the district court. 16 C.F.R. § 2.31; see also 5 U.S.C. 554(c).

1. Consent Order Agreement

As a practical matter, if an investigation discloses that there is merit to the Commission’s allegations of wrongdoing, a franchisor should generally attempt to resolve the matter by entering into a consent order agreement. This course of action usually makes business sense and is consistent with the Commission’s policy to secure compliance with Section 5 and/or the Franchise Rule by a consent order agreement whenever possible. 16 C.F.R. § 2.31. One drawback, however, to entering into a consent

\(^{19}\) See generally 16 C.F.R. §§ 2.31-2.34.


\(^{21}\) See generally 15 U.S.C. §§ 45(m), 53(b) and 57b(b).
order agreement is that it is a matter of public record and must be disclosed in the Uniform Franchise Offering Circular. See generally 16 C.F.R. § 2.34. Nonetheless, as a general rule, the benefits of quickly resolving a matter by agreeing to a consent order far outweigh the disadvantages.

The procedure by which a consent order agreement is finalized differs depending on whether the matter is in the investigatory stage or in an adjudicative posture (i.e., after the Commission has voted to issue a complaint or a complaint has been issued). See 16 C.F.R. §§ 2.31-2.34; 3.25. The following discussion addresses the procedure by which a consent order agreement is entered into while an investigation is pending. The procedures for entering into a consent order agreement after an adjudicative proceeding has been commenced can be found in 16 C.F.R. § 3.25.

At any time during an investigation, a franchisor may elect to submit an executed consent order agreement to the Commission containing certain enumerated items. 16 C.F.R. §§ 2.31 and 2.32. Because it may not always be clear what specific acts/practices the FTC is particularly interested in or what evidence of wrongdoing the Commission has discovered, the better practice is to indicate a general willingness to enter into settlement discussions and invite the Commission to prepare a proposed consent order agreement in the appropriate form.

A consent order agreement will typically include, among other things, (i) a preamble identifying the parties to the agreement; (ii) a recital regarding jurisdiction (i.e., XYZ corporation is involved in the sale of franchises "in or affecting commerce"); (iii) a requirement that an individual signing the agreement notify the Commission of any change of business or employment; (iv) a requirement that any corporation signing the agreement notify the FTC of a change in corporate structure; (v) specific procedures and timing for compliance with the agreement; and (vi) procedures for distribution of the agreement. 16 C.F.R. § 2.32. In addition, the agreement will usually identify specific practices that the franchisor has agreed to discontinue (e.g., making oral and unsubstantiated representations as to the profitability of its franchisees) and may, in the Commission’s discretion, be accompanied by a report signed by the franchisor (and/or individual) setting forth in detail the manner in which it has ceased the offending activity (e.g., distributing allegedly misleading advertising) or will comply with the consent order if entered. 16 C.F.R. § 2.33.

A number of other items may also be included in the consent order agreement. For example, the agreement may provide for the payment of money to the Commission. If possible, the franchisor should negotiate for the inclusion of a provision to the effect that it has entered into the agreement "for settlement purposes only" and that by signing the agreement the franchisor is not admitting that it has violated any laws. 16 C.F.R. § 2.32. In some instances, the consent order agreement may also expressly reserve the Commission’s right to seek consumer redress.

A consent order agreement entered into by the FTC staff is not binding on the Commission until it has been accepted by the full Commission. 16 C.F.R. § 2.34. After
receiving a proposed consent order agreement, the Commission may (i) either accept the agreement as is; (ii) condition its acceptance upon certain revisions to the agreement; (iii) return the agreement to the FTC staff with directions that they enter into further negotiations with the franchisor; (iv) reject the agreement and issue a complaint; or (v) close the investigation.

In the event the Commission accepts the agreement, it is placed on the public record for comment for a period of 30 days or such other period as the Commission deems appropriate. 16 C.F.R. § 2.34(c) and (d). In addition to the agreement, a proposed complaint (which is attached to and incorporated into the consent order agreement), an analysis regarding the investigation (the purpose of which is to advise the public of the nature of the alleged violations, the results of the investigation and the implications of the consent order agreement), a news release, and, if applicable, an initial compliance report are also made part of the public record. Id. During the comment period, any member of the public may submit written comments to the Commission regarding the consent order agreement. At the conclusion of this period, the FTC staff submits a memorandum to the Commission advising it of the nature of any comments made by the public, as well as a recommendation to accept, modify or reject the agreement. The Commission may then (i) withdraw its acceptance of the agreement; (ii) issue a decision and order, which includes the terms of the consent order agreement; or (iii) decide that the decision and order should be modified. 16 C.F.R. § 2.34(e). In the event the franchisor does not consent to the proposed modification, the Commission may initiate a proceeding pursuant to 16 C.F.R. § 2.51 to re-open and modify the decision and order. Id.

2. NFC Alternative Rule Enforcement Program

In 1998, the Commission adopted on a trial basis the NFC’s Alternative Rule Enforcement Program (“the Program”). As a result, in the event an investigation has revealed “lesser” violations of the Franchise Rule (i.e., not involving fraud), the FTC may offer a franchisor the opportunity to participate in the Program as an alternative to an enforcement action.22 If the franchisor elects to participate in the Program, it will not be required to enter into a consent order agreement. This, of course, is an obvious benefit to the franchisor. To date, the FTC has referred nine franchisors to the Program.

The Program consists of compliance training and may also include monitoring of the franchisor’s disclosure documents and/or advertising. The compliance training is administered on site using the NFC’s Franchise Disclosure Law Compliance Manual and includes, among other things, a review of (i) the law governing franchising and the sale of franchises; (ii) the Franchise Rule and applicable state laws; and (iii) requirements and restrictions regarding the franchise sales process. The onsite compliance training typically lasts one day and currently costs $2,500. If additional training is necessary, the franchisor must pay a fee of $500 per additional day of training.

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22 Additional information regarding the Alternative Rule Enforcement Program can be found at the NFC’s website -- www.nationalfranchisecouncil.org.
In addition to the onsite compliance training, the FTC may, at its discretion, direct
the NFC to monitor the franchisor’s disclosure documents and advertising materials. If
the franchisor fails to make required changes to the disclosure documents and/or
advertising materials or otherwise violates the Franchise Rule, the NFC is required to so
advise the Commission.

As a condition of a referral to the Program, the FTC may also require that the
franchisor notify potentially affected franchisees that it may have violated the Franchise
Rule, and is willing to negotiate and/or mediate with any franchisee who files a claim
with the CPR Institute for Dispute Resolution (“CPR”) alleging that he/she suffered
damages as a result of such violation(s).

The negotiations and, if necessary, mediations are conducted in accordance with
the procedures of the National Franchise Mediation Program and are independently
administered by the CPR. Franchisors will receive notice from the CPR of any
franchisees who claim that they have suffered damages as a result of the franchisor’s
potential failure to comply with the Franchise Rule. A franchisor that is unable to
negotiate a resolution with the franchisee(s) will then be required to mediate with such
franchisee(s).

An administrative fee of $1,500 will be charged by CPR in connection with any
mediation. In addition to this administrative fee, the mediator selected by the parties will
charge an hourly or daily fee. Although the costs of the mediation are typically split
equally between the franchisor and the franchisee(s), the FTC may require that the
franchisor pay for more than 50% of the cost of the mediation as a condition of the
referral to the Program.

The identity of the franchisors and individuals that participate in the Program are
not made public by the NFC or the Commission. However, a Freedom of Information
Act request filed with the FTC may lead to the release of information on the participants.

3. Commencement of an Enforcement Action

The decision to file a lawsuit in the United States District Court seeking civil
penalties, injunctive relief and/or consumer redress is made by the Commission pursuant
to a resolution. In deciding whether to file a lawsuit, the Commission considers a number
of factors, including: (i) the nature and duration of the alleged violations of Section 5
and/or the Franchise Rule; (ii) the type and degree of injury caused by the alleged
wrongful practices; (iii) whether the practices are continuing or, if not, whether such
practices are likely to be resumed; (iv) the proposed respondent’s ability to pay consumer
redress and/or civil penalties; and (v) the likelihood of prevailing. The vast majority of
the complaints filed by the Commission against a franchisor involve improper earnings
claims (i.e., either the earnings claims were unsubstantiated/false or the franchisor failed
III. HANDLING A STATE FRANCHISE INVESTIGATION

Each state with franchise enforcement authority has the ability to investigate franchisors that do business in the state. The structure and staffing of the state franchise agencies are very different, but each handles investigations and enforcement actions in much the same way. Although franchisors rarely expect to find themselves the subject of a state investigation, they should nevertheless be prepared for that possibility. Franchisors who are familiar with how state authorities investigate potential franchise law violations invariably fare better in the resolution of an enforcement action than those franchisors who are not prepared. This portion of the article discusses how and why states open a franchise investigation, how an investigation evolves into a formal law enforcement action, and how states resolve those enforcement actions. It also discusses the circumstances under which franchisees and their counsel should consider turning to state authorities for assistance, and offers some predictions about how states may investigate franchise law violations in the future.

The sources for the information set forth below include state franchise laws and interviews with state law enforcement attorneys and franchise administrators from current and former franchise registration jurisdictions.

A. Initiation Of A State Franchise Investigation

States franchise registration and disclosure laws give the state franchise administrator the authority to investigate in or outside the state to determine whether any person has violated the state’s franchise law or any regulation or order passed under it. See, e.g., § 31401 of the California Franchise Investment Law (the “California Franchise Law”), Cal. Corp. Code § 31000, et seq.; § 14-208 of the Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. § 14-201, et seq. (the “Maryland Franchise Law”); § 19.100.242 of the Washington Franchise Investment Protection Act (the “Washington Franchise Act”), Wash. Rev. Code § 19.100.000, et seq.

In the vast majority of cases, state franchise administrators initiate a franchise investigation as a result of receiving one or more complaints from existing franchisees. In other cases, the franchise administrator may open an investigation based on concerns from other sources. For example, states may send undercover investigators to franchise trade shows to pose as potential franchisees. States also review franchise advertising in

23 During the period covered by the Franchise Program Review, the FTC opened a total of 59 investigations regarding the activities of a franchisor (versus 273 investigations regarding business opportunities). During the same period, the FTC filed 22 lawsuits against a franchisor alleging violations of Section 5 and/or the Franchise Rule (versus 148 cases filed against business opportunity promoters). See Franchise Program Review at p. 30.
newspaper classified sections and, increasingly, on the Internet. States may hear about potential problems in a franchise system from other state franchise authorities or the FTC. States may also be alerted to potential problems in a franchise system by the franchisor's competitor, by former employees, and even by ex-spouses of a franchisor's officer.

When evaluating whether to open an investigation in response to a franchisee complaint, a state generally considers: the nature of the complaint and the number of complaints from franchisees complaining about similar issues. With regard to the nature of the complaint, state franchise administrators often receive inquiries from franchisees about purely contractual issues in a franchise system. Typically, these issues are not actionable unless the contractual issue implicates some fraud or misrepresentation traceable to the original offer and sale of the franchise. In contrast, all states have authority to investigate and take action in cases of franchise fraud or misrepresentations. For this reason, states are more likely to initiate an investigation in response to a complaint that alleges some presale misrepresentation by the franchisor, such as an unlawful "earnings claim," gross understatement of the initial investment, or failure to provide a disclosure statement. On the other hand, states are unlikely to open an investigation in response to a complaint that a franchisor has failed to provide some good or service under an existing franchise agreement.

The criteria that states use to determine whether to initiate an investigation in a franchise case are fact-specific. In this regard, states generally consider the same factors as those considered by the FTC. Those factors include the number of complaints, the nature of the complaint, and the chances for success in litigation. In one instance, however, the states differ from the FTC. Many states report that they generally do not consider whether the franchisee complainant is represented by a private attorney or is in the process of filing its own private lawsuit. Most states indicate that knowledge that a franchisee may file a lawsuit against a franchisor does not add or detract significantly in determining whether the state will initiate an investigation or file a formal enforcement action. Other states concede, however, that this knowledge may, in limited circumstances, influence the states' response to complaints against a franchisor.

Increasingly, some states may decide to defer action against a franchisor unless the state receives multiple complaints about that franchisor or its franchise system. The reason for this limitation is purely economic. In many instances, state franchise authorities do not possess the resources to formally investigate each franchisee complaint, even when that complaint alleges a potential violation of the state's franchise law. When a franchise administrator receives an isolated complaint, the administrator may attempt to resolve that complaint informally, or it may note the complaint in the state's complaint records for future reference. Nearly every state reports that it will open a formal investigation when a state franchise enforcement agency receives multiple complaints about a franchisor.

In recent years, states have obtained access to complaint information they did not formerly have. The FTC maintains an Internet-based database of complaints from around the U.S. and the world. The complaints are gathered from a number of official sources,
including the FTC, state franchise agencies, consumer protection agencies, and law enforcement offices. This database, called Consumer Sentinel, is available only to law enforcement personnel. The Consumer Sentinel database includes a specific file for "franchise complaints." The database allows state law enforcement personnel to search complaints by company name, franchise trade name, or state of residence of the complaining person. The Consumer Sentinel database is being used more frequently by government agencies, including state franchise enforcement personnel. Some states have begun to search on Consumer Sentinel whenever the state receives complaints about a franchisor as a preliminary matter, in order to determine whether other franchisees have complained about similar issues. Through the use of the Consumer Sentinel database, states can more readily determine whether a specific complaint about a franchise system is isolated or whether other franchisees have made similar allegations.

B. State Investigative Tools

Once a state decides to open an investigation of a franchisor, the state has a number of resources available to it to gather information and evidence of a law violation. One of the most important tools in a state investigation is the ability to issue subpoenas for testimony and documents. See, e.g., § 688 (3) of the New York Franchise Law ("New York Franchise Law"), N.Y. Gen. Bus. Law § 680, et seq.; §553.55 of the Wisconsin Franchise Investment Law ("Wisconsin Franchise Law"), Wis. Stat. § 553.01, et seq. States often issue subpoenas for documents and testimony as part of their investigative tools. Other states report that they attempt to obtain information informally first, and resort to the issuance of a subpoena only if informal requests for information are unsuccessful.

As part of any state franchise investigation, especially in the beginning stages, state investigators will interview franchisees. The state may contact franchisees based on information received from a complainant or from the list of franchisees contained in the franchisor’s offering circular. States may send out form “surveys” or “questionnaires” to existing and former franchisees in the target franchise system. These surveys may request information relating to a specific complaint, or may seek general information about the entire franchise system. These survey responses can serve two purposes: (i) provide information to the state about specific issues raised by a complainant; and (ii) alert other franchisees with knowledge about potential law violations that a state is looking into the activities of the franchisor. Some states note, however, that the use of surveys has not yielded the responses expected or the type of information they had hoped to obtain. Those states report that, in the future, they are more likely to contact complainants and potential complainants by telephone or e-mail than through the use of mass mailing surveys.

During a franchise investigation where fraudulent activity is alleged, states report that the information they gather is kept strictly confidential, even from the target franchisor. Many states will not even confirm the existence of an ongoing investigation. Some of this information eventually may become available to the franchisor after the filing of a formal action in the course of discovery. A state’s policy regarding what it will
and will not disclose appears to depend, in part, on whether the franchise administrator is part of a state law enforcement agency, such as an attorney general’s office, or a state administrative agency, such as the secretary of state or state corporation commission. A franchise administrator that is part of a law enforcement agency is more likely to maintain the confidentiality of sources.

When a franchisor is not under investigation, some states will freely disclose the existence of specific complaints about a franchisor. Other states will limit disclosure to the name of the franchisor that is the subject of the complaint and, in general terms, the substance of the facts alleged in the complaint. Those states generally will not disclose any identifying information about the person who filed the complaint, preferring to maintain confidentiality of their sources. In Maryland, for example, the franchise administrator is part of the Office of the Attorney General of Maryland. That agency generally will not disclose any information about a complaining franchisee without the express permission of that person.

C. Suggestions For Responding To A State Franchise Investigation

Overwhelmingly, state law enforcement personnel report that they will give favorable consideration to a franchisor who seeks to cooperate with an investigation, except in those cases involving allegations of serious fraud. What constitutes cooperation is usually understood by all sides. In some cases, however, a franchisor under investigation may not recognize that its actions may be viewed as less than cooperative.

States recognize that a franchisor has every right to defend itself vigorously in cases when it does not believe it committed a violation of state law. In other cases, the franchisor is well aware that it has violated the law and seeks not to defend, but to resolve the matter by negotiation and settlement. In those latter cases, the franchisor’s cooperation with state authorities appears to have a positive effect on the final resolution of the investigation.

The following are suggestions that a franchisor should consider if the franchisor seeks to cooperate with a state investigation in an effort to obtain the most favorable resolution.

1. Respond Fully and Promptly to all Requests for Information

Although this suggestion would appear to be obvious, it is surprising the extent to which states report that some franchisors fail to respond fully and promptly to valid requests for information. Most state enforcement authorities concede that they are less likely to resolve an investigation on terms favorable to a franchisor if that franchisor failed to provide the expected information, unreasonably delayed production of documents, or otherwise sought to undermine the state’s ability to obtain and review information. In some states, the failure to provide information in response to a formal request may result in serious sanctions. For example, under Virginia law, any business entity that fails or refuses to obey any order of the Virginia Corporation Commission may
be fined $10,000 for each day the failure or refusal continues. See Va. Code Ann. § 12.1-13. The Virginia Corporation Commission interprets this authority to extend to a business entity’s failure to respond to a Commission subpoena.

In other instances, a franchisor’s failure to provide a complete and accurate response to a state subpoena request may have an indirect negative effect. In a case handled by one state, the state enforcement authorities received information that a franchisee had received a copy of a franchise offering circular that was not the same document registered by the state administrator and was, on its face, very misleading. When the state sent an undercover investigator, posing as a prospective franchisee, to the franchisor’s home office, a franchise salesperson gave the state investigator a similarly misleading and unregistered form of offering circular. Yet when the state authorities issued a subpoena for all franchise offering circular distributed in the state, the franchisor produced only the form registered in the state. The franchisor was either unaware that its salespersons were distributing the wrong form of offering circular or it was attempting to mislead the enforcement authorities. In either case, the failure to provide the information that the state expected to receive did not bode well for the franchisor’s expectation of a prompt and accommodating resolution to the investigation.

In some cases, a franchisor may have a legitimate reason for failing to produce information sought by a state enforcement agency within the time requested or designated. For example, the franchisor may have a limited staff to assist it in reproducing documents or the franchisor may have concerns that information sought by the state should be treated confidentially. In these cases, the state should be made aware of the franchisor’s concerns. Often, the state has encountered similar issues in the past. Most states are willing to accommodate the franchisor’s concerns. For example, in almost every case, a state will extend the due date for production of documents upon reasonable request or for good cause shown.

2. Once a Franchisor Becomes Aware of a State Law Violation, Immediately Bring the Violation to the Attention of the State Franchise Enforcement Agency

In other words, confession is good for the soul and for negotiating better settlement terms. Almost every state franchise enforcement agency reports that it will take into account the fact that a franchisor has alerted the state to the violation, rather than having the state discover the violation. For example, when a franchisor advises a state agency that the franchisor may have violated the state’s franchise law, the state may resolve the matter informally rather than through imposition of an order, or it may reduce or even waive the imposition of civil monetary penalties.

In cases of unregistered franchise sales, many states take affirmative steps to uncover potential violations. Some states routinely attend franchise trade shows and have investigators respond to franchise advertising. Other states report that they inquire about sales activities during unregistered periods as a regular part of their review of registration applications. While it is possible for a franchisor that has committed a registration
violation to avoid detection indefinitely, the odds of avoiding detection are not favorable enough to overcome the benefit of self-reporting.

3. After the Franchisor Becomes Aware of a State Franchise Law Violation, Take Adequate Steps to Ensure That the Violation is Not Repeated

Most franchise enforcement authorities report that they are unlikely to resolve an investigation informally if the franchisor has repeatedly committed the same violation of the state’s franchise law, especially when the violations occur after the franchisor has been notified by the state of the problem. Yet surprisingly, many states report that they have experienced situations when franchisors continue to violate the franchise law after being notified of the potential violation. States report that they have uncovered this problem in cases involving offers and sales of unregistered franchises, failures to provide the appropriate disclosure document, and failures to place initial fees in an escrow account when ordered to do so.

For example, one state reported that, while attempting to negotiate a resolution in a case involving unregistered franchise sales, the state discovered that the franchisor was continuing its sales activities in the state using a slightly modified form of “license agreement.” The franchisor had previously represented to the state that it had ceased all sales activity in the state pending the outcome of the state’s investigation. When the state discovered that this representation was false, it decided not to resolve the investigation informally and promptly filed a formal order to cease and desist.

In some cases, the continuing violation is inadvertent. It may result from a failure of communication between the franchisor’s management or counsel and the franchisor’s salespersons or brokers. In rare instances, the continuing violation may indicate that other serious problems exist in the franchise system. In any event, a state will be less likely to accept a franchisor’s assertions that it will comply with state laws in the future when that franchisor cannot ensure compliance in the present, even after being notified that it is the subject of a state investigation.

4. Review the Provisions of the State Franchise Law Under Which the Investigation is Proceeding

All franchise counsel seeking to resolve a state investigation should immediately familiarize himself or herself with the state’s franchise law and the potential remedies provided under that law. Yet in some instances, states report that all too often counsel is not familiar with the provisions of the applicable state franchise law. Although many of the state franchise laws are very similar, some differences exist. It would be a mistake for franchise counsel seeking to respond to a franchise investigation to fail to review the most updated versions of the state franchise law and regulations.

A number of states also report that some franchisors pursue a number of defense strategies that serve little purpose in resolving an open investigation. For example,
franchisors often attempt to mitigate their culpability by blaming a franchise law violation on a former attorney, officer or employee. In most cases, states may be sympathetic to the franchisor in this situation, but they will not allow the explanation to excuse the franchisor’s violation of an applicable franchise law provision.

D. The Forum For Franchise Enforcement Actions

Many states that decide to bring a franchise enforcement case generally have the option of filing the case as a state court action or as an administrative action. Where to bring the case depends, in part, on the type of relief the state seeks to obtain. If a state seeks any equitable relief, such as an injunction, restitution, the appointment of a receiver or termination of the franchisor’s authority to do business in the state, the state must file the case in state court. Some states, such as Virginia, have authority only to file administrative actions before a state corporation or securities commission. In contrast, other states, such as New York, have the authority only to file formal lawsuits in state court.

Even in those cases where states have the choice about where to file an action, many states will opt to file the action in an administrative setting. In most instances, the relief requested by a state can be obtained by filing an administrative order, either a Stop Order or a Summary Order to Cease and Desist. Both types of orders may be issued by a state franchise administrator. Both direct a franchisor to immediately stop some activity that the state franchise agency finds to constitute a specific violation of the state’s franchise law. A Stop Order is authorized when the state seeks to revoke or suspend the franchisor’s registration in the state. See, e.g., California Franchise Law, § 31115; Maryland Franchise Law, § 14-221; Washington Franchise Law, § 19.100.120. The Summary Cease and Desist Order is authorized when a state finds that a person has violated a provision of the state’s franchise law and seeks to halt that violation immediately. See California Franchise Law, § 31211; Maryland Franchise Law, § 14-210; Washington Franchise Law, § 19.100.248. Under the Uniform Franchise Offering Circular Guidelines, administrative orders, if resolved in favor of the state, must be disclosed by the franchisor in any future franchise disclosure document.

Because a state may obtain immediate relief through the issuance of an administrative order, the franchisor that is the subject of the order has a right to a hearing within a very short amount of time after issuance of the order. In some cases, if the subject of the order requests a hearing, the franchise administrator conducts the evidentiary hearing and issues a proposed ruling on the facts and law alleged in the order. In other cases, the dispute is referred to an independent administrative law judge, who conducts a hearing and issues a proposed decision to the state franchise administrator, who, in turn, can adopt the decision or reject it. The administrator may choose, however, to delegate final decision making authority to the administrative law judge.

States may seek to pursue an enforcement action administratively because that method is quicker and simpler for all parties. In most cases, administrative hearings are held within a relatively short period of time. The rules of evidence often are relaxed in
the administrative forum. The only reason a state may seek to pursue in state court is if
the relief that state seeks is not available through an administrative action.

E. Circumstances When Franchisees And Their Counsel Should Turn
To Their State Franchise Authorities For Assistance

State franchise enforcement authorities have an interest in working with
franchisees and their counsel to ensure compliance with state franchise laws. Although
state enforcement attorneys do not represent individual franchisees and should never be
used in place of private counsel, states often can take steps that assist franchisees to
obtain certain relief. Franchisees most often -- and quite naturally -- are interested in
recovering monetary damages. In contrast, state franchise enforcement attorneys are
primarily concerned with stopping ongoing violations of the law and remedying past
violations to the extent possible.

Franchisees, therefore, should be aware of what state enforcement authorities can
and cannot do in response to franchisee complaints. The following represents actions that
states may take to assist franchisees who choose to bring their own private litigation as
well as those franchisees who choose not to do so.

1. Informal Attempts to Mediate Complaints

In some cases, states may attempt to resolve disputes between franchisors and
franchisees informally. In this regard, the state acts as an unofficial mediator. States
generally do not undertake this role in response to complaints that allege fraud,
misrepresentations, or serious violations of state law. In those cases, the state's more
appropriate role is to investigate the alleged violation and initiate an enforcement action if
warranted. In some cases, states report that they have some success in resolving disputes
between franchisors and franchisees without filing any formal action.

States review and record all complaints sent to the state franchise agency. If the
state enforcement personnel determines that the complaint does not merit opening a
formal investigation, the state can, if it chooses, try to resolve the complaint. One way
that a state can assist in a potential resolution is by contacting the franchisor about the
complaint and requesting that the franchisor respond to the allegations. Most franchisors
will respond to a state franchise agency's request for information.

Franchisors also may be more amenable to resolving a complaint that has been
brought to the attention of a state franchise agency, even if the franchisor is fairly
comfortable that the state will not initiate an enforcement action in response to the
complaint. States may not divulge the names of a person complaining against a
franchisor, but most states will acknowledge when they have received a complaint against
a franchisor and discuss the nature of the allegations in the complaint. State franchise
agencies often receive inquiries from prospective franchisees inquiring about the
complaint history of specific franchisors. For this reason, franchisors have an interest in
ensuring that they maintain a fairly clean complaint history with any state franchise

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agency. Franchisors and franchisees should be aware, however, that some states will not or cannot undertake the role of mediator on issues that are not clearly within their jurisdiction. In addition, states differ on the issue of whether a complaint, once made, may be withdrawn by the complaining franchisee.

2. States Franchise Agencies as a Source of Information

Franchisors may be more responsive to requests for information when that request is made by a state enforcement agency rather than by a franchisee. In addition, states may already have information about a specific franchisor in the form of complaint data and registration records. Franchisees can obtain certain useful information from state franchise agencies through the use of a state’s public information act. All states are required to make their records reasonably available to the public under their respective counterparts to the Federal Freedom of Information Act.

State enforcement attorneys, as well as attorneys from the FTC, have acknowledged that one important factor they consider in determining whether to bring an enforcement action is whether numerous franchisees have filed complaints against the franchisor. In addition, private franchisee litigants may benefit from pooling their resources with other franchisees with similar claims. In that regard, it is extremely beneficial for franchisees in a dispute with their franchisor to determine if other franchisees have filed similar complaints. One way to discover this type of information is by contacting state franchise enforcement agencies and inquiring into whether other franchisees have filed similar complaints. Some states may not freely divulge the name of a complaining franchisee while an investigation is ongoing, but all states will disclose this information with the consent of the complaining franchisee.

In addition, franchisees may benefit from viewing the franchisor’s offering circulars as they are filed over time and in different states. All states grant access to franchise registration records to the public, although states vary on the applicable procedure and fees.

3. Amicus Briefs and Serving as Expert Witnesses

In certain circumstances, a state enforcement agency may be willing to file an amicus curiae brief in support of a franchisee’s position in an ongoing lawsuit if that lawsuit involves issues that the franchise agency believes are important. This action is appropriate only in a limited number of circumstances. In most cases when a state franchise agency has jurisdiction over a dispute that involves issues of interest to that agency, the state will be more likely to take a formal action rather than intervene as amicus curiae. However, states have filed these briefs in the past and, in doing so, contributed their expertise and their authority on behalf of the franchisee’s side in a dispute.

In addition, in some cases, state franchise administrators may be available to offer evidence in an ongoing lawsuit or arbitration through affidavit or even direct testimony.
Some government agencies categorically refuse to allow state personnel to serve as expert witnesses in private lawsuits; other agencies are more amenable to offering this form of assistance, under appropriately compelling facts. Some state administrators have allowed their staff to submit detailed affidavits outlining the registration records of a specific franchisor. These affidavits may be drafted to provide additional information that may be useful to help prove a franchisee's factual allegations and legal theories of a dispute.

The most likely cases in which states will file an affidavit or amicus brief on behalf of a franchisee in private litigation are disputes involving unlawful earnings claims or where a franchisee seeks to challenge the legality of a waiver or integration clause. Many state franchise administrators and attorneys find broad waiver provisions to be especially unfair and onerous, since they prohibit the franchisee from even making a claim of wrongdoing and because they involve contractual provisions that are or may be unlawful under several state franchise laws.

4. Formal Enforcement Action

In many cases, a franchisee may complain to a state franchise agency and request that the state bring a formal action on the franchisee's behalf. The franchisee usually seeks some type of monetary relief in the form of rescission or damages and wishes to utilize the resources of a state agency to obtain that relief against a franchisor whom the franchisee believes has committed some type of law violation, usually in the nature of misrepresentation. A state cannot bring an enforcement action on behalf of any individual. In certain circumstances, however, a state's formal enforcement action may lead to a positive benefit to an individual franchisee. In other instances, however, the franchisee may prefer that the state not pursue an enforcement action.

In a typical case, a franchisee complains to a state enforcement agency that a franchisor has violated some provision of the state's franchise law. The franchisee may have private legal counsel, although most franchisees who complain to a state do not have counsel. The complaining franchisee may have already discovered that bringing a lawsuit against a franchisor is both costly and time-consuming. The state's action against the franchisor costs the franchisee nothing. However, unlike the franchisee who has private legal counsel, the franchisee who relies on the state enforcement action to obtain a remedy has no control over the timing or substance of the state's action or the ultimate resolution of that case. In addition, once the franchisee has made a complaint to the state enforcement agency, the franchisee may not be able to withdraw that complaint, even if the franchisor is willing to settle the case with the franchisee in exchange for that withdrawal.

The most common type of action that states assert against a franchisor is one alleging a registration violation. These actions are generally relatively easy for states to bring and to prove. The state franchise agency maintains the records relating to a franchisor's registration, so the critical facts needed to prove this violation are under the state's control. If a franchisee has reason to believe that it purchased a franchise during a period when the franchisee was not registered as required under state law, the state
generally will be willing to pursue an action against the franchisor and seek a rescission offer for the affected franchisees.

The standard remedy that states seek for a franchise registration violation is rescission of the franchise agreement. States routinely seek rescission whether they pursue a formal enforcement action or agree to enter into a consent order. However, in many instances, franchisees and franchisors have widely differing interpretations of what constitutes “rescission,” especially in those cases where the franchisee has already received training, assistance, or has actually opened a franchised business. States generally try to take a middle ground in their calculation of rescission—taking the position that the franchisee should be placed in the position it would have been in before buying the franchise but not receive a “windfall” and retain any benefits from the franchise without compensating the franchisor. See Cusamano v. Norrell Heath Care, Inc., 239 Ill. App.3d 648, 653, 607 N.E. 2d 246 (1992), quoting Felde v. Chrysler Credit Corp., 219 Ill.App.3d 530, 542, 580 N.E.2d 191 (1991); Bagel Enterprises, Inc. v. Baskin & Sears, 56 Md. App. 184, 201, 467 A.2d 533 (1983), cert. denied, 299 Md. 136, 472 A.2d 999 (1984).

For example, in one case, the Maryland Securities Division attempted to mediate a dispute between a franchisor and franchisee who had been operating a franchise for several years. The franchisor calculated the value of a rescission offer to the franchisee to be approximately $40,000. The franchisee, on the other hand, calculated its rescission damages to be at least $1,000,000. The franchisee argued that the franchisor should reimburse it for all fees, losses, and other damages, including its liability on a long term lease for the franchised location. As is typically the case with mediation, the actual rescission offer the franchisor eventually made was somewhere between the rescission amounts argued for by both sides.

In some cases, a franchisee in a dispute with a franchisor may choose not to involve the state at all. The franchisee and its counsel may prefer to bring the case on their own or as part of a class action in order to retain control over the litigation. The franchisee may hope to recover attorneys’ fees as part of its damages. The franchisee may intend to use the threat of filing a state complaint as leverage in settlement negotiations, or may offer to sign a confidentiality agreement with the franchisor in exchange for more favorable settlement terms.

In most cases, franchisees and their counsel can work together with state enforcement attorneys to seek a satisfactory result for all parties. However, at times, the franchisee may not be satisfied with a state’s determination of an appropriate rescission offer. The state may choose, therefore, to resolve an enforcement action against a franchisor on terms that the franchisee finds unacceptable. The franchisee is free, then, to pursue its own private right of action against the franchisor and to try and obtain a more favorable form of rescission, although the franchisee may choose to settle for the less favorable calculation to save the added expense and time involved in filing its own private lawsuit.
Some states have sought to resolve franchise disputes through alternative methods of enforcement. For example, at least two states, New York and Rhode Island, have participated in the National Franchise Council's Alternative Rule Enforcement Program. Under that program, government agencies may refer a franchisor to the NFC for mediation and training. The program is limited to "technical" law violations, such as a franchisor's inadvertent failure to provide certain required disclosures. The program allows the government agency the choice to respond to the law violation without bringing a formal law enforcement action. In most cases, franchisors who participate in the NFC program agree to undergo training on franchise laws, and mediate disputes with affected franchisees. Not all states refer franchisors to the NFC program. Some states have formal or informal policies that prevent them from resolving law violations through any method other than by entering a formal, discloseable order.

F. Likely Future Trends In State Franchise Enforcement Actions

Clearly, one of the biggest challenges that states face in bringing effective franchise enforcement actions is the lack of resources at the state level. Litigation is expensive and time-consuming in even the most ideal circumstances. Franchise litigation can be extremely complex. In some cases, states may not have the personnel or money to undertake a complex investigation and engage in protracted litigation.

Many state law enforcement attorneys bring actions in a number of different areas, including those dealing with securities, investment advisors, broker dealers, business opportunities, and multi-level marketing. State enforcement agencies may be tempted to pursue actions in other areas, where the issues are not as complex or where fraud may be more easily proven. Alternatively, states may be required to use more creative means for effectively pursuing actions in the franchise arena. In this regard, some states have taken steps to conduct joint investigations with other states and the FTC. Many of the issues and problems raised in franchisee complaints exist in a number of different states. When states work together to investigate these matters, the states can make better use of their limited resources. The same result occurs when the states work together with the FTC. As individual state law enforcement personnel mature, those individuals develop relationships with personnel from other state and federal agencies. These informal contacts can and most likely will develop into more formal agreements to pursue actions jointly.

Many states have participated in multi-state enforcement actions in other areas, including consumer protection, antitrust and multi-level marketing. These joint actions have yielded significant results through a relatively cost effective approach. To date, states have not taken advantage of this form of cooperation in the franchise area. In the future, states will likely seriously consider the benefits of pursuing joint law enforcement actions, both with other states and with federal agencies.
IV. CONCLUSION

A full-scale investigation by the FTC or state equivalent is a serious matter. From the franchisor’s perspective, the specter of an expensive and time-consuming investigation is anything but good news. Understanding the process and policy concerns of the government, however, increases the likelihood of resolving the matter in an expeditious and favorable manner. From the perspective of the franchisee, the FTC and state equivalents play a valuable role in policing the franchise industry and insuring compliance with the applicable franchise laws. The government is not, however, a replacement for private counsel and a franchisee should understand the limitations of the governments’ authority.