

# DIVISION NOTES

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## Representing a Franchisor in Litigation with the FTC

*Editor-in-Chief's note: The first installment of this two-part piece, "Representing a Franchisor in an FTC Investigation," appeared in the Summer 1996 issue of the Journal (vol. 16, no. 1).*

### Introduction

The Federal Trade Commission (the Commission or the FTC) has the power to bring a lawsuit against a franchisor in the United States district courts.<sup>1</sup> This article provides a brief overview of the law governing FTC enforcement actions, how the FTC may attempt to prove its case, and how counsel can develop defenses to the FTC's evidence.<sup>2</sup>

A short factual hypothetical will put the law and defenses in context. Assume the franchisor (XYZ Co.) has several hundred franchisees located throughout the country and has been in business for a decade. The FTC brings an enforcement action in the United States district court against the company, two executive officers, and several of its key salespersons. The action alleges violations of Section 5 of the Federal Trade Commission Act (15 U.S.C. § 45, the FTC Act or the Act) and the FTC Franchise Rule (16 C.F.R. § 436.1, the Franchise Rule or the Rule).<sup>3</sup> Specifically, XYZ and the individual defendants are charged with having made misleading or false oral representations regarding earnings and potential profits to prospective franchisees over a number of years. Although the earnings claims are not purported to have been part of a uniform sales presentation, they are alleged to have been "widely disseminated" within the meaning of the FTC Act. The Commission is seeking a permanent injunction and consumer redress, which could potentially involve a multi-million dollar judgment against XYZ and the individual defendants.<sup>4</sup>

As a threshold matter, counsel for XYZ will need to decide whether it is desirable or even ethically permissible



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for corporate counsel to represent some or all of the individual defendants. For purposes of this article, we will assume that XYZ and the individual defendants are jointly represented by corporate counsel.<sup>5</sup>

### The Law Governing FTC Enforcement Actions in United States District Courts

As noted, the Commission is empowered to enforce Section 5 of the FTC Act and the Franchise Rule by filing actions in district court. The Commission may seek either preliminary or permanent injunctive relief under Section 13(b) of the Act. In addition, the FTC may seek monetary damages, typically as relief "ancillary" to the injunctive relief.<sup>6</sup>

To establish a violation of Section 5(a) of the Act, the Commission must prove: (1) that the franchisor made or engaged in a "representation, omission or practice," (2) that was "likely to mislead consumers acting reasonably under the circumstances," and (3) that the "representation, omission, or practice [was] material."<sup>7</sup>

The finding of a violation of Section 5 does not, however, automatically entitle the Commission to injunctive or monetary relief. In order to obtain a permanent injunction prohibiting the continuation of an unlawful practice, the FTC must meet the separate elements set forth in Section 13(b) of the Act.<sup>8</sup> Courts construing Section 13(b) have concluded that the Commission must prove four elements in order to obtain injunctive relief: (1) that a reasonably prudent person would rely on the misrepresentations made by the franchisor, (2) that these misrepresentations were widely disseminated, (3) that consumers purchased the product or franchise, and (4) that there is a "cognizable danger of recurrent violation" or "some reasonable likelihood of future violations."<sup>9</sup>

These elements are arguably supplemented by two others when monetary relief is sought "ancillary" to injunctive relief. Several decisions have observed that the FTC must also show that consumer injury resulted from the franchisor's deceptive acts or practices.<sup>10</sup> The Act itself, however, does not specify these elements.

In order to establish a violation of the more technical requirements of the Franchise Rule, the Commission must establish three distinct elements: (1) that the sales of franchises are subject to the Rule, (2) that defendants violated the Rule, and (3) that the violations were knowing, rather than negligent.<sup>11</sup>

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## The FTC's Evidence to Establish Liability

There are, of course, many ways for the Commission to gather the evidence necessary to establish liability against XYZ and the individual defendants. Because the Commission will likely seek consumer redress (and perhaps rescission) on behalf of all franchisees who purchased from XYZ, it will select a sampling of allegedly injured franchisees. It will then seek to demonstrate that the sample is typical or representative of the hundreds of past and present franchisees and obtain quick relief without resort to an army of witnesses and unwieldy reams of documents. In short, the Commission will use the well-established principles applicable to class action suits. For example, because it would be impracticable to join all franchisees, the Commission itself seeks consumer redress on behalf of the "class." The representative injured franchisees share "common" factual and legal issues with the class and the representative claims are "typical" of the class.

As an initial evidence-gathering step, the FTC may use investigators or attorneys posing as prospective franchisees at trade shows and follow-up meetings to investigate XYZ's sales and marketing procedures. The Commission may also send questionnaires to franchisees of XYZ, seeking to determine the extent of their alleged injury and to identify prospective witnesses for trial.<sup>12</sup> It may also obtain sworn affidavits or statements from corroborating XYZ franchisees (past or present). To the extent it has not already done so during its pre-litigation investigation of XYZ, the FTC will also likely take the depositions of XYZ employees most knowledgeable about and request the production of documents related to the company's sales practices.<sup>13</sup>

As part of its case against XYZ, the FTC must prove either that the earnings claims were actually false or that XYZ lacked a reasonable basis for believing that the claims were true at the time they were made.<sup>14</sup> In order to meet one or both of these elements, the Commission will almost certainly request the production of all documents in XYZ's possession regarding franchisee earnings and profitability. Unfortunately, many franchisors either do not require their franchisees to provide profit and loss statements or have incomplete records regarding their franchisees financial performance.

### Defense Strategies for Counsel

It would be impossible to provide a comprehensive catalog of defense strategies to an enforcement action brought by the Commission under Sections 5 and 13(b) of the FTC Act. The following discussion, however, focuses on several approaches to critical issues.

#### Section 5 Defense Strategies

As set forth above, Section 5 of the FTC Act is not self-executing. In other words, a violation of Section 5 does not automatically give rise to injunctive relief under 15 U.S.C. § 53(b) or to consumer redress under 15 U.S.C. § 57b(b).<sup>15</sup> Rather, the Commission must affirmatively prove additional

elements prior to obtaining any relief. This additional hurdle is important to keep in mind when formulating theories and marshaling evidence for the defense of the case because it offers opportunities for counsel to force the Commission to meet its burden of proof.

The principal defense (assuming that the facts are consistent with such a defense) is that the alleged earnings claims were never made. Direct and circumstantial evidence that the earnings claims were not made could include: (1) testimony from the person(s) alleged to have made the earnings claims, (2) evidence that the information regarding the profitability of franchisees was available from existing franchisees during the prospective franchisees' investigation of the business opportunity, or was learned post-sale, and (3) evidence of XYZ's policies, procedures and training related to the sale of franchises.

The FTC must next prove that the earnings claims were likely to mislead a consumer acting reasonably under the circumstances.<sup>16</sup> Pursuant to the Commission's policy guidelines, a statement is likely to mislead a reasonable consumer if the statement is either false at the time it was made (the falsity theory), or if the franchisor lacked a reasonable basis for making the statement at the time it was made (the reasonable basis theory).<sup>17</sup> The Commission may elect to proceed under either the falsity theory or reasonable basis theory. It is important to note that the FTC can prevail under these theories even if the claims became true at a later time and even if the franchisor gathers sufficient evidence at a later time to establish that the claims were true at the time they were made.

The falsity theory requires little elaboration. However, what constitutes a "reasonable basis" on the part of a franchisor is a fact-based inquiry that is dependent on a number of factors. First, the district court must determine what level of "substantiation" XYZ was required to have for the claims alleged to have been made.<sup>18</sup> In other words, what facts, documents, industry standards or other evidence existed at the time the claims were purported to have been made that demonstrate that the company had a reasonable basis for believing the earnings claims were accurate? The FTC will argue for a high standard and counsel should consider arguments for a low standard. After determining the requisite level of substantiation, the court will determine whether that level has been met by XYZ.

The level of substantiation is, therefore, a critical issue. Unfortunately, the cases that have addressed the reasonable basis theory involve claims of false product advertising, rather than franchise opportunities. Applying the false advertising case law to the franchise context is somewhat like trying to fit the proverbial square peg into the proverbial round hole. Arguments directed to a low standard of substantiation which are unique to franchisors include the highly regulated nature of franchises, the freedom afforded franchisees to maintain their own operating records (rendering exact information unavailable to the franchisor), and the often lengthy pre-sale due diligence undertaken by the prospective franchisees. Indeed, the false advertising cases deem critical to the question whether "the nature of the product claims" ren-

ders it "difficult or impossible for the consumer to evaluate by themselves."<sup>19</sup>

Obviously, the process of deciding whether to invest in a multi-year franchise differs considerably from the process of deciding whether to buy toothpaste or hair tonic, whatever claims are made about the products. While it is next to impossible for the consumer to evaluate product claims, the prospective franchisee will often take months and employ experts such as attorneys and accountants before executing the franchise agreement. Thus, the requisite level of substantiation for any alleged earnings claims can be argued to be a direct function of the prospective franchisee's ability to "evaluate" the investment "by themselves."<sup>20</sup>

### Section 13(b) Defense Strategies

As noted, to obtain a permanent injunction against XYZ under Section 13(b), the Commission bears the burden of first proving the elements of Section 5, and then proving the additional three elements required under Section 13(b). For permanent (but not preliminary) injunctive relief, the FTC must also show that the misleading or fraudulent representations are likely to recur in the future. These four prerequisites lend themselves to a number of defenses.

First, the Commission must prove that a reasonably prudent person would have relied on the alleged misrepresentations.<sup>21</sup> This issue triggers what is perhaps XYZ's strongest defense. The case law is clear that the franchisor is permitted to develop and present proof that the franchisees did not, in fact, rely upon the alleged representations in making the decision to purchase the franchise. This defense of "lack of actual reliance" is an affirmative one, and the burden lies with the franchisor to establish it with credible proof.<sup>22</sup> It will be important for counsel to depose witnesses who provided statements to the Commission (if feasible), and to cross-examine them at trial, to establish that they engaged in a lengthy and comprehensive investigation of the franchise prior to purchasing and did not actually rely on the alleged earnings claims.

This evidence will include the length of time prospective XYZ franchisees engaged in due diligence, the number and quality of conversations they had with existing franchisees (including selling-franchisees, if applicable), their creation of pro formas and business plans, their review of those plans with XYZ's employees, and their reliance upon the advice of experts such as lawyers or accountants in making the decision to purchase the franchise. As the investigation process is shown to have been increasingly thorough, the Commission's claim that oral statements of earnings directly caused the franchise witness to invest becomes increasingly tenuous.

The Commission must also demonstrate that the alleged

misrepresentations were widely disseminated. Here again, the analogy to class actions under Federal Rule of Civil Procedure 23(a) is helpful. If the representations were not provided to the prospective franchisees in a consistent manner (e.g., if they varied as to content, time or place of delivery, or were not delivered as part of a standardized presentation), the franchisor will be able to argue that this element is not met. In the parlance of Rule 23(a), XYZ can show the existence of questions of fact not common to the entire class of franchisees, and that the claims of misrepresentations put forward by the Commission are not typical of a system-wide pattern and practice.<sup>23</sup>

While the next element of Section 13(b)—consumer purchase—is likely to be impossible to rebut, XYZ can present evidence that the practice complained about has ceased and is unlikely to recur in the future. For example, the offending XYZ employees may have been terminated or disciplined, a program may have been put in place to correct the offending practice and to demonstrate XYZ's commitment to ethical

business practices, and new franchisees may testify regarding the non-offending sales presentations they received and other appropriate conduct by the company.

In addition, to obtain ancillary monetary damages, the Commission will likely have to prove that the company engaged in misrepresentations or

omissions which resulted in consumer injury.<sup>24</sup> Each of these elements—causation and injury—are rebuttable. The Commission will seek to prove injury through franchisees who suffered serious losses or closed their businesses. It will be critical for the franchisor to establish alternative explanations for these "failures." For example, XYZ may demonstrate that the failed franchisee refused to follow XYZ's standard operating plan or implement XYZ's corrective suggestions, was unable to effectively market or otherwise generate business, and was unable to keep expenses in check due to a host of factors. These same factors also may argue for lack of causation. In some instances a review of the franchisee's personal circumstances may help establish additional explanations for the lack of success.

### Franchise Rule Defense Strategies

In the case of XYZ's oral earnings claims, a separate Rule violation is alleged by the Commission for XYZ's failure to adequately support or substantiate the claims.<sup>25</sup> While, as noted, the Commission does not prohibit earnings claims supported by appropriate documentation, the Rule does require that the franchisor have a reasonable basis for an earnings claim, consisting of substantiating evidence in the possession of the franchisor at the time the claim is made.<sup>26</sup> While the Commission has taken the position that only writ-

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ten documentation is admissible to support a reasonable basis defense for a Section 5 violation, authority exists within the Commission's own administrative decisions to support the argument that the reasonable basis standard should be determined on a case-by-case basis under the Franchise Rule.<sup>27</sup> Informal substantiation, while difficult to produce, may be considered by a court, at least as evidence of the franchisor's lack of intent to deceive. Examples include the franchisor's general knowledge of franchisee earnings and royalties (especially if summarized in annual or quarterly reports), and review of information summarizing industry earnings.<sup>28</sup>

## The Law Governing Individual Liability and Defense Strategies

The Commission's complaint against XYZ also named individual officers and sales employees. If the franchisor is not well capitalized, or may have difficulty satisfying a monetary judgment, the impact of a judgment against the individual defendants could be catastrophic. The elements relating to the liability of individual defendants vary somewhat and are generally more difficult to prove than those for corporate liability.

Before an individual can be liable, the Commission must first establish liability on the part of XYZ.<sup>29</sup> In addition to corporate liability, the Commission must prove two additional elements. First, the Commission must prove that the individual defendant(s) participated in the deceptive acts of the franchisor or had authority to control the conduct in question.<sup>30</sup> Second, the Commission must prove that the individual had knowledge that the corporation engaged in the conduct.<sup>31</sup>

In order to meet its burden as to the first element, the FTC may attempt to show that the individual defendants actually made the earnings claims themselves, as in the case of sales people, or had control over the XYZ employees who made them, in the case of the officers and owners. Generally speaking, the higher up the corporate ladder the individual is, the lighter the Commission's burden. At least some courts have found liability on this prong where the individuals had responsibility for the making of corporate policy, regardless of whether such policy was directed to the alleged misconduct.<sup>32</sup> The Commission has, on occasion, argued that even general involvement in XYZ's business affairs could be sufficient to meet the first prong of this test. The case law does not seem to agree, although the Commission's argument may, in certain factual circumstances, receive a sympathetic hearing from a district court where the franchise is found to be a "fly-by-night" scam, rather than a genuine business opportunity.

The knowledge requirement may be proved by the Commission in three distinct ways. For example, the Commission may prove that the individual had actual knowledge of material misrepresentations, or was recklessly indifferent to the truth or falsity of such material misrepresentations, or had an awareness of the high probability of fraud and the intentional avoidance of the truth.<sup>33</sup> While the defense of a claim of individual liability is difficult where the individual owns the majority share of stock, where the individual defendant does not own a controlling interest or does not obviously domi-

nate the organization, arguments and evidence can be presented that the individual did not have sufficient knowledge of the specific practice to impose liability. Evidence of complaints by franchisees, discussions regarding earnings claims among sales employees and prior history of earnings claims in other companies may all be advanced by the Commission to show knowledge.

In addition, if the alleged violation pertains to the Franchise Rule, rather than to Section 5, an additional defense may be argued. In instances of technical Rule violations—e.g., failure to provide a disclosure statement containing the earnings claims—the individual defendant can argue and present evidence of the fact that he/she did not directly participate in or control the actual disclosure and registration process. At least one court has refused to impose liability where an individual defendant did not prepare the UFOC sections at issue.<sup>34</sup> Thus, if the individual did not authorize, draft or approve the contents of the UFOC provided to prospective franchisees, this defense may apply to the alleged Rule violation.<sup>35</sup>

## Other Possible Defenses

### Statute of Limitations

Section 19b(d) of the FTC Act—which empowers the Commission to seek consumer redress for violations of FTC trade regulations, including the FTC Franchise Rule—expressly limits the period for which the FTC may seek relief thereunder to three years from the date of the alleged violation.<sup>36</sup> In contrast, Section 13(b) of the Act—which empowers the Commission to seek equitable relief, including the ancillary remedies of restitution, rescission and "the payment of damages"—does not contain an express limitations period.

Whether the three-year limitations period set forth in Section 19b(d) is or should be applicable to Section 13(b) was, and perhaps still is, a matter of some debate. Essentially, both Section 13(b) and Section 19b(b) of the FTC Act provide for "monetary relief." Given this, at least one commentator has argued that Congress could not have possibly intended for Section 13(b) to provide essentially a similar type of monetary relief as is available under Section 19(b) without also intending that the three-year limitations period set forth in Section 19b(d) be applicable to Section 13(b).<sup>37</sup>

Notwithstanding the apparent logic of this argument, a federal district court in Massachusetts recently concluded that the three-year limitations period for consumer redress actions does not apply to claims for equitable relief.<sup>38</sup> However, the court did not specifically address the issue of whether "consumer redress" under Section 13(b) was available independent of Section 19b(d).<sup>39</sup> Thus, there is at least some room for argument that the Commission should not be allowed to seek monetary relief for a period in excess of three years before filing.

### Releases

In many instances, a current or former franchisee will have signed a general release in connection with, for example, the

sale of their business to a third party. Such a release should preclude the Commission from obtaining consumer redress as to that franchisee.<sup>40</sup> Of course, if there is evidence of fraud, coercion or economic duress in obtaining the release, the release may be invalidated or disregarded by the Court. In addition, the fact that a current or former franchisee executed a general release would not bar their testimony relevant to other issues, such as whether the earnings claims were "widely disseminated."

## Conclusion

The law governing FTC actions has not been extensively developed. However, a thorough understanding of the distinct elements the Commission must prove can help counsel to defend the action effectively, as well as minimize or eliminate the exposure of the franchisor and the individual defendants.

## Endnotes

1. This discussion follows up on a previously published article regarding issues confronting a franchisor when it is the target of a pre-litigation investigation by the Commission. See C. Towle, *Representing a Franchisor in an FTC Investigation*, 16 *FRANCHISE L.J.*, Spring 1996, at 11.

2. As an alternative to filing suit in federal court, the FTC may initiate proceedings before an Administrative Law Judge. See generally 16 C.F.R. §§ 3.1-3.83.

3. Section 5(a) of the FTC Act prohibits unfair and deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45(a). The Franchise Rule governs the type and scope of pre-sale disclosures by a franchisor. Among other things, a franchisor is prohibited from making an earnings claim unless it is set forth in a disclosure document and is "substantiated." See 16 C.F.R. § 436.1(b)-(e).

4. See 15 U.S.C. § 53(b)—equitable relief, including a temporary/permanent injunction and ancillary remedies; and 15 U.S.C. § 57b(b)—consumer redress, including rescission and restitution. The FTC may also seek civil penalties of up to \$10,000 per violation pursuant to 15 U.S.C. § 45(m). Unlike when it is seeking injunctive relief and consumer redress, the Commission must affirmatively prove actual knowledge (or "knowledge fairly implied on the basis of objective circumstances") on the part of the franchisor in order to obtain civil penalties.

5. The attorney will need to obtain the appropriate waivers from each of the defendants, as well as evaluate the evidence on an ongoing basis to determine whether joint representation remains appropriate.

6. The Commission may also seek monetary relief pursuant to Section 19(b) of the Act. See 15 U.S.C. § 57b(b).

7. *F.T.C. v. Pantron I Corp.*, 33 F.3d 1088, 1095 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 1794 (1995).

8. As noted, Section 19 of the Act also provides for monetary damages, but is frequently less appealing to the Commission because it contains a three-year statute of limitations. See 15 U.S.C. § 57b(d). Section 13(b) contains no such express statute of limitations. See 15 U.S.C. § 53(b).

9. See, e.g., *F.T.C. v. World Travel Vacation Brokers, Inc.*, 861 F.2d 1020, 1029 (7th Cir. 1988), *citing* *F.T.C. v. Kitco of Nevada, Inc.*, 612 F. Supp. 1282, 1293 (D.Minn. 1985).

10. See, e.g., *Pantron*, 33 F.3d at 1102 ("A corporation is liable for monetary relief under Section 13(b) if the F.T.C. shows that the corporation engaged in misrepresentations or omissions of a kind usually relied on by reasonably prudent persons and that consumer injury resulted"). The FTC can be expected to argue that a presumption of

injury and causation arises if the three-part test for injunctive relief under Section 13(b) is met. There is no controlling case law on point.

11. *F.T.C. v. National Business Consultants*, 781 F. Supp. 1136, 1151 (E.D. La. 1991) (listing elements); 15 U.S.C. § 57a(d)(3) (a violation of the Franchise Rule also constitutes a violation of Section 5(a)(1) of the FTC Act).

12. The defense attorney should request that the FTC produce the completed questionnaires during discovery. The form of the questions, as well as the responses, should be carefully reviewed for bias, etc.

13. For a further discussion of pre-litigation investigations, refer to "Representing a Franchisor in an FTC Investigation," *supra* note 1 at 11-13.

14. See FTC Policy Statement on Deception, Oct. 14, 1983, *reprinted in* *Cliffdale Associates, Inc.*, 103 F.T.C. 110, 177, 182 (1984); *Pantron*, 33 F.3d at 1096.

15. See, e.g., *AMREP*, 705 F. Supp. at 127.

16. *Pantron*, 33 F.3d at 1095.

17. FTC Policy Statement on Deception, Oct. 14, 1983, *reprinted in* *Cliffdale Associates, Inc.*, 103 F.T.C. 110, 177, 182 (1984); *Pantron*, 33 F.3d at 1096.

18. *Id.*

19. *Pantron*, 33 F.3d at 1096, n. 23, *citing* *Thompson Medical Co.*, 104 F.T.C. 648, 821-25 (1984).

20. *Id.*

21. See, e.g., *World Travel Vacation Brokers*, 861 F.2d at 1029.

22. *Id.* ("[T]he burden shifts to the defendants to prove that the representations were not relied upon by the consumers"); see also *Kitco*, 612 F. Supp. at 1293 (same).

23. *AMREP*, 705 F. Supp. at 128 ("[t]he false representations were contained in a variety of written and filmed sales materials, as well as in oral presentations").

24. See, e.g., *Pantron*, 33 F.3d at 1102.

25. See 16 C.F.R. § 436.1(b)-(e).

26. *Id.*

27. *In the Matter of Pfizer*, 81 F.T.C. 23, 1972 FTC LEXIS, 12 \* 9 (1972).

28. *Id.* at 102-109.

29. *FTC v. Patriot Alcohol Testers, Inc.*, 798 F. Supp. 851, 859 (D.Mass. 1992).

30. *Id.*

31. *Id.*

32. *Kitco*, 612 F. Supp. at 1292 ("Authority to control a company is evidenced by active involvement with business matters and corporate policy including assumption of officer duties"); *FTC v. Amy Travel Serv., Inc.*, 875 F.2d 564, 573 (7th Cir.), *cert. denied*, 493 U.S. 954 (1989).

33. *Kitco*, 612 F. Supp. at 1292.

34. *United States v. The Building Inspector of America, Inc.*, 894 F. Supp. 507, 518-20 (D.Mass. 1995) ("Although [defendant] assisted [corporate] counsel in drafting parts of the UFOC, the record does not reveal whether he was involved in drafting the sections at issue here, or whether he had actual authority in the company to determine the final content of the UFOC which was distributed to state regulators and potential franchisees"). This decision appears to be the only published order solely involving Franchise Rule violations leveled against individual defendants.

35. Of the nine reported decisions involving Franchise Rule violations, eight involve violations of both the Franchise Rule and Section 5 of the FTC Act. In all eight of the decisions, the corporate defendants failed to provide a UFOC to perspective franchisees.

36. See 15 U.S.C. § 57b(d).

37. P. Ward, *Restitution for Consumers Under the Federal Trade Commission Act: Good Intentions or Congressional Intentions?*, 41 *AM.U. L. REV.* 1139, 1179-84 (1992).

38. *The Building Inspector*, 894 F. Supp. at 513-14 (D.Mass. 1995).

39. *Id.* at 513, n. 3.

40. *AMREP*, 705 F. Supp. at 124-25.