

# REPRESENTING A FRANCHISOR IN AN FTC INVESTIGATION

BY C. GRIFFITH TOWLE

The Federal Trade Commission (the Commission or FTC) is charged with protecting the public from unfair and deceptive acts or practices in or affecting commerce. Such acts or practices are deemed "unlawful" pursuant to Section 5 of the Federal Trade Commission Act (the FTC Act) and, in appropriate circumstances, may give rise to equitable remedies, civil penalties and/or consumer redress.<sup>1</sup> Within the Commission, the Bureau of Consumer Protection is responsible for, among other things, investigating and prosecuting potential violations of Section 5 of the FTC Act (15 U.S.C. § 45) and the FTC Franchise Rule (16 C.F.R. § 436.1) by franchisors. In order to effect its charter, the Commission has promulgated a number of trade regulation rules pursuant to the authority granted to it under the FTC Act.<sup>2</sup> These trade regulation rules and various provisions of the FTC Act set forth the policies and procedures which guide the Commission in its investigation and prosecution of franchisors. This article will provide a general overview of the issues that confront a franchisor when it is the subject of an investigation by the Commission.

An investigation into the affairs of a franchisor may be based on or initiated for any number of reasons, including complaints from current/former franchisees or employees of the franchisor, upon the request of a governmental agency (federal or state), the Attorney General's office, Congress, or the President. In addition, the Commission may commence an investigation on its own initiative. There are two levels to an FTC investigation—an "initial phase" and, if warranted, a "full phase." An initial phase investigation may be begun and pursued for up to 100 hours by a Regional Director or an Assistant Director of the Bureau of Consumer Protection. In the event that the FTC staff believes that the initial phase investigation has unearthed sufficient evidence of wrongdoing on the part of a franchisor and/or its employees, they may elect to recommend that a full phase investigation be commenced. As suggested by its name, a full phase investigation is a considerably more serious undertaking and



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requires the approval of the Director of the Bureau of Consumer Protection before being initiated.

For better or worse, FTC investigations are pursued in a shroud of secrecy. As a general rule, any information received by the Commission during the course of an investigation is exempt from disclosure under the Freedom of Information Act, 5 U.S.C. § 552.<sup>3</sup> Accordingly, the FTC is prohibited from revealing to the public that a particular franchisor is the subject of an ongoing investigation. Nor, with certain limited exceptions, may the Commission disclose the identity of any person who provides information to the FTC during an investigation without the permission of such person.<sup>4</sup> Thus, 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.<sup>5</sup> In addition, in the event an administrative action or an action in a United States district court is commenced, some, but not all, of the information obtained during an investigation may be obtained through discovery or otherwise disclosed in connection with such proceedings.

Having begun an initial phase investigation, the FTC may undertake to gather information by various "noncompulsory" investigational procedures, including (i) a letter (also known as an access letter) to the franchisor requesting that it voluntarily provide the Commission with documents, materials and information regarding various aspects of the franchisor's operations; (ii) informal or formal surveys or questionnaires sent to prospective, current or former franchisees; or (iii) interviewing persons with knowledge of the areas of the franchisor's business that are being investigated. Some or all of these procedures may also be used during a full phase investigation.<sup>6</sup>

### Access Letters

As a general rule, a franchisor first 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 person 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."<sup>7</sup> Unfortunately, the "notice" that must be given by the FTC may not be particularly illuminating. For example, the access letter may simply

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indicate that the purpose of the Commission's inquiry is to determine whether or not the franchisor 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 FTC 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 related to a number of subjects, it may be virtually impossible to discern what is really at issue. Needless to say, this makes it extremely difficult for a franchisor to either assess its potential exposure or devise a strategy for dealing with the investigation.

After receiving an access letter, one of the first questions that a franchisor will likely ask 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 question is not necessarily as straightforward as it might seem. Neither the FTC 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 an ongoing FTC investigation. However, 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.<sup>8</sup>

The franchisor is under no obligation to provide information to the FTC in response to an access letter, although such a course of action could hardly be characterized as prudent. There are few, if any, reasons not to cooperate with an FTC investigation. A refusal to cooperate in general or respond to an access letter is simply inviting heightened scrutiny and will almost certainly cause the Commission to seek documents, and information through compulsory process. However, in the event the FTC requests a large number of documents regarding a number 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. The Commission is not required to pay for the cost of locating and copying documents being produced pursuant to an access letter. Nonetheless, if the documents requested by the FTC are particularly voluminous, the franchisor should also consider requesting that it be reimbursed for all or part of its copying costs.

### **Compulsory Procedures**

In addition, or as an alternative, to the above means of developing information in connection with a pending investigation, the FTC may gather information through so-called "compulsory" procedures. However, prior to resorting to

compulsory process, the Commission must first authorize such procedure by an investigational resolution.<sup>9</sup> The resolution may take the form of (i) a special resolution authorizing an investigation into the acts or practices of particular entities and/or individuals; (ii) an omnibus resolution—e.g., a 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 general. The Commission usually does not resort to compulsory procedures during the initial phase of an investigation.

### **Civil Investigative Demands (CIDs)**

The only type of compulsory process available in investigations regarding potential violations of Section 5(a)(1) of the FTC Act—i.e., unfair or deceptive acts or practices on the part of a franchisor—are civil investigative demands (CID).<sup>10</sup> There are three types of CIDs: (i) a request for production of documents or tangible things; (ii) written reports or answers to questions (i.e., interrogatories); or (iii) the giving of oral testimony (i.e., a deposition).<sup>11</sup> Whichever form it takes, 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."<sup>12</sup>

The receipt of a CID raises several important issues that a franchisor should consider. Assuming that 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 to warrant a more comprehensive investigation. This is the time to engage in a frank and serious discussion with the FTC attorney responsible for the investigation. If possible, the franchisor should endeavor to learn what specific acts or practices are being investigated and what, if any, concrete evidence of malfeasance 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.

In addition, the franchisor must decide whether it wishes to challenge, either informally or formally, 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 questions. If these efforts are unsuccessful, the franchisor may elect to petition to limit or quash the CID.<sup>13</sup> An individual Commissioner designated by the Commission to consider petitions to limit or quash will rule on the matter unless he/she refers the petition to the full Commission for determination. One considerable downside to seeking to limit or quash a CID is that the petition is part of the public record and is *not* exempt from disclosure to the public. The FTC is not required to submit a response to the petition unless

specifically requested to do so by the designated Commissioner. Should a response be requested, it is neither made available to the franchisor nor placed on 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.<sup>14</sup> 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.<sup>15</sup> The franchisor is also subject to criminal prosecution.<sup>16</sup>

In most respects, the procedural and substantive rules regarding a CID are 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. Similarly, the franchisor 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. However, in appropriate circumstances, the franchisor may withhold documents or information on the basis of a privilege.<sup>17</sup> In such event, 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.<sup>18</sup>

After having obtained whatever information it deems necessary and relevant, the Commission may dispose of an investigation in one of several ways. If an investigation reveals that the franchisor has not violated Section 5 or the FTC Franchise Rule, the investigation will be closed. In this case, the Commission may—but is not required to—send a letter to the franchisor advising it of this fact. Unlike the information gathered in connection with the investigation, the “closing” letter is part of the public record.<sup>19</sup> As a general rule, the individual with the authority to initiate an investigation must approve the closure of the investigation. In some cases, an investigation may be closed despite some evidence of a technical violation of the FTC 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.

Alternatively, if the investigation reveals that there has been one or more violations of Section 5 and/or the FTC Franchise Rule *and* the Commission believes that corrective

action is appropriate, the FTC may either: (i) afford the franchisor an opportunity to enter into a consent order agreement;<sup>20</sup> (ii) initiate adjudicative proceedings before an Administrative Law Judge;<sup>21</sup> or (iii) file a complaint in the United States district court seeking injunctive relief, civil penalties and/or consumer redress.<sup>22</sup> The FTC staff will usually 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.

### Consent Order Agreements

For any number of reasons, if an investigation discloses that there is merit to the Commission's allegations of wrongdoing, a franchisor should ordinarily attempt to resolve the matter by entering into a consent order agreement. Not only will this course of action usually make business sense—assuming the Commission is being reasonable—but it is consistent with the Commission's stated policy to secure compliance with Section 5 and/or the FTC Franchise Rule by a consent order agreement whenever possible. The primary drawback to entering into a consent order agreement is that it is a matter of public record and must be disclosed in the Uniform Franchise Offering Circular.<sup>23</sup> Nonetheless, as a general rule, the benefits of quickly resolving a matter by agreeing to a consent order far outweigh the disadvantages.

Perhaps not surprisingly, the procedure by which a consent order agreement is negotiated and finalized is convoluted. Moreover, the applicable procedures differ 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).<sup>24</sup> 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. The following discussion addresses the procedure by which a consent order agreement is entered into while an investigation is pending.

At any time during an investigation, a franchisor may take it upon itself to submit an executed consent order agreement to the Commission containing certain enumerated items.<sup>25</sup> 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.<sup>26</sup> 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 franchises).

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 to include 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.<sup>27</sup> In some instances, the consent order agreement may also expressly reserve the Commission's right to seek consumer redress. In these cases, it is extremely unlikely that the Commission will agree to a provision that the agreement is for settlement purposes only and that it does not constitute an admission of wrongdoing.

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. After receiving a proposed consent order agreement, the Commission may either (i) 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.

If the Commission accepts the agreement, it is placed on the public record for comment for a period of 60 days. 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. During this 60-day period, any member of the public may submit written comments to the Commission regarding the consent order agreement. At the end 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. If the Commission does not withdraw its acceptance of the agreement, it issues a decision and order, which includes the terms of the consent order agreement.

## Endnotes

1. See 15 U.S.C. § 45(m)—civil penalties; § 53(b)—equitable relief, including a permanent injunction and ancillary remedies; and § 57b(b)—consumer redress, including rescission and restitution.

2. These trade regulation rules are found in the first two volumes of Title 16 of the Code of Federal Regulations. See 16 C.F.R. §§ 1-999.

3. See 15 U.S.C. § 57b-2(f); 16 C.F.R. §§ 4.9, 4.10 and 4.11.

4. See 5 U.S.C. § 552(b)(7)(D); 16 C.F.R. § 2.2(d).

5. See 15 U.S.C. § 57b-2(b)(3)(C); 5 U.S.C. § 552(d).

6. In addition to obtaining information under the procedures set forth above, the Commission may employ FTC attorneys to investigate a franchisor's sales and marketing practices by posing as prospective franchisees.

7. See 16 C.F.R. § 2.6.

8. 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").

9. See 16 C.F.R. § 2.7(a).

10. See 15 U.S.C. § 57b-1(b); 16 C.F.R. § 2.7(b).

11. *Id.*

12. See 15 U.S.C. § 57b-1(c)(2).

13. See 15 U.S.C. § 57b-1(f); 16 C.F.R. § 2.7(d).

14. See 15 U.S.C. § 57b-1(e).

15. See 16 C.F.R. § 2.13(b)(4).

16. See 15 U.S.C. § 50.

17. See 16 C.F.R. § 2.8A.

18. See 15 U.S.C. § 57b-1(c)(14)(D)(iii); 16 C.F.R. § 4.16.

19. See 16 C.F.R. § 4.9(b)(4)(ii).

20. See generally 16 C.F.R. §§ 2.31-2.34.

21. See generally 16 C.F.R. §§ 3.1-3.83.

22. See generally 15 U.S.C. §§ 45(m), 53(b) and 57b(b).

23. See generally 16 C.F.R. § 2.34.

24. See 16 C.F.R. §§ 2.31-2.34; 3.25.

25. See 16 C.F.R. §§ 2.31 and 2.32.

26. See generally 16 C.F.R. § 2.32.

27. *Id.*

I am pleased to announce that, in accordance with 6.1 of the Forum on Franchising's Bylaws, the Nominating Committee nominates the following candidates to fill vacancies on the Governing Committee for terms commencing August, 1997, and recommends their election by the general assembly at the 1996 Annual Forum to be held on Thursday, October 17, 1996:

### For Members-at-Large of Governing Committee

(For 3 year terms)

Robert T. Joseph

Ann Hurwitz

Craig J. Madson

### For Forum Chair

(2 year term)

Richard M. Asbill

### To fill Mr. Asbill's term as Member-at-Large of Governing Committee

(1 year term)

J. Michael Dady

Rochelle B. Spandorf

Chair, ABA Forum on Franchising