THE ULTIMATE REMEDY: MANAGING REGULATORY ENFORCEMENT ACTIONS

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VII. HOW SHOULD A FRANCHISOR APPROACH AND RESPOND TO THE REGULATORS? .......................................................... 15

A. Assess the Exact Nature of the Issue and Any Mistake and Diligence the System for Other Potential Issues Prior to Initiating a Response .................................................................................................................................................. 16

B. Meet with the Appropriate Franchisor Representatives to Address the Issues, Including What Should be Done Going Forward and Potential Changes to the FDD or Sales Practices ...... 16

C. Identify Any Defenses/Explanations ............................................................................................................................... 17

D. Establish an Initial Dialogue with the Regulator and an Appropriate Approach to the Next Steps in the Process .......................................................................................................................... 18

E. Understand the Impact of the Franchise System, Existing Franchisees and Prospective Franchisees .............................................................. 19

F. Does Self-Reporting Ever Make Sense? ................................................................. 19

VIII. BEST PRACTICES: PREVENTION/RISK MANAGEMENT ........................................ 20

IX. CONCLUSION ................................................................................................................................. 26

Appendix A – Registration States: State Administrators and State Statutes

Appendix B – State Relationship Statutes

Biographies
THE ULTIMATE REMEDY: MANAGING REGULATORY ENFORCEMENT ACTIONS

I. INTRODUCTION

Every franchisor’s stomach turns inside out when it receives an inquiry from a federal or state franchise regulator or the franchisor is subject to a federal or state enforcement action. In many instances the inquiry or enforcement action can have a material and system-altering impact on the franchisor, the franchisor’s employees, existing and prospective franchisees and, potentially, the customers of the brand. Under these circumstances a franchisor is best served by focusing on gathering all relevant information and facts related to the inquiry or action, identifying all potential approaches and outcomes, and then proactively and strategically designing an approach that can achieve the most desired outcome.

The danger for a franchisor managing a regulatory action extends beyond the action itself. Most franchisors can adequately address how to confront the action legally by hiring experienced counsel to represent the franchisor in the enforcement action. What franchisors often overlook are the indirect but related aspects of the action. These aspects can have a profound impact on not only how the action is resolved but also the overall well being of the franchise system itself and all its stakeholders. An example is how a regulatory enforcement action impacts the franchisor’s relationship with its existing franchisees. An existing franchisee likely will be concerned with what impact a regulatory action will have on its franchisor, whether the action will impact the franchisor’s financial resources or the support it provides franchisees. If the franchisor fails to recognize and proactively address these concerns, rumors regarding a negative impact in the franchise system may permeate the system and damage franchisor/franchisee relations. Franchisors who acknowledge and address these types of issues have a much higher likelihood of moving the franchise system forward in a positive direction.

Our objectives for this paper are to (i) discuss the current regulatory enforcement environment and focus, (ii) identify key pressure points for franchisors to address in responding to inquiries or enforcement actions and understand the impact of an action on the franchise system, (iii) discuss best practices for franchisors when faced with an enforcement action, (iv) analyze the pros and cons of rescission, including alternatives to rescission, and (v) review franchise compliance programs, as the best defense often is a good offense.

II. WHO ARE THE REGULATORS?

A. Federal Trade Commission

The Federal Trade Commission (“FTC”) is the federal agency charged with enforcing the Franchise Rule (the “FTC Rule”) since its adoption in 1979. The FTC Rule requires franchisors

1 The authors would like to acknowledge and thank Mike Maciszewski and Daniel Graham, an associate and summer associate, respectively, at Faegre & Benson LLP, for their valuable contributions to this paper.

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to provide prospective franchisees with a pre-sale Franchise Disclosure Document ("FDD") and articulates prohibited practices in the offer and sale of franchises.\(^3\)

After determining that greater pre-sale disclosures were required to enable prospective franchisees to make informed decisions and to better protect against fraudulent franchise sales practices, the FTC amended the FTC Rule in 2007 (the "Amended Rule").\(^4\) Under the Amended Rule, which took effect in July 2008, franchisors must provide prospective franchisees with “material information, including background information on the franchisor, the costs of entering into the business, the legal obligations of the franchisor and the franchisee, statistics on franchised and company-owned outlets, and audited financial information.”\(^5\)

By adopting the Amended Rule, the FTC continued its focus on disclosure by imposing even more disclosure requirements upon franchisors than it did under the FTC Rule.\(^6\) Furthermore, enactment of the Amended Rule reaffirmed the FTC’s general mission of “protect[ing] the public from ‘unfair and deceptive acts or practices’ in or affecting the advertising and marketing of goods and services.”\(^7\)

To carry out this mission, the FTC may enforce the Amended Rule only through civil litigation.\(^8\) The FTC does not have criminal enforcement authority to enforce the Amended Rule, nor does the Amended Rule provide a franchisee with a civil private right of action against a franchisor.

Nevertheless, since the adoption of the Amended Rule in 2007, the FTC has primarily focused its efforts on protecting the public from unfair and deceptive acts or practices within other contexts. Notably, the official website of the FTC lists only enforcement actions predating the Amended Rule, and the FTC brought these actions prior to its enactment of the Amended Rule at a time when the FTC Rule governed both franchises and business opportunities.\(^9\)

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\(^3\) Id.


\(^7\) Dale Cantone, Steven Toporoff, C. Griffith Towle, Keeping the Enforcers at Bay – Handling an FTC or State Franchise Investigation, ABA Forum on Franchising (2001).

\(^8\) See, e.g., FTC v. USA Beverages, Inc., 2005 WL 5654219 *3 (S.D. Fla. Dec. 5, 2005)(court held that the franchisor violated the FTC Rule in its franchise advertisements).

\(^9\) See http://www.ftc.gov/bcp/franchise/caselist.shtm; see also FTC v. World Traders Ass’n, Stipulated Judgment and Order (Apr. 7, 2008), available at http://www.ftc.gov/os/caselist/worldtradersassoc/090714wastipulatedorder.pdf (ruling that a company selling a work-at-home opportunity to consumers had engaged in deceptive practices in violation of The FTC Rule, awarding the FTC a $30.7 million judgment (suspended for inability to pay), and prohibiting World Traders from selling franchises or business opportunities in the future); FTC v. Network Servs. Depot, Final Judgment and Order (Mar. 5, 2009), available at http://www.ftc.gov/os/caselist/0423188/090305nsdjdgmt.pdf (ruling that a seller
B. State Regulators

There are fourteen states with franchise laws that require a filing with the state regulatory agency prior to the offer and/or sale of a franchise in that state. It is the regulators of these states who review the franchise registration applications, monitor the required filings and enforce the registration and disclosure compliance requirements in addition to enforcing the states’ anti-fraud franchise laws. A number of states also have “relationship laws” that apply to the post-sale franchisor/franchisee relationship. While there are other states that may have laws affecting the offer and sale of franchises, the registration/filing states and their enforcement of their respective franchise laws will be the focus of this paper.

Most of the franchise regulatory agencies are members of the North American Association of Securities Administrators (“NASAA”), a non-profit association comprised of the state or provincial securities regulators of the U.S., the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada and Mexico. NASAA is the organization responsible for promoting uniform state franchise laws and investor protection. The Attorney Generals’ Offices of Illinois and Michigan are non-NASAA franchise regulators.

III. ENFORCEMENT ISSUES FACING FRANCHISE REGULATORS

In an environment of shrinking and competing demands on resources, the FTC staff and state regulators face some common but also differing enforcement challenges. Among the common challenges is the broad range of issues relating to the protection of potential franchisees.

Investigations of fraud and misrepresentation in the offer and sale of franchises is a common priority as evidenced by the FTC’s charge to regulate unfair and deceptive acts or practices under the FTC Act and prohibited practices under the Amended Rule and the anti-fraud provisions of the states’ franchise acts.

In their efforts to address fraud and misrepresentation in the offer and sale of franchises, the regulatory agencies have traditionally tried to address the following issues: (i) franchisors’ failure to adequately disclose litigation and bankruptcy history; (ii) failure to disclose rebates/kickbacks in the supply chain; (iii) misleading financial performance representations (“FPRs”) or other failures to comply with the rules regarding FPRs; (iv) misrepresentation of goods and services to be provided by the franchisor; and (v) misleading or lack of financial statements as required by the franchise disclosure laws.

of internet kiosk business opportunities to consumers had provided false information in its disclosures and thereby violated The FTC Rule, awarding the FTC a judgment in excess of $18 million, and banning Network Services from selling business opportunities or franchises in the future).

10 See Appendix A, Registration States:  State Administrators and State Statutes.

11 See Appendix B, State Relationship Statutes


13 16 C.F.R. § 436.9 (2010).

14 See Appendix A, Registration States:  State Administrators and State Statutes.
While there is no registration/filing obligation under the Amended Rule, most state franchise laws require registration or a notice filing to be made prior to an offer of a franchise. Policing franchisors who fail to comply with the registration or filing requirements is an enforcement priority for state regulators. Another common complaint received by state regulators is a franchisor’s failure to comply with the timing requirements regarding the delivery of the FDD.

A central theme to the franchise regulatory framework is the requirement that a franchisor provide the material information about its offering to enable the prospective franchisee to make an informed investment decision. As a result, both the FTC staff and state regulators seek to ensure that franchisors not only deliver the FDD to prospective franchisees within the prescribed timeframes in order to give the prospect an adequate period of time in which to review the document but also do so with an FDD that meets the disclosure requirements.

This theme then creates the foundation for regulators. They take their role very seriously. For example, state franchise regulators want legitimate franchisors who comply with the rules to do business in their states without unnecessary delays. On the other hand, the state regulators do not want the residents of their states to suffer from the abuses of companies who fail to comply with the franchise laws.

Several state franchise laws also require the filing of advertising that franchisors use to promote the offer and sale of their franchise opportunity. The examiners will review the advertising for potential misrepresentations, inaccuracies and FPRs not supported in the FDD. As noted in Section II, a number of states have “relationship laws” which govern the post-sale relationship between franchisors and franchisees and provide franchisees with certain rights relating to things such as termination of the franchise and a franchisee’s right to renew the franchise agreement. Although fewer regulatory complaints address franchise relationship law violations, as those violations are more prone to private litigation between the franchisor and franchisee, it is worth noting that relationship issues often spark franchisees to file complaints with the states.

The FTC also regulated the sale of business opportunities under the FTC Rule until 2007 when it adopted the Amended Rule and then subsequently a separate Business Opportunity Rule. Because of the scope of the problems and harm to consumers in this area, the FTC has focused its enforcement efforts on business opportunities in the past ten years. Similarly, many state agencies that regulate franchising also administer their state securities laws, investment advisor and broker/dealer acts, business opportunity acts, or multi-level marketing acts. Thus, franchise complaints “compete” with a variety of other complaints for attention and resources.

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15 Id.
16 Id.
17 See Appendix B, State Relationship Statutes.
IV. COMPLAINTS RECEIVED BY REGULATORS

The majority of state and federal enforcement actions are initiated through a consumer complaint filed by an existing or former franchisee. In addition, state regulators frequently receive competitor complaints when a registered franchisor complains that a competitor is offering a similar licensing program without registering its offering and providing an FDD in its state licensing activities. Some regulators monitor the Internet, trade publications, trade shows, newspapers and other media for the possible offer of unregistered franchises. Regulators also may receive referrals from fellow regulators as well as other sources. In addition, it is not an infrequent occurrence for a franchisor to self report a violation to a regulator, particularly in cases of an unintentional or inadvertent offer or sale of an unregistered franchise. The bottom line is that with today’s technology and ease of today’s communication, franchisors who do not comply with the regulatory requirements will not fly undetected under the regulatory radar.

In addition to the complaints or other activities described in the preceding paragraph, state examiners reviewing a franchise registration application may initiate an investigation. It is not uncommon for an examiner to identify unregistered franchise sales by reviewing Item 20 of the franchisor’s initial FDD or subsequent FDDs after the registration has lapsed. Time permitting, an examiner may review the franchisor’s website and check the store or franchisee locations webpage. In Washington State, an examiner may check with the Secretary of State or Department of Revenue websites to determine if franchisees may already be operating under the franchisor’s trade name(s). Washington is not alone in these efforts. An examiner also may run the name of the franchisor and its principals through an online search engine or other database to identify undisclosed litigation or bankruptcy information.

The regulators do not perform their duties on an island. Examiners may contact another regulator when a state or federal regulatory agency has been identified in Item 3 of an FDD as having taken an action against a franchisor. This is particularly true if the action disclosed in Item 3 might be a basis for an examiner to deny a franchisor’s registration application. An examiner also may find a reference to another regulatory agency in other areas of the FDD such as the notes to the financial statements. Finally, many examiners meet periodically at training sessions or other conferences or participate in a regulator-only list serve where they may share concerns or questions regarding enforcement or FDD disclosure issues.

A “typical” franchisee complaint contains an allegation that the franchisor has failed to provide the products or services it said it would provide in the FDD or other various misrepresentations based on the franchisor’s practices or its FDD disclosures. More often than not the franchisee has lost all or part of its investment in the business and feels that the franchisor has misled him in getting him to join the franchise system. Oftentimes the complaint will include a breach of contract claim. Franchisees also may complain about unreasonable requirements imposed upon them by the franchisor that were not adequately disclosed in the FDD such as the payment of “hidden” fees, limitations on the franchisees’ ability to source products and services for the operation of their businesses, or the requirement to participate in sales promotions or upgrade stores upon renewal. One other area often mentioned in franchisee complaints is the franchisor’s violation of rules regulating FPRs. The common thread in these circumstances is that the franchisee or former franchisee requests the state to exercise its enforcement powers to hold the franchisor accountable for its actions.

The type of franchisee complaints also may depend on whether the franchisor is an emerging franchisor. For example, complaints that allege the failure of a franchisor to provide an FDD or failure to register the franchise offering often involve those companies who are
relatively new to franchising rather than the more mature franchisors who have been franchising for years.

An informal survey of franchise regulators indicates that the number of complaints filed has decreased over the past three years. There also has been a similar decline in the number of franchise registration filings over the past three years. At least one state, Virginia, has reported a significant decline in the number of complaints in the past year, dropping from 53 complaints in 2009 to 35 complaints in 2010. The reason for the decline is not clear, but it may be an indication that fewer franchises have been sold over the past several years, resulting in a corresponding decline in complaints.

V. WHAT TO EXPECT FROM REGULATORS

Once a complaint or an investigation is initiated, a regulator has a number of options on how to proceed. Depending on the nature of the potential violation and complexity of the matter, a regulator likely will want to gather additional information and/or documents before making a determination to take further action or close the case. This information gathering step is where franchisors can encounter a crossroads in how the complaint or investigation proceeds. Too frequently franchisors fail to recognize that cooperation with the regulator in the early stages can assist the regulator by providing a more complete understanding of all the facts and circumstances of a matter, rather than just the one sided version described in the complaint. As noted below in Section VII, franchisors should not overlook this opportunity to achieve an early resolution of the complaint or investigation that can save the franchisor and franchise system from a long and costly battle.

In gathering additional information early in the process, many state regulators often make an informal request for information from a franchisor. In some cases, the regulator may share the complaint that generated the inquiry with the franchisor and offer an opportunity for the franchisor to respond. In other instances, the examiner will not share the complaint or specifics circumstances surrounding the complaint.

If a regulator determines there has been a possible violation, the state regulator may issue a “warning letter” advising the franchisor of the apparent violation, for example an unregistered offering violation. The warning letter may contain an informal request for a response, explanation or clarification and a request for documents or information such as the identity of possible franchisees in the state. Depending on the nature of the violation, regulators may contact a company’s franchisees or other potential witnesses directly, typically by phone or through use of a questionnaire by mail.

Regulators also may obtain testimony and documents by more formal means such as through a subpoena or civil investigative demand. In Washington State, the failure to comply with a state administrative subpoena can subject the person subpoenaed to a civil contempt proceeding.

Once a regulatory agency has completed its initial investigation, it may decide to take no action, typically where it has found insufficient evidence or no violation of franchise laws or if the

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20 Id.
violation is a “technical” one or *de minimis* and there has been no harm to consumers/franchisees. Alternatively, some regulators have the option of taking informal enforcement action. Examples of informal action include a “warning letter” issued to the franchisor or an “informal” settlement in which the franchisor agrees to comply with state franchise law and/or take other remedial action. The “warning letter” used in the informal action is along the lines of “don’t do it again” rather than the “warning letter” described above as part of the information gathering step.

In today’s environment of limited resources, situations also may exist in which a regulator may have reason to believe that a violation has occurred, but does not take any enforcement action due to reasons such as a lack of resources to prosecute every violation that has been brought to its attention.

Once regulators have determined they have sufficient evidence of a violation, they have a varied array of enforcement tools at their disposal. These tools take the form of civil lawsuits and state administrative actions. While the FTC must pursue violations of the Amended Rule exclusively in the courts\(^1\), most state agencies have the ability either to file a civil lawsuit\(^2\) or to issue an administrative order.\(^3\)

In cases where the violation concerns a franchisor with a pending registration application, a regulator may issue a stop order that prevents the application from being made effective. If the franchisor is already registered, a state regulator may suspend or revoke the franchisor’s registration in addition to entering a cease and desist order to halt further violations of the state’s franchise laws.\(^4\) Some regulators may summarily enter these administrative orders, or depending on the facts and circumstances provide a franchisor with notice and an opportunity for a hearing on the merits prior to the entry of an administrative order.\(^5\) Some regulators also may choose to offer a franchisor the option to enter into a formal settlement of either an administrative or civil action prior to the filing of a lawsuit or the administrative action. This settlement can take the form of consent to entry of an order where the franchisor/respondent acknowledges that it agrees to informal disposition of the matter without a hearing. This type of consent also can include a statement that by entering into the consent order the franchisor/respondent does not admit any violation of law.

As stated earlier, state regulators have limited resources and thus generally are not able to thoroughly investigate and/or take action on every single complaint. This limitation has a direct impact on how a regulator handles a complaint and the complaint’s outcome. As a result, complaints that involve “technical” violations rather than fraud, or as further described in the next paragraph, other similar criteria determined by the regulator may be closed after limited review. Legislative and agency priorities may influence the priority of a particular complaint. Interest in a particular industry or certain business practices also may influence what types of


\(^{2}\) See, *e.g.*, WASH. REV. CODE § 19.100.210 (2011).

\(^{3}\) See, *e.g.*, WASH. REV. CODE § 19.100.248 (2011).

\(^{4}\) See, *e.g.*, WASH. REV. CODE § 19.100.120 (2011).

\(^{5}\) See, *e.g.*, WASH. REV. CODE § 19.100.248 (2011).
complaints receive investigative resources. Other factors that may affect how a regulator handles a complaint/investigation and the outcome of the investigation include the nature of the violation (technical or material), who is the injured party and how many persons are affected, when the violation occurred, and whether the franchisor has a history of prior violations.

The following observations were obtained in an informal survey of state enforcement staff. Violations involving intentional fraud, as opposed to technical disclosure violation complaints, are viewed more seriously by regulators and receive greater attention. Complaints from less sophisticated franchisees may garner greater attention than those from financially sophisticated “well heeled” franchisees. Violations involving a large number of franchisees in a system generally will be given priority over a complaint that only involves a single franchisee. A franchisee may be in a system four or five years before filing a complaint and because of statute of limitations and evidentiary issues, these complaints may not receive the same attention that might be given to current ongoing fraudulent activity. Recidivist franchisors generate greater interest in the regulators because they are perceived to be a greater risk to franchisees.

VI. SANCTIONS/REMEDIES

The various state franchise laws provide regulatory agencies with a wide array of sanctions and remedies for carrying out enforcement actions against noncompliant franchisors in their respective states. Franchisor executives also can be held responsible individually as several states have “control person” liability provisions (some of which include a “joint and several” component).26

The state franchise laws afford state regulators broad discretion to employ any combination of these sanctions and remedies to protect the consumers of their respective states.27 However, state regulators must usually take action within three or four years after the act or transaction in question, with some variation as to when that period begins.28 Nevertheless, the available sanctions and remedies are as follows:

A. Stop Order and Cease and Desist Order

When confronting a noncompliant franchisor, issuing a stop order or cease and desist order is usually the first step state regulators take.

As stated in Section V, if the violation involves a franchisor’s pending application, a state regulator may issue a stop order that prevents the application from being made effective in that

26 See, e.g., CAL. CORP. CODE § 31302 (West 2010); MINN. STAT. § 80C.17.2 (2010); N.Y. GEN. BUS. LAW § 691 (Consol. 2010).


28 See, e.g., CAL. CORP. CODE § 31405 (West 2010) (four years after the act or transaction “constituting the violation”); HAW. REV. STAT. § 482E-10.5 (2010) (five years “subsequent to the date of the violation or two years subsequent to the discovery of facts constituting the violation, but in no event shall any civil action be brought later than seven years subsequent to the date of the violation.”); IND. CODE § 23-2-2.5-30 (2011) (three years “after discovery by the plaintiff of the facts constituting the violation”); MICH. COMP. LAWS § 445.1533 (2011) (four years after the act or transaction “constituting the violation”); MINN. STAT. § 80C.17.5 (2010) (three years after the “cause of action accrues”); N.Y. GEN. BUS. LAW § 691 (Consol. 2010) (three years after the act or transaction “constituting the violation”); VA. CODE ANN. § 13.1-571 (2011) (four years “after the cause of action”).
particular state. If the franchisor is already registered, a state regulator may suspend or revoke the franchisor’s registration, in addition to entering a cease and desist order to halt further violations of the state’s franchise laws. Some regulators may summarily enter these administrative orders or, depending on the facts and circumstances, may provide a franchisor with notice and an opportunity for a hearing on the merits prior to the entry of an administrative order. Other regulators may choose to offer a franchisor the option to enter into a formal settlement of either an administrative or civil action prior to the filing of a lawsuit or the administrative action.

Notably, in carrying out such enforcement actions, state regulators must adhere to one general statutory principle: they must act in “the public interest” when doing so. In Washington State, this may manifest itself by the regulator taking enforcement action to fulfill its mission statement of protecting and educating the public. If the regulator makes a finding that a franchisor has omitted material information in its registration application and prospective franchisees are likely to be harmed in making an investment decision without the information, the regulator will issue a stop order or a cease and desist order to prevent the harm. The administrative action also has the effect of educating prospective franchisees as well as franchisors as to the requirements imposed on franchisors by the franchise statute and regulations.

B. Injunctive Relief and Receivership

Once a civil action commences alleging a franchisor’s violation of state franchise laws, a state court may grant a permanent or temporary injunction or restraining order against the noncompliant franchisor to prevent any further violations. A state court may also appoint a receiver for the franchisor’s assets. While a regulatory receivership action is uncommon, a regulator might seek the appointment of a receiver in situations where a franchisor is believed to be misappropriating assets that are held in trust for franchisees such as money in an advertising fund.

C. Fines

To ensure their bites are as big as their barks, the franchise laws also grant state regulators the power to penalize noncompliant franchisors financially, albeit within a framework of established guidelines and fine schedules. Generally speaking, financial penalties are meted out on a per violation basis. However, the amounts vary throughout the registration states from as low as $1,000 per violation in New York to as high as $100,000 per violation in Hawaii. Some states have established more complex frameworks in which the maximum allowable fine per violation varies based on the type of violation involved.
The penalty framework in some states also distinguishes between administrative penalties and civil penalties. For example, Rhode Island allows the Director of Business Regulation to impose an administrative assessment up to $5,000 for each violation, as long as notice and an opportunity to be heard are provided to the accused franchisor. Alternatively, if the same state regulator brings a civil action on behalf of the state, the maximum allowable penalty increases to $50,000 for each violation. Similarly, California allows the Corporations Commissioner to impose a maximum of $2,500 per violation, while a civil action brought by the same state regulator can penalize a noncompliant franchisor for $10,000 per violation.

Some regulators may be flexible in negotiating the amount of any fine. Many regulators post their enforcement actions on the Internet and it is possible to gain some idea of what a “typical fine” might be through the review of recent actions. Depending on the nature or character of the violation, a fine for a “technical” or de minimis violation may be avoided entirely. In the event of a violation for failure to make a material disclosure or “fraud,” a substantial fine may be the rule. The franchisor’s conduct prior to the filing of the action may influence the willingness of the regulator to negotiate the fine. Factors that might be taken into account include: What steps did management take when it first learned of the violation? Did the franchisor self report the violation? What was the level of cooperation with the regulator’s investigation? What was the amount of “harm” to franchisees? What remedial actions did the franchisor take?

Despite the established maximums, the total monetary penalties assessed against a noncompliant franchisor can be significant if the franchisor committed numerous state franchise law violations. For example, based on a finding that it had collected franchise and other fees prior to fulfilling its pre-opening obligations to franchisees, Sacramento Juice Franchising Corporation was required to pay the State of California administrative fines totaling $80,000 based on 32 violations involving three different code sections. Similarly, the State of California imposed a total of $132,500 in administrative fines against Play N Trade, a franchisor that committed 53 disclosure-related violations under the California franchise laws. As these examples illustrate, violating state franchise laws can add up quickly.

D. More Significant Fines and Imprisonment

Franchisors that willfully violate state franchise laws and/or commit fraud may face a more punitive set of enforcement actions that involve both financial penalties and prison sentences. Specifically, under most state franchise laws, state regulators and courts are permitted to exact financial penalties as high as $100,000 per willful violation or fraudulent act.

35 CAL. CORP. CODE § 31406 (West 2010).
38 See, e.g., CAL. CORP. CODE § 31410 (West 2010) (“Any person who willfully violates any provision of this law, or who willfully violates any rule or order under this law” shall be fined not more than $100,000 “or imprisoned in state
A willful violation of the Washington State Franchise Act or regulations is a class B felony and can subject a franchisor to a maximum $5,000 fine and ten year prison sentence.39

E. Recovery of Investigation Costs and Attorneys’ Fees

In addition to administering fines, state regulators are permitted to recoup the costs they incur while investigating alleged violators of their franchise laws. Such a recovery of investigation costs is available in connection with both administrative actions as well as civil actions.40 The same holds true regarding attorneys’ fees.41 Not surprisingly, and especially given the current environment of dwindling state resources, state regulators do not shy away from seeking recovery of even the smallest amounts.42 The fact that costs and attorneys’ fees are “hard” costs may tend to make them less negotiable, but as in the case with fines, some regulators may be willing and flexible in negotiating costs, attorneys’ fees and the amount. In Washington State, a respondent may file a financial declaration to establish financial hardship or an inability to pay that may lead to a suspension of costs.

F. Rescission/Restitution

The purpose of rescission is to put the parties where they were before they entered the contract.43 The general goal of this remedy is to “undo the contract.”44 To achieve this ambitious goal, rescission alone may not be adequate – restitution may also be required. Restitution complements rescission by providing a monetary award when such an award is necessary in order to place the parties in their “pre-contract positions.”45

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40 See, e.g., IND. CODE § 23-2-2.5-34(c) – (d) (2011) (“In a final order, the commissioner may charge the costs of an investigation . . . .” and “In a proceeding in a circuit or superior court under this section, the commissioner is entitled to recover all costs and expenses of investigation to which the commissioner would be entitled in an administrative proceeding, and the court shall include the costs in its final judgment.”); 815 ILL. COMP. STAT. § 705/31(i) (2011).


44 Id.

45 Id.
There are two types of rescission: statutory rescission and common law rescission. Most states that have statutes relating to pre-sale disclosures have provisions that specifically provide for a right of rescission. This approach, commonly referred to as statutory rescission, exists in differing forms throughout the applicable statutes. Alternatively, in the states that do not have statutes that provide for rescission as a remedy, rescission still exists under a common law theory known as common law rescission.

Statutory rescission can be pursued by four entities: (i) the FTC, (ii) the state regulatory agency; (iii) the franchisee; and (iv) the franchisor. The FTC and state regulatory agencies may seek rescission to carry out their goals of protecting the public (i.e., prospective franchisees) from unfair trade practices of franchisors. Clearly, the franchisee may seek rescission if it believes it was harmed by a franchisor’s unlawful conduct; as such, rescission may provide the franchisee with the means to returning to its pre-deal position. A franchisee also may threaten a rescission remedy as leverage to get a better deal with the franchisor. Lastly, the franchisor may choose to offer rescission to a franchisee in the hopes of avoiding litigation with that franchisee or as part of a remedy to a regulatory enforcement action.

For state regulators as well as franchisees and franchisors, the thresholds for initiating an action for statutory rescission vary among the states. For example, California requires a showing that the franchisor willfully violated its disclosure obligations in order for any party to bring a claim for rescission. When a person fails to make the proper disclosures, he or she “shall be liable to the franchisee or subfranchisor, who may sue for damages caused thereby, and if the violation is willful, the franchisee may also sue for rescission,” unless the plaintiff knew about the improper disclosure or the defendant did not know and should not have known about the improper disclosure. Additionally in California the Commissioner can bring a claim for rescission, restitution, or disgorgement, on behalf of the injured franchisee. This option presents an additional avenue for a claim of rescission against a franchisor.

Franchisors also must recognize that regulators in certain states like California, Illinois and Maryland may want or demand that the franchisor work with the regulator in constructing the rescission remedy, including reviewing the language of the rescission offer itself. In a few instances the state has not approved the rescission remedy or has required the franchisor to do

46 Id. at 5.
47 Id. at 5.
50 Modell, supra note 41, at 14.
51 Id. at 5-6.
52 CAL. CORP. CODE § 31300 (West 2010).
it again if the state regulators were not involved in the process to offer rescission. Part of the process is that a state will look for precise rescission language that is either required by statute or regulatory practice.

Even in states where statutory rescission is not available, common law rescission remains an alternative for franchisees and/or franchisors looking to return to their pre-contract positions.\(^{54}\) As such, common law rescission serves as an equitable remedy.\(^{55}\)

A claim for common law rescission most often arises after fraud, mistake, breach, or repudiation.\(^{56}\) The elements of a common law claim for rescission vary by state.\(^{57}\) However, they generally include: actual injury, willfulness, timeliness/waiver, unclean hands, and reliance.\(^{58}\) Franchisees and franchisors must understand the elements of a claim for rescission in their state, so they can evaluate their chances for success on a particular claim.\(^{59}\)

A claim for rescission—and the accompanying claim for restitution—have limitations and challenges. These limitations and challenges generally relate to the difficulty of putting parties back to their pre-sale financial positions.\(^{60}\) For example, even if a franchisor returns to the franchisee the consideration the franchisor received in connection with the franchisee’s purchase of the franchise, the franchisee may have taken out loans or incurred other liabilities that still burden the franchisee. Typically the franchisee will find it difficult to recover these costs.\(^{61}\) From the franchisor’s point of view, the franchisee has received a benefit by operating the franchise for the period in which it continued to operate it, and the value of that benefit should reduce the amount which the franchisor is required to pay, unless the franchisee suffered substantial losses while operating the business.\(^{62}\)

Nevertheless, the remedies of restitution and rescission can accomplish their purposes. For example, based on power granted by the California Corporations Code, the California Corporations Commissioner recovered $1.7 million in restitution on behalf of the California franchisees of Sacramento Juice Franchising Corporation, which illegally collected franchise and other fees from them prior to fulfilling its pre-opening obligations to them.\(^{63}\)

\(^{54}\) Modell, supra note 41, at 1.

\(^{55}\) Id.

\(^{56}\) Id. at 2.

\(^{57}\) Id. at 22.

\(^{58}\) Id. at 22-28.

\(^{59}\) Id. at 22.

\(^{60}\) See id. at 28-32.

\(^{61}\) Id. at 28.

\(^{62}\) Id. at 31.

The alternatives to rescission often depend on how long the franchisee or franchisees have been in business with the franchisor and how many franchisees might have a potential claim. If the problem is isolated with one or a small number of franchisees and the franchisor has identified the problem early, then rescission may be a viable option, especially if the franchisor believes that the franchisee(s) will reject the rescission offer and continue in the franchise business. If the franchisor believes rescission is not viable because the amounts that the franchisor could potentially pay would have a crippling effect on the franchisor’s financial position, then the franchisor could consider other options. In these instances the franchisor likely will need to make material changes to its franchise agreement with the aggrieved franchisees or some other similar material change to the franchise relationship or the way it does business. In these instances the franchisor’s decision can have a systemwide or system altering impact.

G. Damages/Treble Damages

An even more significant remedy available to franchisees that fall prey to noncompliant franchisors involves the recovery of damages. Most notably, some state franchise laws grant discretion to the courts to award treble damages. As noted earlier, joint and several “control person” liability for individuals and potential treble damages should influence a culture of compliance in franchise organizations.

H. Criminal Referrals

The state franchise laws also permit state regulators to refer evidence to other state enforcement bodies to pursue criminal actions against the noncompliant franchisors. These laws go beyond merely encouraging collaboration or fostering the sharing of information, as some of them allow state regulators to assist the district attorney in presenting the law or facts at the trial.

I. Asset Freeze and Accounting

In rare circumstances, the FTC may petition a court to freeze the noncompliant franchisor’s assets or, borrowing an approach taken in the context of securities laws, to require an accounting of the franchise fees collected by the franchisor. In both cases, these remedies are not typically carried out by state regulators.

J. Registration Conditions

When settling claims with noncompliant franchisors through an order, state regulators typically require the franchisor to register in their respective states. Furthermore, state regulators may impose conditions in connection with such orders. Regulators often require

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64 See, e.g., HAW. REV. STAT. § 482E-9 (2010); S.D. CODIFIED LAWS § 37-5B-49 (2011).

65 See, e.g., CAL. CORP. CODE § 31404 (West 2010); N.Y. GEN. BUS. LAW § 692 (Consol. 2010); S.D. CODIFIED LAWS § 37-5B-40 (2011).

66 See, e.g., In re Seniors Helping Seniors LLC, Consent Order, FR 2900285/DPK (Nov. 18, 2009) (requiring Respondent to send written communication of a potential violation of state law to all of its existing franchisees “notifying them that they may have rights under the law to pursue legal action for the offer and/or sale of unregistered franchises,” as a condition for Respondent’s registration in Minnesota).
that the franchisor provide franchisees with a special notice and copy of the order. Depending on the nature of the violation, regulators may require the franchisor to escrow all initial fees at a bank registered to do business in the state, with release of the initial fees conditioned upon confirmation by the franchisee and state that the franchised business is open. Alternatively, the state may permit the franchisor to defer the franchisee’s payment of the initial fees until after the unit is open or to post a surety bond. If a surety bond is posted, the bond must remain in place until the units sold while the bond was in place are opened.\footnote{HAW. REV. STAT. § 482E-8(e) (2010); IND. CODE § 23-2-2.5-12 (2011); N.Y. GEN. BUS. LAW § 685 (Consol. 2010).} State regulators may require inclusion of risk factors on the cover page of the FDD as well as enhanced disclosure in the body of the FDD to address complaints concerning inadequacy of disclosure (e.g., additional substantiation of financial performance representations or disclosures in Item 11 and 20 concerning units that have not timely opened because of lack of site selection assistance).

**K. Other Remedies and/or Requirements**

A wide range of other remedies and requirements exists for state regulators, administrative courts, and civil courts in addressing the noncompliant franchisor and/or rectifying the fallout created by the noncompliant franchisor. For instance, some states may require the noncompliant franchisor to attend remedial education or training.\footnote{See, e.g., CAL. CORP. CODE § 31408 (West 2010).} Another example, Washington has required a franchisor to pay for an arbitration service to settle disputes with franchisee or to provide a special notice of an enforcement action to its franchisees, sales staff and in an agreement.

**VII. HOW SHOULD A FRANCHISOR APPROACH AND RESPOND TO THE REGULATORS?**

A franchisor’s attitude plays a pivotal role in its approach and response to a regulatory inquiry or action. The more sophisticated franchisors in these instances realize that attitude can be multi-faceted, can change over time depending on the nature of the inquiry or action and should be fully explored and understood at the outset before responding to a regulator, rather than adopting a confrontational approach of denial and win at all costs every step of the way. A key part of the initial internal work for a franchisor is to identify all the potential outcomes of the inquiry or action, which outcomes are most and least desirable or likely and then proactively design a strategy to achieve the most desired outcomes. Sophisticated franchisors also understand that regulators have an important job to do and pursue their responsibilities just like franchise lawyers do in the representation of their clients.

In this section, we examine several key factors that a franchisor should consider in designing its approach and response. If properly assessed, designed and executed, the franchisor is far more likely to achieve at least one of its desired outcomes rather than one or more of the least desirable outcomes.
A. **Assess the Exact Nature of the Issue and Any Mistake and Diligence the System for Other Potential Issues Prior to Initiating a Response**

Too often a franchisor fails to assess the issues fully and completely at the outset, as the typical initial reaction of denial and the “regulator must be wrong” belief shrouds a totally objective approach that would focus on understanding all the different aspects of the matter. A totally objective approach begins with the right person or people taking the right steps and asking the right questions of the right people. The people conducting this internal investigation should be different from those who may have been involved in the practices that are the subject of the inquiry or investigation. This approach also includes a dispassionate focus on asking all the questions that uncover all the facts, rather than allowing assumptions and past practices to go unchallenged.

For example, is the conduct or practice that is the subject of the inquiry or action isolated to a single instance or more widespread? Is the conduct or practice related to a single rogue salesperson or something that the franchisor includes as part of its standard franchise sales practice? If the inquiry involves language that appears in the franchisor’s FDD or franchise agreement, how many agreements have been signed and how many years has the potentially compromising language appeared in the documents?

Is the nature of the issue one that is critical to the franchise system? Examples of those types of issues include understating the initial investment estimates in Item 7; supply chain, vendor rebates and Item 8 disclosure issues; advertising fund matters; and Item 19 FPR related claims. An example of an issue that may be less critical to the franchise system overall is one sale of a franchise when the franchisor’s registration had lapsed in a particular state. A franchisor must take the unregistered sale seriously, however, its impact on the franchise system overall likely has less impact than those issues identified above.

A related point that a franchisor should not overlook is to consider if one issue is being questioned or challenged, are there other areas for concern? Here again, a totally objective approach with the right people taking the right steps and asking the right questions will not limit their review to the narrow issue that is the subject of the inquiry but indeed will go much more broadly to fix other areas proactively in order to avoid bigger problems in the future.

B. **Meet with the Appropriate Franchisor Representatives to Address the Issues, Including What Should be Done Going Forward and Potential Changes to the FDD or Sales Practices**

The person in charge of the internal investigation should initially meet with all the appropriate franchisor representatives to get a full and complete understanding of the issues and practices. These meetings likely should be one on one so that no one person’s version of the facts or practices is influenced by anyone else. Group interviews often result in at least one or more people not feeling like they can be totally open and honest. The internal investigator also should request copies of and review all relevant documents. This piece can be difficult if there is any reluctance with any of the people involved in the practices being reviewed. In addition, all interviews and conversations must be conducted in an environment where each person can speak freely regarding all they know or have observed and do so without influence or a perceived threat of potential retribution. Otherwise, the franchisor will not have access to all the information that is necessary to identify all the potential outcomes and then design a proactive strategy to achieve the most desired outcome.
Another key part of the investigation is to see how other franchisors are addressing the disclosures or practices that are being challenged. A franchisor can easily use resources like the California Department of Corporations CAL-EASI\(^{69}\) website to get FDDs from other franchisors. Companies like FranData also can be engaged to conduct specific research on certain disclosure questions or practices. For example, FranData can review its data bank of hundreds of franchisors to determine which franchisors disclose certain supply chain issues in Item 8 of their FDDs.

Once all the necessary information has been gathered and analyzed, the person in charge of the internal investigation then should meet with the franchisor CEO or other key executive decision makers. The purpose of the meeting is to explain the issues and all the information that has been gathered from the various sources. Ample time should be allotted during this meeting for a frank, candid and open discussion of the issues, the information learned, and the potential outcomes and approaches (including the risks of each outcome and approach and the possible remedies available to the regulator and impacted franchisees). Oftentimes a franchisor tends to overlook one or more of the outcomes or approaches and settles on a strategy that will produce something less than the most desired outcome. This mistake can be avoided with a rigorous discussion from all key participants with the end result being a fully aligned and vetted approach to the most desired outcome.

Part of the most desired outcome should include a decision on what, if any, changes should be made to the franchisor’s FDD, franchise agreement or franchise practices. For example, if the inquiry or enforcement action relates to Item 19 FPR issues and allegations that the franchisor is making unlawful representations outside the Item 19 requirements, then the franchisor should determine whether it should include a FPR in its Item 19 going forward or, alternatively, whether it should modify its franchise sales practices to address the allegations. Based on the decisions made, the franchisor should consider including the changes it intends to make as part of the response to the franchise regulator.

C. Identify Any Defenses/Explanations

Similar to the approach regarding the internal gathering of all facts and information, the franchisor should also identify all defenses and explanations for the inquiry or action. This area of the response depends on the nature of the allegations and a full and complete understanding of those allegations and how those types of allegations have played out with other franchisors and in other situations.

The first line of defense should include any plausible explanation in response to the allegations, especially when the matter is an inquiry from a franchise regulator rather than an enforcement action. Typically, the regulator’s inquiry relates to questions the regulator may have regarding some part of the FDD. In those instances the franchisor should provide a full explanation of the issue. Oftentimes such explanation will be sufficient and the inquiry will be closed.

All available legal defenses should be identified and considered just like a franchisor would do in any dispute or lawsuit. Those defenses include procedural defenses available under the franchise laws like any applicable statute of limitations or challenges to jurisdiction. With any procedural defense, a franchisor must exercise due care in understanding the precise

\(^{69}\) Available at http://www.corp.ca.gov/calaasi/caleasi.asp.
parameters of the statute of limitations, as the defense can vary from state to state. For example, statutes of limitations under the state franchise laws generally vary from two to four years. The trigger of the statute of limitations also varies with some statutes beginning to run upon the sale of the franchise and other statutes upon discovery of the violation.

A franchisor also should consider all available substantive defenses. If violations of the franchise laws are alleged, a franchisor must look specifically at each element of the alleged violation. For example, if the claims are fraud based, can the franchisor raise “no reliance” defenses? Franchisors also have successfully used defenses focused on the non-materiality of the alleged violation.

D. **Establish an Initial Dialogue with the Regulator and an Appropriate Approach to the Next Steps in the Process**

The franchisor’s initial dialogue with the franchise regulator is crucial to the early stages of the process, but that dialogue also sets the tone for the entire process. If the franchisor does not have any experience with the regulator, it should reach out to other franchisors or outside lawyers who have direct experience with regulatory or enforcement matters. Specific experience with the regulator also can be helpful. The goal with this step is to learn as much as possible about the regulator: how long have they been in their position, how willing are they to engage in conversations about the issue, do they have a supervisor who should be involved in the conversations, have they raised the same issues with other franchisors and anything else that may be meaningful in developing a productive working relationship.

Franchise regulators often are very willing to share their concerns with the specific matter, especially if the franchisor or its counsel approaches the matter with professionalism and respect. As part of the initial dialogue, the franchisor should ask specific process questions. How does the regulator prefer to communicate? Will the regulator involve others in the agency? What are the steps (officially and unofficially) in the process? Has the regulator pursued this same issue with other franchisors? If so, is any of that past information available?

It is relatively easy to anticipate the types of information and documents that a regulator will want a franchisor to produce during the course of an investigation of potential violations. A dialogue with the regulator can lead to a precise list of what documents the regulator is going to want to see. It is often to the benefit of a franchisor to offer and/or agree to produce these documents voluntarily without the necessity of a subpoena being issued. A typical request could include contact information for franchisees or other witnesses, agreements, correspondence, marketing materials, FDDs, receipt pages, cancelled checks, wire transfers, or other relevant materials. Anticipation of such requests may lead to a speedier resolution of the investigation and possibly more favorable settlement terms. The franchisor should carefully review the documents to assess potential violations and adjust strategy based upon the record.

Although a regulator is not going to be able to tell a franchisor in advance as to the specific outcome of the investigation, some regulators may be willing and able to discuss outcomes of similar complaints/investigations.

As appropriate, the franchisor then should confirm the communications in writing, particularly the next steps in the process and any applicable timeline. The failure to address these logistical steps can lead to communication breakdowns with the regulators, which of course rarely result in positive outcomes.
E. Understand the Impact on the Franchise System, Existing Franchisees and Prospective Franchisees

The impact on the franchise system, existing franchisees and prospective franchisees depends on the nature of the inquiry or enforcement action. This impact analysis should be part of the franchisor's assessment of potential approaches and desired outcomes.

Prospective franchisees are impacted if the franchisor's current FDD must be amended to disclose the regulatory action or if the franchisor determines that it should change its FDD as part of its approach moving forward. The franchisor must consider the timing of any amended disclosures, as FDD updates/amendment filings will impact the franchisor's franchise sales activity. In certain instances the franchisor may not have many available options. For example, a state enforcement action likely needs to be disclosed in Item 3 prior to the franchisor concluding any additional franchise sales, unless the franchisor can negotiate a less formal resolution such as some form of letter of discontinuance without an admission of liability and not rising to the level of an order requiring disclosure in Item 3 of the FDD. It is critical that a franchisor understand what types of negotiated resolutions must be included in Item 3, as some do and some do not. The answer depends on several factors, including whether the state actually filed the action or opened an official investigation rather than an initial inquiry with no further action.

The impact on existing franchisees and the franchise system overall may be minimal if, for example, the nature of the inquiry or enforcement action is isolated to a particular state. On the other hand, inquiries or actions that involve matters like supply chain issues can have a material impact on existing franchisees and can erupt into systemwide issues that can bog down many material aspects of the franchise system. All inquiries and actions have the potential to require the franchisor to divert significant time and monetary and other resources away from the franchisor's business objectives.

If the issues that are the subject of the inquiry or complaint are systemwide in nature, the franchisor also must consider an appropriate communication strategy with its franchisees. This often includes a balancing of many interests, most notably proactively addressing the substantive issues, but also assessing how the issue is impacting other aspects of its relationships with its franchisees. The risk that a franchisor faces if it doesn't balance these interests, including the communications piece, is that if there is a void in communications, franchisees may fill that void with perception and assumptions that poison the relationship.

F. Does Self-Reporting Ever Make Sense?

Prior to a regulator initiating an inquiry or enforcement action, should a franchisor self-report a violation to the appropriate regulatory authority? The franchisor's decision will ultimately depend on the nature of the violation and related circumstances. In this analysis the franchisor should identify how many franchisees are impacted, how material the violation is (is it a technical violation or more material), what potential remedies might be available to the state and franchisee(s), whether the franchisees are doing well from a business perspective or whether this will be used as an opportunity to obtain rescission, is this the franchisor's first violation in the state, how the state has addressed the issue with other franchisors and any applicable statutes of limitations.

A common example where self-reporting is appropriate is where the franchisor has inadvertently sold a single or limited number of unregistered franchises in a single registration
state. This may occur if the franchisor has never been registered in the state and jumps the gun on a sale or where the franchisor’s registration has lapsed and the franchisor closes a deal prior to the renewal being approved. In either case, a number of the states will require the franchisor to offer rescission to the impacted franchisee and pay a fine. If the case is the first instance and self-reported, the franchisor likely can avoid disclosing this type of violation in its FDD and may be afforded the opportunity to enter into some form of letter agreement that does not include the types of orders required to be disclosed in Item 3.

VIII. BEST PRACTICES: PREVENTION/RISK MANAGEMENT

In matters involving compliance with the Amended Rule and state regulatory requirements, like dealing with most hazardous activity, “an ounce of prevention is worth a pound of cure.”70 While admittedly a complicated framework of intertwining and overlapping federal and state laws, each with its own nuances, once a company has determined that the franchise laws apply to its business structure, the company must understand and embrace the general registration and disclosure compliance obligations, all of which can be managed successfully with careful planning.71 All franchisors, regardless of size, should have a franchise sales and disclosure compliance program that provides the franchisor a practical system of processes and procedures to enable the franchisor to conduct its business and comply with the legal obligations in this area.72 Programs of this nature are available through a variety of reputable law firms but then should be customized through involvement of in-house counsel (if there is one for the company) and executives responsible for the development of the FDD and conducting franchise sales activities.73

From a philosophical perspective, the most successful business relationships are created and maintained when the parties enter the relationship with the best possible understanding of their respective rights and obligations – essentially a clear meeting of the minds and the expectations of the parties.74 The FDD is a legal document although not a contract. It contains material business information and should be viewed as a tool for facilitating the notion that the franchisor and franchisee should have this meeting of the minds when they sign the franchise agreement.

The development and annual updating of the FDD will require the use of a questionnaire to be utilized to elicit the information from the various business units responsible for each subject matter covered by the FDD (e.g., initial and on-going fees and charges, marketing and advertising, initial investment/development costs, rebate and purchasing requirements, training, etc.).

70 Benjamin Franklin, Letter to the Editor, Protection of Towns from Fire, PA. GAZETTE, Feb. 4, 1735 (originally considered within the context of fire prevention, this quote also applies to franchisors and the preventive steps they need to take to prevent their systems from being burned by regulatory claims).

71 Although beyond the scope of this paper, a franchisor is well served to understand that a number of the registration and disclosure obligations include applicable exemptions that may apply to certain franchisors or transactions.

72 THE FRANCHISE LAW COMPLIANCE MANUAL, ch. 2 (Brett Lowell & Steven M. Goldman, eds., 2000).

73 Id.

74 This meeting of the minds can be challenging in the franchise context, as franchise agreements must attempt to plan for adaptations and modifications to the system over time. No ten or twenty year franchise agreement will ever be able to fully address all the issues that will arise during the term of the agreement.
and technology/point of sale systems). The form of questionnaire will contain certain standard questions dictated by the requirements of the Amended Rule and state disclosure requirements and certain questions that are customized based on the business to assist the business people to understand how the disclosure requirements apply to their particular business (obviously, the nature and complexities of the businesses franchised vary substantially, and as a result so will the questionnaires). \(^{75}\)

Best practices dictate that each person responsible for providing information that will go into the FDD should sign a certification as to the accuracy of the information in the FDD that he or she provided. These certifications are valuable for two reasons: (1) people generally pay more attention when they have a sense that they are going to be held accountable for what they do or information they provide; and (2) the certifications provide a foundation and defense on which senior executives may rely when they are signing certifications required by state registration requirements when those senior executives for large and complicated systems cannot possibly have firsthand knowledge of every piece of information in the FDD. \(^{76}\) In addition, each person identified in Item 2 of the FDD must complete a litigation and bankruptcy questionnaire containing certain representations indicating whether the individual is, or has been for the requisite time period, subject to any litigation claims or proceedings of the type required to be disclosed in Item 3 of the FDD and/or any bankruptcy proceedings required to be disclosed in Item 4 of the FDD. \(^{77}\)

Each year, the FDD must be updated either within 120 days of the franchisor’s fiscal year end or a date tied to its registration schedule in the registration states (or potentially both if they are not the same). \(^{78}\) In connection with the annual update requirements, the FDD (or applicable portions thereof) and an update questionnaire (or applicable portions thereof) should be distributed to the business persons with current responsibility for the subject matter in question. It is important to distribute the questionnaire along with the applicable FDD portion because it is easy for the business person simply to review last year’s FDD and to focus only on what is in the existing FDD (e.g., looks fine to me or this number has not changed), rather than think about what is not in the FDD and what the FDD disclosure requirements are trying to accomplish. Simply re-distributing the FDD is a potential recipe for omission of material modifications or changes to the system.

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\(^{75}\) At a minimum the questionnaire should track the disclosure requirements of the Amended Rule as well as any unique aspects of the state disclosure requirements. Each of the 23 items of the FDD should be included in sufficient detail so that the information provided in the questionnaire responds directly to the applicable disclosure requirements. Franchisors who look for shortcuts will miss something along the way.

\(^{76}\) Many of the filing states require a franchisor to include a certification form with its franchise filings. The certification form must be signed by an officer of the franchisor who certifies that the information provided in the registration application is true and correct.

\(^{77}\) This litigation/bankruptcy questionnaire is separate from the FDD disclosure questionnaire. The objective for the litigation/bankruptcy questionnaire is to determine if any officer, director or other Item 2 person with management responsibility has information that must be disclosed in Item 3 or Item 4.

\(^{78}\) Most franchisors will try to coordinate their state filings renewal dates with the 120 day requirement under the Amended Rule rather than address state renewals at various times during the year. For example, if a franchisor has a calendar fiscal year and its registration in Virginia expires in August and its Washington registration expires in October and other states may have expiration dates in other months, the franchisor may be well served in coordinating all renewal filings the following year in March and April around its 120 day update requirement under the Amended Rule.
Business people should be encouraged to think about what is in effect today and what may go into effect during the upcoming year in which the franchisor intends to utilize the FDD. For example, if the FDD will be issued in March/April (90-120 days after a calendar fiscal year end), and the company anticipates rolling out a new point of sale system by the end of the second quarter (June), to the extent the company knows that it will roll out the system change, it may have a duty to disclose that change to franchisees purchasing in May, especially if the change will be systemwide and require an additional investment. Being proactive and building in disclosures concerning potential system changes on the horizon may also alleviate the need for amending the FDD mid-year upon the implementation of a program that arguably (or at least debatably) may constitute a material change.

Under the Amended Rule, a material change is defined as “any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchised business or which has any significant financial impact on a franchisee or prospective franchisee.”79 All of the registration states have laws and/or regulations that define what constitutes a “material change” for purposes of their respective regulatory schemes.80 The Amended Rule requires a franchisor to update its FDD quarterly to include any material changes.81 State laws typically require the franchisor to amend either upon the occurrence of a material change82 or within thirty days of the occurrence of a material change.83 The conservative approach upon the occurrence of a material change is to cease closing all deals (but not necessarily offering or negotiation activity) until the franchisor has updated its FDD and/or amended its state registrations (as applicable), and properly redisclosed the prospective franchisee for the required period prior to closing the transaction.84 Either inside or outside counsel should work with the franchisor to establish a communication process and protocol with

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80 See, e.g., CAL. CORP. CODE § 31123 (West 2010) (requiring an application relating to a material change to be “accompanied by a proposed disclosure form”); 815 ILL. COMP. STAT. 705/11 (2011) (requiring the franchisor to deliver the updated disclosure form to any prospective franchisee); WASH. REV. CODE § 19.100.070(3) (2011) (mandating the update of a franchisor’s registration – after a material change – before the franchisor can sell any additional franchises).


82 See, e.g., CAL. CORP. CODE § 31123 (West 2010) (requiring the franchisor to “promptly” notify the commissioner in the event of a material change); N.Y. GEN. BUS. LAW § 683(9)(a) (Consol. 2010) (requiring prompt notification by franchisor of material changes); WASH. REV. CODE § 19.100.070(3) (2011) (stating that the franchisor must notify the director “as soon as reasonably possible and in any case, before the further sale of any franchise” when a material, “adverse” change occurs).

83 See, e.g., 815 ILL. COMP. STAT. 705/11 (2011) (mandating that a franchisor file an updated disclosure statement within 30 days of the close of the quarter).

business people responsible for franchise activities for determining when a material change has occurred, and the appropriate action to take upon its occurrence. A franchisor does not want to be in the position of having to argue that it has offered and sold a franchise without making appropriate disclosures concerning a material change, particularly if it has no process for on-going monitoring, and had there been such a process the violation could have been avoided.

In addition to the FDD focus, the franchisor’s compliance program should address franchise sales compliance. The sales compliance aspects should minimally coordinate and track franchise registration activity and compliance with FDD delivery requirements. Sales training should be provided to all new salespersons and on an annual basis to the entire development team to ensure that everyone understands the “rules of the road” with respect to the FDD requirements and permissible practices and representations in connection with franchise sales activity. The on-going training serves two functions: (i) generally speaking, persons who are aware of their compliance obligations will abide by them (assuming a level of integrity of the persons hired); and (ii) it provides a defense to the franchisor and senior executives of the company and the ability to address issues with a rogue salesperson in the event of an infraction.

Franchise sales compliance monitoring programs must be simple and capable of being managed and checked and then double checked. The simplest approach is to have a series of checklists and persons responsible for coordinating that activity (which can be handled by an in-house legal department in coordination with the sales department) or a franchise administration function in coordination with outside counsel.\textsuperscript{85} To state the obvious, there has to be a gatekeeper to throw the switch on and off advising the team where and when the franchisor is effectively registered and where and when they can sell. There must be an internal tracking process for confirming that the properly registered FDD was timely delivered to the prospective franchisee.\textsuperscript{86} A second backstop is to have a checklist requiring that a copy of the dated FDD receipt be provided with the delivery of all franchise applications, along with diligence on the franchisee to confirm, prior to the franchisor accepting any payment: (i) the ownership of the proposed franchisee, (ii) the state of formation of any proposed franchisee entity, (iii) the principal place of business of the proposed franchisee, and (iv) the proposed location of (or operation of if no fixed location) the franchised business. That information will confirm which states’ franchise laws apply to the transaction prior to a more serious violation of an unregistered sale, and will provide the franchisor the opportunity to cure an unregistered offer. Once the diligence information is received and adequate timing of the delivery of the FDD confirmed, the franchisor can accept the application fee.

\textsuperscript{85} A franchisor’s checklist should identify all the key dates and all the key documents that will enable the franchisor to prove its compliance with the applicable franchise sales requirements.

\textsuperscript{86} The FTC Rule, until amended in 2007, required the FDD be delivered at the earlier of the first personal meeting for the discussion of the sale of a franchise or ten business days prior to execution of any binding agreement with respect to the sale of the franchise or payment of any consideration. The Amended Rule eliminated the requirement that the disclosure be provided at the first personal meeting and opted for a clear bright line test that requires the FDD be delivered 14 days prior to the execution of any binding agreement with respect to the sale of the franchise or payment of any consideration. A few states still have a personal meeting requirement for the delivery of the FDD – so the conservative approach is to still require that the FDD be delivered at the onset of communications concerning the sale of the franchise, as it is too difficult and confusing to have salespeople worrying whether in this state or that state the timing is different.
A third checkpoint should be in place to confirm that a fully signed receipt form for the most current form of FDD is in the file before the franchisor countersigns any binding agreement or accepts any consideration with respect to the franchise sold and the acceptance or “sale” of the franchise takes place. Oftentimes there will be a significant period of time that lapses from the date the franchise salesperson and the prospective franchisee commenced communications and the actual execution of the franchise agreement and payment of the initial fees. During that period, a material change/amendment to the FDD may have occurred or the franchise registration renewed and a new FDD issued. If at the time of closing, no receipt for the most current FDD is in the file, the franchisor must review sales correspondence to confirm that the most recent FDD was delivered to the prospective franchisee and obtain the properly dated FDD receipt, or in the event no evidence of delivery is available, provide the FDD and wait the required period prior to closing.

The first thing any regulator asks for in an investigation is a copy of all executed receipt forms and executed franchise agreements for the period in question. In the event the franchisor is unable to produce FDD receipt forms for each franchise agreement showing the requisite time period between the date of the receipt of the FDD and the date of the franchise agreement, the regulator will assume it has prima facie evidence of a franchise law violation and likely inquire further.

Misleading or non-compliant FPRs is another significant potential source for sales compliance issues or regulatory inquiries or actions. The first question is—how can a prospective franchisee make an informed decision to invest in a business enterprise without some information to assess the value of the opportunity and return on the prospective franchisee’s investment, and prepare a business plan to obtain financing? The answer is—the prospective franchisee cannot. Therefore, the prospective franchisee must obtain some information in some way, shape, manner or form to allow the prospect to make an informed investment decision. The next question from a compliance standpoint is whether the franchisor complied with its obligations in the prospect’s endeavors to find and understand this type of information. Item 19 of the Amended Rule requires that the franchisor either (i) make no financial performance representation concerning the franchised business and include a disclaimer that no such information is provided in the FDD, or (ii) include financial performance information in the FDD and explain the basis and assumptions underlying the FPR. The franchisor must have a reasonable basis for providing the FPR at the time it is made and the FDD is provided to the prospective franchisee (not just at the time the FPR was included in the FDD).

One method for compliance in this area is simply to have the franchise salespersons trained to discuss the information contained in the FDD and provide no financial performance representation outside of what, if anything, is included in Item 19. Salespersons also should understand the parameters of how they may refer prospective franchisees to other sources of information, such as existing franchisees, lending sources, landlords (if the business is, for example, one operated in malls to mall operators for information on rent and performance of units in other malls), and industry sources.

So long as the salespersons stick to what the franchisor has authorized, they will not encounter compliance problems, but if the franchisor does not include an Item 19 FPR in its

FDD, the salesperson then may be prevented from having an intelligent conversation with the prospective franchisee concerning the financial performance of the franchised business. In circumstances where no FPR is included in the FDD, violations occur when franchise salespersons do not stick to the script and feel compelled to provide information concerning the financial performance of the franchised business in order to close the sale, particularly, since most franchise salespersons are compensated on some form of commission basis (no sale no pay). Oftentimes they are simply oral representations, which later result in a “he said/she said” contest between the franchisee and the salesperson in the event of a dispute. Under these circumstances there often is insufficient evidence for the regulatory agency to bring any action. Less frequently, the salesperson will prepare some form of informal FPR on the “back of the envelope” which can be provided as evidence to a regulatory authority, but may be wiped out by an integration clause in a contractual dispute as to whether the franchisee relied on such information in connection with the franchisee’s purchase of the franchise.88

If a franchisor makes an FPR in its FDD, the franchisor must have a reasonable basis at the time of making the representation. The franchisor also must include in Item 19 the basis and assumption underlying the representation and the number and percentage of franchisees that have achieved the results stated and the time period in which they were achieved. Once included in the FDD, the salesperson can discuss the information contained in the Item 19 FPR with the prospective franchisee. The salesperson can also provide a supplemental FPR to the prospective franchisee that speaks to a specific location or subset of the data included in the FPR, so long as the salesperson provides it in writing and leaves it with the prospective franchisee. The supplemental FPR must explain the differences between the information contained in the FPR and the information contained in the supplemental FPR, but cannot deviate from the same type of information contained in the FPR. For example, if the FPR is a representation describing system-wide gross sales, the supplemental FPR could be a subset describing results of franchised units grouped on a geographic or other defined basis and should again set forth the basis and assumptions and number and percentage of similarly situated franchise units achieving similar results. The supplemental FPR could not, however, disclose net operating profit, as that is an entirely different category of information if net operating profit was not discussed in the FPR included in the FDD.

As part of this Item 19 FPR analysis, the franchise sales force must identify the types of financial performance information that the salespersons need to provide to the prospective franchisee to effectively manage the sales process and get deals done effectively and legally. In most systems where the franchisor is paid its royalty on gross sales, providing accurate, historic gross sales data is relatively easy to do and relatively low risk for creating liability for failure to comply with the Amended Rule and state disclosure requirements. The key is to identify a financial metric that is helpful to the prospective franchisee and the development team so that the franchisor can obtain the supporting data necessary to establish the reasonable basis to make the claim and withstand any challenge as to accuracy and compliance. An important related point is that each salesperson must understand the financial metrics used from both business and legal perspectives. One final note is that franchisors must be mindful of dramatic changes in economic or other conditions that could affect the reasonableness of the FPR at the time it is made (e.g., material changes in supply or other economic changes that bring into question the representativeness of the data contained in the FPR).89

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89 Depending on the type of claim made and the basis and material assumptions underlying the claim, a precipitous
IX. CONCLUSION

As noted in the Introduction, a federal or state enforcement action can have a material and system altering impact on the franchisor and other stakeholders in the franchise system. Franchisors who proactively and strategically identify the key pressure points and then design an approach that meets their objectives will have a much higher likelihood of a positive outcome. A critical part of a franchisor’s approach must be a focused effort to understand the role the regulator plays and the tools that the regulator has available to enforce the franchise laws.

A franchisor’s attitude, diligence and response throughout the complaint inquiry or enforcement action will have a significant impact on the outcome. The final point to underscore is that a franchisor must understand and embrace a full commitment to compliance as that commitment can minimize the franchisor’s need to have to manage any regulatory enforcement action.

decline in same store sales, or a material increase in costs affecting the operating results, may cause an FPR claim made based on historical data that is in fact an accurate representation of the performance of the units at the time the disclosure was developed to be no longer reasonable if it is no longer representative of unit performance at the time the FDD is delivered to the prospective franchisee. Also see the FTC Rule’s separate duty to “notify the prospective franchisee of any material change that the seller knows or should have known [emphasis added] occurred in the information contained in the financial performance representation”. 16 C.F.R. § 436.7(d) (2007) (as amended), 72 Fed. Reg. 15,444 (Mar. 30, 2007); Bus. Franchise Guide (CCH) ¶ 6017.
### APPENDIX A
**REGISTRATION STATES: STATE ADMINISTRATORS AND STATE STATUTES**

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<tr>
<th>STATE</th>
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<tr>
<td>CALIFORNIA</td>
<td>Department of Corporations One Sansome Street, Suite 600 San Francisco, CA 94104 415-972-8559 1-866-275-2677</td>
<td>California Corporations Code, Title 4, Division 5, Parts 1 through 6, Sections 31000 through 31516 (¶3050)</td>
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<td>HAWAII</td>
<td>State of Hawaii Business Registration Division Securities Compliance Branch Dept. of Commerce and Consumer Affairs 335 Merchant Street, Room 205 Honolulu, HI 96813 808-586-2465</td>
<td>Hawaii Revised Statutes, Title 26, Chap. 482E, Sec. 482E-1 through 482E-5, 482E-8, 482E-9, 482E-11, and 482E-12 (¶3110)</td>
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<td>ILLINOIS</td>
<td>Franchise Division Office of the Attorney General 500 South Second Street Springfield, IL 62706 217-782-4465</td>
<td>815 Illinois Compiled Statutes Sec. 705/1 through 705/44 (¶3130)</td>
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<td>INDIANA</td>
<td>Securities Commissioner Indiana Securities Division 302 West Washington Street, Room E 111 Indianapolis, IN 46204 317-232-6660</td>
<td>Indiana Code, Title 23, Article 2, Chap. 2.5, Sec. 1 through 51 (¶3140)</td>
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<td>MARYLAND</td>
<td>Office of the Attorney General Securities Division 200 St. Paul Place Baltimore, MD 21202 410-576-6360</td>
<td>Annotated Code of Maryland, Article Business Regulation, Title 14, Sec. 14-201 through 14-233 (¶3200)</td>
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<td>MICHIGAN</td>
<td>Michigan Department of Attorney General Consumer Protection Division Antitrust and Franchise Unit Williams Building, 1st Floor 525 W. Ottawa Street Lansing, MI 48909 517-373-7117</td>
<td>Michigan Compiled Laws, Chap. 445, Sec. 445.1501 through 445.1545 (¶3220)</td>
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<td>MINNESOTA</td>
<td>Minnesota Department of Commerce 85 7th Place East, Suite 500 St. Paul, MN 55101 651-296-4026</td>
<td>Minnesota Statutes, Chap. 80C, Sec. 80C.01 through 80C.22 (¶3230)</td>
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<tr>
<td>NEW YORK</td>
<td>Bureau of Investor Protection and Securities New York State Department of Law 120 Broadway, 23rd Floor New York, NY 10271 212-416-8222</td>
<td>New York General Business Law, Article 33, Sec. 680 through 695 (¶3320)</td>
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<tr>
<td>NORTH DAKOTA</td>
<td>North Dakota Securities Department 600 East Boulevard Avenue State Capitol, Fifth Floor, Dept. 414 Bismarck, ND 58505-0510 701-328-4712; Fax: 701-328-0140</td>
<td>North Dakota Century Code Annotated, Title 51, Chap. 51-19, Sec. 51-19-01 through 51-19-17 (¶3340)</td>
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| RHODE ISLAND | Rhode Island Department of Business Regulation Securities Division
John O. Pastore Center – Building 69-1
1511 Pontiac Avenue
Cranston, RI 02920
401-222-3048 | General Laws of Rhode Island, Title 19, Chap. 28.1, Sec. 19-28-1-1 through 19-28.1-34 (¶3390) |
| SOUTH DAKOTA | Department of Commerce and Regulation Division of Securities
445 E. Capitol Avenue
Pierre, SD 57501-3185
605-773-4823 | South Dakota Codified Laws, Title 37, Chap. 37-5A, Sec. 37-5A-1 through 37-5A-87 (¶3411) |
| VIRGINIA    | State Corporation Commission Division of Securities and Retail Franchising
Tyler Building, 9th Floor
1300 E. Main Street
Richmond, VA 23219
804-371-9051 | Virginia Code, Title 13.1, Chap. 8, Sec. 13.1-557 through 13.1-574 (¶3460) |
| WASHINGTON  | Department of Financial Institutions Securities Division
150 Israel Rd S.W.
Tumwater, WA 98501
360-902-8762 | Washington Revised Code, Title 19, Chap. 19.100, Sec. 19.100.010 through 19.100.940 (¶3470) |
| WISCONSIN   | Wisconsin Dept. of Financial Institutions Division of Securities
345 W. Washington Avenue, 4th Floor
Madison, WI 53703
608-266-8557 | Wisconsin Statutes, Chap. 553, Sec. 553.01 through 553.78 (¶3490) |
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<td>IOWA</td>
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<td>MISSOURI</td>
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<td>Washington Revised Code, Title 19, Chap. 19.100, Sec. 19.100.180 and 19.100.190 (¶4470)</td>
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<td>WISCONSIN</td>
<td>Wisconsin Statutes, Chap. 135, Sec. 135.01 through 135.07 (¶4490)</td>
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Martin is a Franchise Legal Examiner and enforcement attorney with the Washington State Dept. of Financial Institutions-Securities Division where he investigates consumer complaints involving investments in securities, commodities, franchises and business opportunities. He is a member of the North American Securities Administrators Association (NASAA) Franchise/Business Opportunities Project Group, a former Young Lawyer’s Division’s liaison to the Forum and former member of the ABA Government and Public Sector Lawyers Division’s Council. He received his J.D. and B.A. degree in English from the University of Washington.
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Mr. Forseth is Vice President and Assistant General Counsel, Brand and Franchise Transactions for Marriott International, Inc. Among other duties, Mr. Forseth is responsible for responding to legal issues involving the development and operation of franchised hotels and regulatory compliance in both domestic and international markets for the company’s multiple lodging brands. Before joining Marriott, Mr. Forseth was in private practice, focusing on representation of franchise and other licensing and distribution companies in both domestic and international markets, and related business structuring, regulatory and relationship issues. Prior to that, Mr. Forseth was the Senior Franchise Examiner for the Maryland Division of Securities, responsible for enforcement of the Maryland Franchise Registration and Disclosure Law. Mr. Forseth is currently the Chair of the International Franchise Association Legal Legislative Committee, and is a past advisor to the North American Securities Administrators Association Franchise Project Group, and a current member of: the American Bar Association - Forum on Franchising; International Franchise Association Corporate Counsel Committee; and Maryland Bar Association - Franchise Law Committee (Past Chairman). He is a recognized speaker on the topic of franchising and related legal issues and has published numerous papers and articles on the subject.
Brian B. Schnell

Brian is a partner in Faegre & Benson LLP's Minneapolis office and is a leader of the Faegre Franchise Team. Brian counsels both emerging and mature franchisors in a variety of industries with regard to all aspects of their franchise programs. He is the lead corporate franchise lawyer for more than 80 franchisors, ranging from companies with thousands of locations worldwide to companies who are in the initial stages of building their franchise systems. Brian is a past chair of the International Franchise Association’s (IFA) Supplier Forum, a past ex officio member of IFA’s Board of Directors and Executive Committee, and a member of its Legal Symposium Task Force and its Legal/Legislative, Awards and Membership Committees. The first male to receive the IFA Women’s Franchise Committee Crystal Compass, Brian was distinguished for this honor in 2009 based on his leadership in franchising. He is a frequent speaker and author on franchising, and for many years has been consistently recognized as one of franchising’s leading lawyers by The Best Lawyers in America, Chambers Global, Chambers USA, and International Who’s Who of Franchise Lawyers.