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INTENDED AND UNINTENDED CONSEQUENCES: AN INSIDE LOOK AT THE REGULATORS' PERSPECTIVES ON ENFORCEMENT OF STATE FRANCHISE LAWS AND REGULATIONS

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I. INTRODUCTION

Depending on one's perspective, the practice area of franchise law is either blessed or cursed with a multitude of statutes and regulations.[1] For most franchisors in the United States, franchise law compliance means not only complying with federal regulations but also with state law regulations in multiple states. While the words "franchise law violations" might make one think of unscrupulous lawbreakers using the franchise business model to defraud and swindle investors, the reality is often much less Hollywood-esque. The majority of franchise law non-compliance is unintended. But compliance is not an easy task when dealing with multiple complex and detailed laws, especially when those laws affect the day-to-day operation of a franchisor's business. Even for the most conscientious and careful franchisors, mistakes can happen and may occasionally lead to that dreaded email or letter – a legal inquiry or notice from a state franchise examiner regarding certain actions or inactions by the franchisor.

Because the focus of franchisors and their lawyers is typically on ensuring legal compliance, they are often very familiar with the portions of applicable statutes and regulations that regulate franchise registration, disclosure, and relationship matters. Their familiarity with the portions of the laws that regulate violations is often not as extensive, until counsel is required to focus on such portions of the law. Consequently, even the *potential* of an inquiry or enforcement action by a state examiner may cause unease and concern.

This paper is intended to relieve some of that concern by providing a general description of the enforcement mechanisms and available remedies under franchise laws. It focuses on how state examiners determine whether and when to initiate an investigation into potential violations of their respective state franchise laws, how they conduct those investigations, and the types of state enforcement powers they may exercise in general.

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[1] These laws include the following franchise laws: California Franchise Investment Law, CAL. CORP. CODE § 31000 *et seq.*; Hawaii Franchise Investment Law, HAW. REV. STAT § 482E-1 *et seq.*; Illinois Franchise Disclosure Act, 815 ILL. COMP. STAT. 705/1 *et seq.*; Indiana Franchises Law, IND. CODE § 23-2-2.5-0.5 *et seq.*; Maryland Franchise Registration and Disclosure Law, MD. CODE ANN., BUS. REG. § 14-201 *et seq.*; Michigan Franchise Investment Law, MICH. COMP. LAWS § 445.1501 *et seq.*; Minnesota Franchises Law, MINN. STAT. § 80C.01 *et seq.*; New York Franchise Sales Act, N.Y. GEN. BUS. LAW § 680 *et seq.*; North Dakota Franchise Investment Law, N.D. CENT. CODE § 51-19-01 *et seq.*; Oregon Franchise Transactions Law, OR. REV. STAT. §650.005 *et seq.* Rhode Island Franchise Investment Act, R.I. GEN. LAWS § 19-28.1-1 *et seq.*; South Dakota Franchise Investment Law, S.D. CODIFIED LAWS § 37-B5-1 *et seq.*; Virginia Retail Franchising Act, VA. CODE ANN. § 13.1-557 *et seq.*; Washington Franchise Investment Protection Act, WASH. REV. CODE § 19.100.010 *et seq.*; and Wisconsin Franchise Investment Law, WIS. STAT. § 553.01 *et seq.* The following business opportunity laws are also relevant to most franchisors: Connecticut Business Opportunity Investment Act, CONN. GEN. STAT. § 36b-60 *et seq.*; Florida Sale of Business Opportunities Act, FLA. STAT. § 559.80 *et seq.*; Georgia Business Opportunity Sales Law, GA. CODE ANN. § 10-1-410 *et seq.*; Kentucky Sale of Business Opportunities Law, KY. REV. STAT. ANN. § 367.801 *et seq.*; Louisiana Business Opportunity Sellers and Agents Law, LA. REV. STAT. ANN. § 51:1801 *et seq.*; Maine Regulations of the Sale of Business Opportunities, ME. REV. STAT. § 4691 *et seq.*; Nebraska Seller-Assisted Marketing Plan Act, NEB. REV. STAT. § 59-1701 *et seq.*; North Carolina Business Opportunity Sales Law, N.C. GEN. STAT. § 66-94 *et seq.*; Texas Business Opportunity Act, TEX. CODE ANN. § 51.001 *et seq.*; South Carolina Business Opportunity Sales Act, S.C. CODE ANN. § 39-57-10 *et seq.*; and Utah Business Opportunity Disclosure Act, UTAH CODE ANN. § 13-15-1 *et seq.*

An exhaustive review of these topics across all fourteen franchise regulatory states would be voluminous and beyond the scope of this paper.[2] However, to offer illustrative examples and reference points, this paper will examine the approaches taken by two prominent franchise regulatory states, California and Washington. Throughout the discussion, the authors will address common issues that franchisors and their counsel may face in the course of such investigations and discuss possible strategies for addressing and mitigating the consequences of state investigations and enforcement actions.

II. WHO ARE THE REGULATORS?

A. A State Overview

In each state that requires registration of franchises, there are state agencies tasked with the administration and enforcement of those laws, regulations, and the various policies and guidelines enacted by the North American Securities Administrators Association[3]. Although each state regulating the offer and sale of franchises has attorneys and staff overseeing the operation of the agency, how each state has structured its staff differs, as does the size and background of the staff.[4] In some states, the attorneys and staff overseeing franchise administration and enforcement are wholly devoted to that task, while in other states the scope of their responsibilities is significantly broader, often including other functions such as administration of securities and/or consumer-protection statutes. In preparation of this paper, the authors contacted the various state agencies and received the following information about how their departments in charge of franchise law enforcement were organized:[5]

In California, the Department of Financial Protection and Innovation, formerly known as the Department of Business Oversight, ("DFPI") is the state agency that provides protection to consumers and services to businesses engaged in financial transactions. The DFPI regulates over eighteen areas of the law relating to a variety of financial services, products, and professionals.[6]

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[2] *See id.*

[3] *See* N. AM. SEC. ADM'R ASS'N, NASAA FRANCHISE RESOURCES, http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf (last visited Aug. 16. 2022) (for information relating to the policies and guidelines adopted by NASAA).

[4] States with business opportunity laws likewise have staff that enforce the business opportunity laws. A complete examination of them is beyond the scope of this paper. *See* Beata Krakus & Alexander Tuneski, *Caught in the Web of Federal and State Business Opportunity Laws: Managing and Avoiding Entanglement of Regulations*, ABA 36TH ANNUAL FORUM ON FRANCHISING W-7 (2013).

[5] The authors surveyed the regulators in all franchise regulation states. Where not otherwise referenced, the information in this Section is based on those survey responses. Michigan did not respond to the authors' survey request and is omitted from this section.

[6] CAL. CORP. CODE § 31400 *et seq.* The DFPI oversees the operations of state-licensed financial institutions, including banks, credit unions, money transmitters, issuers of payment instruments and travelers checks, and premium finance companies. Additionally, the DFPI licenses and regulates a variety of financial businesses, including securities brokers and dealers, investment advisers, deferred deposit (commonly known as payday loans), and certain fiduciaries and lenders. The DFPI regulates the offer and sale of securities, franchises, and off-exchange commodities in California.

Within the DFPI is the Securities Regulation Division ("SRD"), which regulates securities and franchise annual filings, qualifications, registrations, renewals, and complaints relating to both the California Securities Law of 1968 ("CSL")[7] and the California Franchise Investment Law ("CFIL").[8] SRD also conducts examinations, investigations, and takes enforcement action in the public interest. SRD is currently comprised of nine attorneys who act in an examiner capacity by reviewing and approving CSL and CFIL filings. There are also currently ten non-attorney support staff and three financial examiners who conduct financial examinations, accountings, and assist with CSL and CFIL investigations.

DFPI also has a separate, general Enforcement Division, which does not review and approve any filings, unlike SRD. The Enforcement Division conducts, investigations, and takes enforcement action in the over eighteen areas of law within DFPI's jurisdiction, including matters relating to CSL and CFIL that are referred by SRD. SRD may refer matters to DFPI's Enforcement Unit for handling and enforcement action on a case-by-case basis.[9]

The Hawaii Department of Commerce and Consumer Affairs' ("DCCA") Business Registration Division-Securities ("BRD") regulates the offer and sale of franchises. The BRD's Securities Section handles franchise filings and similar issues.[10] Hawaii currently has seven staff members engaged in franchise review, two of whom are attorneys. The DCCA's Securities Enforcement Branch ("the Branch") investigates and enforces against violations of state securities laws and franchise laws. The Branch initiates administrative actions, enters into agreements with, and issues orders against, individuals and entities who violate state franchise laws.[11] The offer and sale of unregistered franchises is the most common enforcement issue and are discovered principally through the registration review process and staff surveillance of various media.

In Illinois, the Franchise Bureau of the Illinois Attorney General's Office is the agency in charge of enforcing the state's franchise law.[12] As the name of the Franchise Bureau indicates, this division of the Office of the Illinois Attorney General is solely devoted to registering franchise offerings, and other franchise-related filings, such as advertising registrations, and monitoring compliance with the Illinois Franchise Disclosure Act.[13] The state currently employs a staff of three

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[7] *Id*. § 25000 *et seq.*

[8] *Id*. § 31000 *et seq.*

[9] *See File a Complaint,* CA DEP'T. OF FIN. & CONS. PROT., https://dfpi.ca.gov/file-a-complaint/ (last visited on Sept. 7, 2022).

[10] *See Bus. Reg. Div.-Securities,* H.I. DEP'T. OF COMM. & CONS. AFFRS., https://franchise.law/hawaii-state-laws/#:~:text=Within%20this%20division%2C%20the%20securities%20section%20handles%20franchise,some%20other%20jurisdictions%20regarding%20franchise%20law%20and%20registration. (last visited on Sept. 7, 2022).

[11] *See Bus. Reg. Div.-Securities,* H.I. DEP'T. OF COMM. & CONS. AFFRS., https://cca.hawaii.gov/sec/enforcement_actions/ (last visited on Sept. 7, 2022).

[12] 815 ILL. COMP. STAT. 705/22.

[13] See *Franchise Information and Publications*, ILL. ATT'Y GEN., https://illinoisattorneygeneral.gov/consumers/franchise.html (last visited on Aug. 16, 2022).

individuals, comprised of one attorney and two examiners, though the number of examiners has historically been higher and is expected to increase.

In Indiana, the state's franchise law is enforced by the Securities Division of the Indiana Secretary of State.[14] The state currently employs five investigators who investigate potential violations, plus several enforcement attorneys who prosecute criminal actions and enforce civil violations. Since the Indiana franchise law only requires a notice filing, there are no examiners specifically focused on franchise registration matters. The Securities Division is tasked with enforcing other statutes, including the Indiana Uniform Securities Act, and laws and regulations regarding collection agencies, loan brokers, continuing care and retirement communities, and several other industries.[15] Anecdotally, the person in charge of franchise registrations resigned this summer and franchisors' notice filings were not being processed for many weeks while the Division trained one of its remaining examiners to take over this task.

The Securities Division of the Maryland Attorney General's Office is in charge of enforcing that state's franchise law.[16] There are currently seven staff members in total, of which one is an attorney and one is an accountant. Like the Indiana Securities Division, the Maryland Securities Division also oversees many different statutes and industries. It has a focus on protecting investors from fraud and misrepresentation and handles, in addition to franchise filings, registration of stockbrokers, investment advisors, and of securities. It also oversees the Maryland Business Opportunity Act.[17]

The Minnesota Department of Commerce-Securities Division ("MDOC") is responsible for overseeing and helping to maintain the integrity of the franchise community in Minnesota.[18] The Securities Division currently has two examiners who review registration filings. The MDOC also enforces the state franchise laws through its ability to issue cease and desist orders and orders denying, suspending, or revoking franchise registrations and exemptions.[19] Registration reviews and consumer complaints are the primary sources for MDOC enforcement actions.

The Investor Protection Bureau of the New York Attorney General's Office enforces the state's franchise law.[20] The state currently employs five staff members of which one is an attorney and one is an accountant. Of the five staff members, four are examiners. The Investor Protection

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[14] IND. CODE § 23-2-2.5-32.

[15] *See Securities Portal*, IND. SEC'Y OF STATE, SEC. DIV., https://securities.sos.in.gov/about-the-division/ (last visited on Aug. 16, 2022).

[16] MD. CODE ANN., BUS. REG. § 14-205.

[17] *See Maryland Securities Division – What We Do*, MD. ATT'Y GEN., https://www.marylandattorneygeneral.gov/Pages/Securities/default.aspx#:~:text=To%20find%20out%20if%20a%20franchise%20offering%20is%20registered%20in,(410)%20576%2D7786 (last visited on Aug. 16, 2022).

[18] *See Franchises*, MN DEP'T. OF COMM., https://mn.gov/commerce/industries/securities/franchises/ (last visited on Sept. 7, 2022).

[19] MINN. STAT.§ 80C.12.

[20] N.Y. GEN. BUS. LAW § 692.

Bureau, in addition to enforcing the New York Franchise Law, also enforces the state's securities law.[21]

In North Dakota, the state franchise law is enforced by the North Dakota Securities Department.[22] The state currently employs only one staff member who handles all registrations. In addition to franchise matters, the Securities Department also administers the North Dakota Securities Act, the North Dakota Commodities Act, and the North Dakota Pre-Need Funeral Services Law.[23]

Since Oregon does not require franchisors to file their franchise disclosure documents ("FDD") with the state, franchisors and their counsel do not interact with the state examiners except in the event of a potential violation of the state franchise law. The state's Division of Financial Regulation is in charge of enforcement.[24] Currently, the Division does not appear to be very active with respect to franchise law enforcement, and, despite the fact that the state operates a website that complaints should be submitted through, it does not have a complaint form for franchise-related violations on that site.[25]

The Securities Division of the Department of Business Regulation of the state of Rhode Island is the agency responsible for enforcement of the state's franchise law.[26] The state currently employs one staff member who is the examiner for the state. Similar to other states with notice filing requirements, franchisors rarely interact with examiners in Rhode Island. The Securities Division regulates securities, timeshares, charitable organizations, and senior financial exploitation, in addition to franchising.[27]

The South Dakota Department of Labor Regulation's Division of Insurance-Securities protects investors of securities products, franchises and business opportunities by investigating complaints, conducting examinations, enforcing anti-fraud provisions, ensuring investments sold meet standards of full disclosure, and providing investor education.[28] The agency oversees the

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[21] *See Investment Protection Bureau*, N.Y. ATT'Y GEN., https://ag.ny.gov/bureau/investor-protection-bureau (last visited on Aug. 16, 2022).

[22] N.D. CENT. CODE § 51-19-13.

[23] *See Securities*, N.D. SEC. DEP'T, https://www.securities.nd.gov/ (last visited on Aug. 16, 2022).

[24] OR. REV. STAT. 50 § 650.055.

[25] *See Financial Institutions and Professionals*, OR. DIV. OF FIN. REG., https://dfr.oregon.gov/business/licensing/financial/Pages/franchises.aspx (last visited on Aug. 16, 2022).

[26] R.I. GEN. LAWS § 19-28.1-18.

[27] *See Securities Division*, R.I. DEP'T. OF BUS. REG., https://dbr.ri.gov/insurance-banking-securities-and-charitable-organizations/securities-and-charities (last visited on Aug. 16, 2022).

[28] See *Div. of Insurance-Securities,* S.D. DEP'T. OF LABOR*,* https://dlr.sd.gov/securities/default.aspx (last visited on Sept. 6, 2022).

notice filing of franchise applications filed in the state.[29] The agency currently has two examiners who are responsible for franchising as well as the agency's other substantive areas of regulation.

The Virginia State Corporation Commission is in charge of franchise law enforcement.[30] The state currently employs six staff members, all of whom are involved in franchise registrations. The Corporation Commission is likely unique in having its powers outlined in the Virginia Constitution.[31] Franchise matters are specifically handled by the Division of Securities and Retail Franchising, which also handles registration of securities.[32]

In Washington, the Washington State Department of Financial Institutions ("DFI") is the state agency responsible for regulating a wide range of financial enterprises and individuals, such as: banks, credit unions, mortgage brokers, payday lenders, and securities issuers and salespeople. The Securities Division is one five DFI divisions and regulates securities investments, franchises and other investments, business opportunities, and off-exchange commodities sold in Washington. The Securities Division registers/licenses the firms and individuals that sell these products or provide investment advice. The Securities Division handles complaints, conducts investigations,[33] and manages enforcement actions to protect investors and combat fraud. The Securities Division has approximately forty-five full-time employees.

The Securities Division Registration Unit currently has six attorneys who are responsible for the review of franchise registration and exemption applications. The Registration Unit currently has five support staff to assist in the processing of securities and franchise filings. The primary job of five of the Registration Unit attorneys is reviewing the initial franchise registration applications submitted (the sixth attorney is the manager for the Registration Unit). One or more of the Registration Unit's support staff also assist in screening franchise renewal applications, franchise exemption filings, and franchise broker applications. During the screening of these various applications and associated filings, the Registration Unit staff comment on compliance with the franchise and FDD requirements and may informally correct minor rule violations such as material omissions in the documents filed or modifying potentially misleading advertisements. In the event of more serious violations, such as the sale of unregistered franchises, the Registration Unit may refer the matter to the Enforcement Unit for further investigation and possible enforcement action.

The Securities Division Enforcement Unit currently has eleven attorneys, four financial examiners, and two support staffers. Generally, only a small percentage of the Enforcement Unit's

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[29] See *Div. of Insurance-Securities,* S.D. DEP'T. OF LABOR, https://dlr.sd.gov/securities/franchise_registration.aspx (last visited on Sept. 16, 2019.

[30] VA. CODE ANN. § 13.1-559.

[31] *See About the SCC – Overview of the Commission*, VA. STATE CORP. COMM'N, https://scc.virginia.gov/pages/About-the-SCC (last visited on Aug. 16, 2022).

[32] *See Securities and Retail Franchising*, VA. STATE. CORP. COMM'N, https://scc.virginia.gov/pages/Securities-Retail-Franchising (last visited on Aug. 16, 2022).

[33] WASH. REV. CODE § 19.100.242.

time is devoted to franchise investigations because of the Unit's focus on securities-related administrative and criminal investigations.

The Wisconsin Department of Financial Institutions' Securities Division ("WDFI) administers the Wisconsin Franchise Investment Law.[34] The WDFI has one paralegal who responds to inquiries regarding the filing process in Wisconsin, which only requires that a filing be made prior to a sale. There is no substantive review of the filings. Complaints are referred to a staff attorney. Consumer and competitor complaints are common sources for WDFI enforcement actions.

B. <u>Federal Trade Commission</u>

Since the FTC Franchise Rule[35] does not require registration, franchisors and their counsel have limited reasons to interact with the FTC on a regular basis. While the FTC has signaled an increased intent in franchising in general,[36] at least to date, the FTC has only rarely used its resources to investigate franchisor's compliance with the FTC Franchise Rule, and enforcement by the FTC appears to be limited to extreme cases. One recent example is the *Burgerim* matter.[37] In February of this year, the FTC filed a complaint against Burgerim Group USA, Inc. ('Burgerim") and its CEO, Oren Loni, for violation of the FTC Franchise Rule.[38] The allegations made in that case were highly unusual. Burgerim allegedly entered into franchise agreements with over 1,500 franchisees, but an overwhelming majority never opened their locations.[39] Hundreds of the franchisees sought to cancel their agreements with Burgerim, but Burgerim allegedly failed to honor many of those requests.[40] Burgerim's own website included statements such as "All you need is the will to succeed" and allegedly Burgerim employees made untenable financial performance representation claims to prospective franchisees.[41] The FTC complaint was only filed after state agencies in several states had initiated various actions against

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[34] WIS. STAT. § 553.01 *et seq.*

[35] Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule, 72 Fed. Reg. 15444 (Mar. 30, 2007) (to be codified at 16 C.F.R. pt. 436), https://www.ftc.gov/sites/default/files/070330franchiserulefrnotice.pdf.

[36] *See, e.g., List of October 2021 Recipients of the FTC's Notices of Penalty Offenses Concerning Money-Making Opportunities and Concerning Deceptive or Unfair Conduct around Endorsements and Testimonials*, FTC, (Oct. 25, 2021) https://www.ftc.gov/system/files/attachments/penalty-offenses-concerning-money-making-opportunities/list-recipients-mmo_notice_0.pdf (the notice sent by the FTC to over 1,100 companies, many of which were franchisors, regarding deceptive or unfair conduct around endorsements and testimonials).

[37] Complaint, United States v. Burgerim Grp. USA, Inc., Case No. 2:22-cv-00825 (C.D. Cal. filed Feb. 7, 2022).

[38] *Id.*

[39] *Id.* at 3.

[40] *Id.*

[41] *Id.* at 9.

the franchisor.[42] As of the time of this paper, the federal case was still in early stages of motion practice.

III. FRANCHISE LAW STATUTES AND COMMON VIOLATIONS

A. A General Overview

Franchise laws are typically considered consumer protection laws in the United States. Their provisions regarding statutory violations reflect this purpose by including extensive provisions regarding violations and remedies against them. The spirit of these statutes is sometimes reflected in the preambles or introductory paragraphs of the statutes, such as, in the New York Franchise Sales Act:

> The legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business, which has created numerous problems in New York. New York residents have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between the franchisor and franchisee, the prior business experience of the franchisor, and other factors relevant to the franchise offered for sale.[43]

State franchise laws typically distinguish between a few different types of violations, each type of violation leading to different consequences, and giving the state law examiners different enforcement tools. For example, in some states violations are divided into fraudulent or prohibited practices, and unlawful or unfair practices. Typically, the fraudulent and prohibited practices are considered more serious than the unlawful practices. Another type of categorization of violations relates to who can bring an action enforcing the statutory violation. Some actions can only be brought by franchisees, while others, and the ones focused on in this paper, can only be brought by the state agencies enforcing the statutes. Violations commonly enumerated in state franchise statutes include:

- Sales of unregistered franchises, or misrepresentations regarding registration status.[44]

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[42] One of those state actions was taken by the Maryland Securities Commissioner. That action resulted in a stop order revoking Burgerim's Maryland state franchise registration. *See* In re Burgerim Grp. USA, Inc., Case No. 2019-0213 (Md. Sec. Comm'n Feb. 5, 2020), https://www.marylandattorneygeneral.gov/Securities%20Actions/2020/Burgerim_Group_Final_Stop_Order_020520.pdf.

[43] N.Y. GEN. BUS. LAW §680.

[44] 815 ILL. COMP. STAT. 705/5; IND. CODE § 23-2-2.5-9; MICH. COMP. LAWS § 445.1507a; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS §§ 37-5B-4, 37-5B-25; and WASH. REV. CODE § 19.100.020.

- Failures to deliver an FDD, or failures to do so in a timely fashion.[45]

- Filings of untrue applications or reports.[46]

- Making untrue statements of material facts in the FDD, or wilful omission of material facts from the FDD.[47]

- Offerings or sales of franchises by means of communications that include untrue statements or omit material facts necessary to make the communications not misleading.[48]

- Employing any device, scheme, or artifice to defraud.[49]

- Engaging in any act, practice, or course of business, which operates or would operate as fraud or deceit on any person.[50]

- Violating an order of the franchise state agency.[51]

- Representing to prospective franchisees that the filing of an FDD or its registration with a state agency constitutes a finding by that agency that the FDD is true, complete, and not misleading.[52]

The above is not a complete list of violations under the various state franchise laws, but covers the violations most commonly found in state statutes. In addition, many state laws have a

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[45] 815 ILL. COMP. STAT. 705/5; MICH. COMP. LAWS § 445.1508; S.D. CODIFIED LAWS § 37-5B-17; and VA. CODE ANN. § 13.1-563.

[46] CAL. CORP. CODE § 31200, 815; ILL. COMP. STAT. 705/5; MD. CODE ANN., BUS. REG. § 14-231; MINN. STAT. § 80C.13; N.Y. GEN. BUS. LAW § 687; N.D. CENT. CODE § 51-19-11; R.I. GEN. LAWS § 19-28.1-17: S.D. CODIFIED LAWS § 37-5B-25; WASH. REV. CODE § 19.100.170; and WIS. STAT. § 553.41.

[47] CAL. CORP. CODE § 31202; HAW. REV. STAT § 482E-5; 815 ILL. COMP. STAT. 705/6; IND. CODE § 23-2-2.5-27; MD. CODE ANN., BUS. REG. § 14-230; N.D. CENT. CODE § 51-19-11; S.D. CODIFIED LAWS § 37-5B-25; VA. CODE ANN. § 13.1-563; and WIS. STAT. § 553.41.

[48] HAW. REV. STAT. § 482E-5; 815 ILL. COMP. STAT. 705/6; IND. CODE § 23-2-2.5-27; MD. CODE ANN, BUS. REG. § 14-229; MICH. COMP. LAWS § 445.1505; MINN. STAT. § 80C.13; N.Y. GEN. BUS. LAW §. 687; N.D. CENT. CODE § 51-19-11; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-25; VA. CODE ANN. § 13.1-563; and WIS. STAT. §. 553.41.

[49] HAW. REV. STAT. § 482E-5; 815 ILL. COMP. STAT. 705/6; IND. CODE § 23-2-2.5-27; MD. CODE ANN, BUS. REG. § 14-229; MICH. COMP. LAWS § 445.1505; N.Y. GEN. BUS. LAW § 687; N.D. CENT. CODE § 51-19-11; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-24; VA. CODE ANN. § 13.1-563; and WASH. REV. CODE § 19.100.170.

[50] HAW. REV. STAT. § 482E-5; 815 ILL. COMP. STAT. 705/6; IND. CODE § 23-2-2.5-27; MD. CODE ANN., BUS. REG. § 14-229; MICH. COMP. LAWS § 445.1505; N.Y. GEN. BUS. LAW § 687; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-25; VA. CODE ANN. § 13.1-563; and WASH. REV. CODE § 19.100.170.

[51] HAW. REV. STAT. § 482E-5; N.D. CENT. CODE § 51-19-11; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-25; WASH. REV. CODE § 19.100.170; and WIS. STAT. § 553.41.

[52] MINN. STAT. § 80C.13; N.D. CENT. CODE § 51-19-11; R.I. GEN. LAWS § 19-28.1-17; S.D. CODIFIED LAWS § 37-5B-25; and WIS. STAT. § 553.41.

catchall provision making any non-compliance with the state law a violation that the state agency enforcing the law can take action against.[53]

Many of the violations listed are similar, and it is very common that where one of the violations has occurred, so have others. As will be discussed below in the review of the common violations of California and Washington law, it is not uncommon for state agencies to determine that several of the statutorily prohibited acts or omissions arose out of just one act or omission by the franchisor, and seek enforcement for each alleged violation separately.

Remedies for these statutory violations are discussed in Section VII below and are also outlined in Exhibit A to the paper.

While a detailed discussion of the violations regulated in each of the state franchise laws is beyond the scope of this paper, below is a review of common violations under the California and Washington franchise disclosure laws.

B. <u>California Franchise Investment Law</u>

Just as the New York statute quoted in the previous section, the CFIL expressly states that its purpose is to protect investors, prospective franchisees, and the entire California franchise industry.[54] The California Legislature acknowledges that franchisees have suffered substantial losses where a franchisor has not provided full and complete information regarding the franchisor-franchisee relationship and the franchise that is being considered for sale.[55] Like in other states with franchise registration statutes, the backbone of the CFIL is the requirement that franchisors register franchises that are offered and/or sold in California. Franchisors file a current FDD with DFPI, in addition to all other required documents for review and registration. Often, it is the failure to disclose material facts to either the Commissioner of DFPI[56] or the consumer[57] (in both cases through failure to include material information in the franchisor's FDD) that pose the most frequent and significant violations of the CFIL.[58]

A review of investigations undertaken by DFPI in 2021 and 2022 revealed a pattern in the type of violations that were most frequently investigated:[59]

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[53] *See, e.g.*, CAL. CORP. CODE § 31400.

[54] CAL. CORP. CODE § 31001.

[55] *Id*.

[56] CAL. CORP. CODE § 32100.

[57] *Id*. § 32101.

[58] *Id*. §§ 31200 - 31201.

[59] Investigations are conducted internally and the results are not publicly available.

1. **Unregistered Offer/Sale of Franchises**[60]

Several different situations fall within this category. In particular, SRD has seen an uptick in attempts to pass off "license agreements" entered into before a franchisor is registered in California as agreements that are not franchises. It is common for trademark license agreements to meet the statutory definition of a franchise agreement. Consequently, upon review by SRD, these agreements are often found to be franchises within the meaning of the CFIL. Large penalties are often assessed in this situation. For example, a fine of $45,000 was assessed against Path to Prosperity, LLC.[61] Without registering with DFPI, the company had entered into several "territorial holder agreements." The agreements met the criteria for a "franchise" under the CFIL.[62]

Franchisors that exhibit at trade or franchise expositions and shows before first registering also fall into this category. Like other states' franchise disclosure laws, the CFIL regulates not only the sale but also the offer of franchises, and trade show activities may fall within the definition of an offer.[63]

Both of the situations described above are deemed the unregistered offer or sale of a franchise in violation of Section 31110 of the CFIL. In the case of the trademark license agreement, it is often also a violation of Section 31119 of the CFIL, which requires that prospective franchisees receive an FDD.[64] As alluded to above, where an act is a violation under several sections of the CFIL, SRD will not limit its enforcement of the CFIL to only one of those sections, but will find the franchisor in violation of all applicable sections. Further, where multiple offers or sales are involved, SRD, pursuant to the CFIL, considers each offer or sale a separate violation of the CFIL.

2. **Taking Deposits before Fourteen Days after FDD Disclosure**[65]

In the authors' experience, franchisors are usually aware that they must disclose prospective franchisees with the FDD at least fourteen days before they can sign an agreement with the prospect or receive any payment from them, pursuant to the CFIL.[66] Some franchisors, however, fail to grasp that the payment-part of this rule applies not only to the initial franchise fee,

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[60] The sale of franchises without registration is a violation of California Corporations Code Section 31110.

[61] Consent Order, Comm'r of Fin. Prot. & Innovation v. Path to Prosperity, LLC, (Cal. Dep't Fin. Prot. & Innovation Mar. 2, 2022), https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/03/Purchase-Green-Consent-Order-SIGNED.pdf.

[62] *Id. See also* Consent Order, Comm'r of Fin. Prot. & Innovation v. Nutrishop, Inc., (Cal. Dep't Fin. Prot. & Innovation Sept. 15, 2021), for another example of the sale of an unregistered franchise under the guise of the agreement being a license agreement.

[63] CAL. CORP. CODE § 31013.

[64] *Id*. § 31119.

[65] California Corporations Code Section 31119 requires that a prospective franchisee receives a disclosure document at least 14 days before paying any money to the franchisor or its affiliates.

[66] CAL. CORP. CODE § 31119.

but to all consideration, including deposits and application fees. In some instances, the DFPI has also found cases of the FDD receipts being backdated to "meet" the fourteen-day requirement.

3. **Misrepresentation or Failure to Disclose to the Commissioner**[67]

Failures to disclose information in the franchisor's FDD are not only failures to disclose to a prospective franchisee,[68] but are also an offense to the Commissioner.[69] Thus, even though only one act has been committed (submission of an FDD to the DFPI) it often has two violations embedded in it. As a result, penalties for two violations would typically be assessed. The penalty for each violation can be up to $2,500, and normally the maximum penalty will be assessed. By the same token, if the franchisor is misrepresenting information set forth in the FDD that is likewise a violation.[70] If the violation has occurred for several years, DFPI may assess the penalty for each time the violation occurred.

A failure to disclose may also arise where, even though following the disclosure requirements of the FTC Franchise Rule, the franchisor does not satisfy the disclosure requirements of the CFIL. For instance, the FTC Franchise Rule does not require disclosure of criminal actions after ten years have passed, but the CFIL does. In one investigation undertaken by DFPI, a person disclosed in Item 2 of the franchisor's FDD had been convicted of crimes related to their involvement in a Ponzi scheme in violation of the CSL.[71] The person had served jail time and paid restitution twelve years before the filing of an FDD with DFPI.[72] The conviction was not disclosed in Item 3 of the FDD. Disclosure was not required under the FTC Franchise Rule because the conviction was more than ten years old; however, it was required to be disclosed under the CFIL. The Commissioner, issued an enforcement action against the franchisor for failure to disclose to the Commissioner a material fact, and the misrepresentation that there was no litigation that the Commissioner would find to be material.[73]

4. **Misrepresentations or Failure to Disclose to Consumers**[74]

SRD has also found violations stemming from the omission of necessary information. For example, SRD has identified violations stemming from the failure to disclose to consumers that a certified public account ("CPA") was no longer licensed or certified to do audits, or not part of the

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[67] *Id*. § 31200.

[68] *Id*. § 31201.

[69] *Id*. § 31200.

[70] *Id.*

[71] Consent Order, Comm'r of Fin. Prot. & Innovation v. Ringside Dev. Co., (Cal. Dep't Fin. Prot. & Innovation May 27, 2021), https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/05/RIngside-Development-Company-dba-Bio-One-Colorado-Inc-Consent-Order.pdf.

[72] *Id.* at 2.

[73] *Id.*

[74] CAL. CORP. CODE § 31201.

national peer review program, and the misrepresentation that the CPA was in fact licensed and certified made on documents submitted to the Commissioner.[75]

It has come as a surprise to many franchisors that their long-time CPAs were not properly registered and licensed.[76] However, because the franchisor, in violation of CFIL,[77] submitted the FDD and related financial statements that include the assertion that the CPA is, in fact, a certified and licensed public accountant to the Commissioner, and that franchisor certifies that all information is true and correct, SRD must take enforcement action against the franchisor.

C. Washington Franchise Investment Protection Act

The Washington Franchise Investment Protection Act ("FIPA")[78] protects prospective franchisees by requiring franchisors to register with DFI,[79] to provide prescribed disclosures to prospects in the form of a current FDD,[80] and comply with the FIPA's anti-fraud provisions.[81] The FIPA also imposes the requirement that franchise brokers also register with DFI and makes it unlawful for a franchisor to employ an unregistered franchise broker in making a sale in Washington.[82] DFI has also adopted administrative rules to further the purpose of the FIPA.[83] Similar to California, there are certain types of violations that more frequently result in enforcement actions, though the specific type of violations differ a little. The four violations that were most likely to trigger investigations or enforcement actions from January 2020 to March 2022 are discussed below.

1. Unregistered Franchise

The most common form of violation that is subject to enforcement action by DFI is the failure to register the offer of a franchise. The FIPA makes it unlawful for any franchisor or subfranchisor to sell or offer to sell any franchise in Washington unless the offer of the franchise has been registered or exempt.[84] From January 2020 to March 2022, the Securities Division filed

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[75] Consent Order, Comm'r of Fin. Prot. & Innovation v. Send Me A Trainer Franchising, LLC (Cal. Dep't Fin. Prot. & Innovation Oct. 29, 2021), https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/11/Send-Me-a-Trainer-Franchising-LLC-Consent-Order_11-01-2021_062714.pdf.

[76] To check if a CPA or their firm is properly registered in a state, a franchisor can use www.cpaverify.org. To confirm that the CPA firm is part of the peer review program, a franchisor can use https://peerreview.aicpa.org/public_file_search.html.

[77] CAL. CORP. CODE § 31200.

[78] WASH. REV. CODE § 19.100.01 et seq.

[79] *Id*. § 19.100.020(1).

[80] *Id*. § 19.100.080(1).

[81] *Id*. § 19.100.170.

[82] *Id*. § 19.100.140.

[83] WASH. ADMIN. CODE § 460-80.

[84] WASH. REV. CODE § 19.100.020(1).

allegations of unregistered franchise offers or sales in thirty-one of thirty-seven franchise enforcement actions.

2. Anti-Fraud Violations/Misrepresentations

The Securities Division filed allegations of misrepresentations or omission in the offer and/or sale of a franchise in fifteen of thirty-seven franchise enforcement actions from January 2020 to March 2022. The FIPA anti-fraud provisions are based in large part on the language of the Washington Securities Act anti-fraud provisions[85] and make it unlawful to do any of the following in connection with the offer, sale, or purchase of any franchise or subfranchise:

> (1) To make any untrue statement of a material fact in any application, notice, or report filed with the director under this law or willfully to omit to state in any application, notice or report, any material fact which is required to be stated therein or fails to notify the director of any material change as required by RCW 19.100.070(3).
>
> (2) To sell or offer to sell by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading.
>
> (3) To employ any device, scheme, or artifice to defraud.
>
> (4) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.
>
> (5) To violate any order of the director.[86]

3. Failure to Provide an FDD

The Securities Division filed allegations of failure to provide a prospective franchisee with a current FDD in sixteen of thirty-seven franchise enforcement actions from January 2020 to March 2022. It is unlawful for any person to sell a franchise that is registered, or required to be registered, without first furnishing to the prospective franchisee a copy of the franchisor's current disclosure document.[87]

4. Unregistered franchise broker

The Securities Division filed allegations of failure to register as a franchise broker in two of thirty-seven franchise enforcement actions from January 2020 to March 2022. It is unlawful for

[85] *Id*. § 21.20.010.

[86] *Id*. § 19.100.170.

[87] *Id*. § 19.100.080(1).

any franchise broker to offer to sell or sell a franchise in Washington unless the franchise broker is registered with DFI.[88] The growing number of business brokers and consultants who are assisting franchisors with online marketing could make this an area of increased focus for the Enforcement Unit in the future.

With the potential of increased focus on policing unregistered franchise brokers, additional attention may be forthcoming to franchisors who employ unregistered brokers in Washington. It is unlawful for any franchisor, subfranchisor, or franchisee to employ a franchise broker unless the franchise broker is registered.[89] In 2021, the Securities Division pressed an enforcement action against a franchisor in which it alleged, among other things, that the franchisor employed an unregistered broker.[90] As a result, the franchisor entered into a settlement with the Securities Division in the form of a consent order in which it agreed to cease and desist from the hiring of unregistered franchise brokers and to reimburse the investigation costs.[91]

Given the large number of potential unregistered franchise brokers who are offering franchises in Washington, the increased enforcement of this statutory provision may provide franchisors with greater incentive to vet their agents who are offering franchises on their behalf in Washington. There are a variety of grounds upon which DFI may deny, suspend, or revoke a franchise broker's application or registration ranging from whether a person has violated a specific provision of the FIPA, has been convicted or enjoined for a violation of franchise related laws, or simply is insolvent.[92] In 2020, DFI denied a franchise broker application in the form of a Consent Order based on the facts in a prior enforcement action.[93] The basis of the denial was that the applicant had engaged in dishonest or unethical practices in the franchise industry by allegedly providing prospective franchisees misleading financial performance representations.[94] The applicant had entered into a prior consent order, in which DFI alleged and adopted as fact that the applicant had violated the FIPA's anti-fraud provisions by making misleading statements to prospective franchisees about the profitability of owning a franchise.[95] The applicant, in the prior consent order, neither admitted nor denied DFI's findings of fact.[96]

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[88] *Id*. § 19.100.140.

[89] *Id.*

[90] Consent Order, In re Lopez and Dental Fix Rx, LLC, Order No.: S-19-2776-20-CO01 (Wash. Dep't Fin. Inst., Sec. Div. Apr. 15, 2021), https://dfi.wa.gov/documents/securities-orders/S-19-2776-20-CO01.pdf.

[91] *Id.*

[92] *Id.* at 2.

[93] Consent Order, In re Rothschild, Order No.: S-20-2868-20-CO01 (Wash. Dep't Fin. Inst., Sec. Div. Aug. 27, 2020), https://dfi.wa.gov/documents/securities-orders/S-20-2868-20-CO01.pdf.

[94] WASH. REV. CODE § 19.100.252(6).

[95] Consent Order, In re Rothschild and Party Princess Int'l, LLC, Order No.: S-17-2288-18-CO01 (Wash. Dep't Fin. Inst., Sec. Div. Aug. 10, 2019), https://dfi.wa.gov/documents/securities-orders/S-17-2288-18-CO01.pdf.

[96] *Id.*

D. Enforcement Trends in Other States

In the interest of brevity, this paper does not review enforcement action data in the twelve other franchise regulatory states in the same manner as the California and Washington examples above. However, it can be useful to look at enforcement trends across the franchise regulation states generally, when that data is available. In the recent period, the trend in enforcement activity across the other states has been somewhat uneven. For example, the state of Indiana lists four enforcement actions taken since the spring of 2019.[97] The state of Virginia does not list any.[98] Minnesota, however, has significant enforcement activity, comparatively, with seventeen actions since the spring of 2019.[99] Information about actions can also be hard to obtain, due to confidentiality restrictions. For example, the state of New York was unable to disclose the type or number of actions undertaken by the Investor Protection Bureau, as the agency's investigations have resulted in confidential consent orders. Uniformly, the actions the authors found in other states involved the sale of unregistered franchises. Links to web resources listing state enforcement actions are included in Exhibit B.

IV. HOW INVESTIGATIONS ARE INITIATED

Up to this point, this paper has focused on painting the general framework within which state franchise examiners act and the types of violations that, in practice, are encountered and enforced by the examiners. The focus will now shift to examining what happens once the state agency is first alerted to a potential violation.[100]

There are any number of ways that a regulatory agency can become alerted to a potential or alleged violation, including complaints from franchisees/potential franchisees, reports from third parties (including reports from other franchisors), referrals from other state agencies, internal referrals from the state's franchise registration unit, or self-reporting by franchisors. In addition, some state agencies may actively seek out potential violations. For example, some state agencies will look at trade publications and visit trade shows in an effort to discover if unregistered franchisors are offering franchises in their state or making unlawful financial performance representations.

Once the state agency is alerted to such an alleged or possible violation through its own efforts or through a complaint by a third party, then in both concept and purpose, the basic process that franchise regulatory agencies follow to investigate and initiate action against franchise law violations are the same, although notable procedural differences may exist from agency to agency. The best way to gain an understanding of the basic process is to look at specific state

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[97] *See Administrative Action Search,* IND. SEC'Y OF STATE, SEC. DIV., https://securities.sos.in.gov/admin-actions-search/ (last visited Sept. 7, 2022).

[98] *See Docket Search,* VA ST. CORP. COMM., DIV. OF SEC. & RETAIL FRANCHISING, https://scc.virginia.gov/docketsearch# (last visited Sept. 7, 2022).

[99] *See Enforcement Actions,* MINN. DEPT. OF COMM., https://www.cards.commerce.state.mn.us/ (last visited Sept. 7, 2022).

[100] In part this paper reflects the personal experiences of the authors and is not necessarily reflective of the policy of any governmental agency. Those experiences may not reflect the views and practices of other individuals at their respective governmental agencies.

examples in context – within the framework of those states' statutes and regulations. Accordingly, this section of the paper illustrates the processes used in California and Washington as specific examples.

A. Complaints within California

The Commissioner of DFPI is vested by the California legislature with the power to enforce and uphold the CFIL.[101] The Commissioner's powers are vast and unfettered when used in the public interest.[102] Part of those powers is the power to investigate possible and actual violations of the CFIL.[103] DFPI commences enforcement investigations when DFPI receives information of possible (however remote) CFIL violations. DFPI may be apprised of potential CFIL violations in California through several different channels: franchisor self-reporting; consumer complaints filed with DFPI; complaints by franchisors reporting on another franchisor; complaints by franchisees reporting on their franchisor; "whistleblower" third-party complaints; internal referrals from other DFPI divisions; review of franchise registration applications; and referrals from other states' regulators. With respect to complaints, those may either be filed online at www.dfpi.ca.gov or submitted in writing to DFPI.

Franchisors often wish to know where a complaint against them came from, and what was alleged; however, this information is cannot be provided because it is considered confidential pursuant to the California Public Records Act.[104] The only way a complaint will be made available to a franchisor is if DFPI takes formal enforcement action in the matter. Then, through discovery pursuant to the California Administrative Procedures Act, the franchisor will receive all the documents relating to the matter, including the complaint, with the exception of the usual privileged documents.[105]

The DFPI is also not able to provide case or complaint updates to the franchisor, complainant, or any third party. The most that counsel may do is advise whether there is an open or closed enforcement investigation.

B. Complaints within Washington

DFI has discretion to make such public or private investigations inside or outside the state as deemed necessary to determine whether any registration should be granted, denied, revoked, or suspended, or whether any person has violated or is about to violate the FIPA, any rule or order issued by DFI.[106]

DFI receives complaints from a variety of sources: from franchisees complaining about their franchisor; referrals from the Securities Division's Registration Unit; self-reporting by franchisors; referrals from other agencies; competitor complaints; and miscellaneous other

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[101] CAL. CORP. CODE § 31001.

[102] *Id.*

[103] *Id*. § 31401.

[104] *Id*. § 6250 *et seq.*

[105] CAL. GOV. CODE § 11507 et seq.

[106] WASH. REV. CODE § 19.100.242.

sources, such as online surveillance. In some instances, franchisors or their counsel are proactive in pointing out potential problems with sales in Washington prior to registration. Registration Unit staff will also compare the FDD's Item 20 disclosure with information on the franchisor's website to look for inconsistencies. Registration Unit staff may also do a web search for locations in the state or check with the Secretary of State and Department of Revenue for potential existing franchisees. Of those listed above, the greatest source of complaints that result in enforcement action are complaints received from franchisees and referrals from the Registration Unit.

Once a complaint has been filed (by a third party) or generated by the Registration Unit (directly), then complaint information is reviewed by the Enforcement Unit manager, who either assigns it directly or gives it to a supervisor to assign to an attorney or enforcement examiner. Information received through any of the sources listed above results in a complaint file being set up.

DFI strives to investigate every complaint that it receives. Occasionally DFI is unable to act on every complaint received and investigations may be prioritized based on the criteria below:

- **Nature of Complaints.** Unregistered franchise sales, failure to provide an FDD, and allegations of misrepresentation or fraud receive the highest priority. Complaints that involve post-sale issues or involving contractual disputes tend to receive a lower priority.
- **Number of Persons Affected.** If a large class of franchisees is affected, it may affect the priority assigned to the case.
- **Dollar amount involved.** The amount of money involved in the complaint may affect the case priority.
- **Staff resources.** The overall workload of the staff greatly affects the amount of time and attention that can be devoted to any particular case. All of the attorneys and examiners have non-franchise caseloads and duties that may consume a significant amount of their time, thereby causing the DFI to prioritize the complaints that are accepted and investigated.

DFI tries to take reasonable steps to ascertain whether a violation of the FIPA has occurred. If it is determined there is sufficient evidence that a violation has occurred, and DFI has the resources available, DFI takes the appropriate enforcement action.

V. INVESTIGATIONS

Many different investigatory tools are available to state franchise examiners and enforcement personnel. Since these tools are a matter of state law, the specific tools available under different state laws differ. Common investigatory tools include:

- Public and private investigations;[107]
- Taking of testimony under oath;[108]
- Subpoena witness interviews;[109] and
- Request for documents.[110]

The above is only a list of the most common investigatory powers that the state franchise agencies have. As is evidenced by the two subsections within this section, while the powers of different state agencies are similar, one should not assume they are exactly the same, or that the investigative process will be conducted in exactly the same manner.

A. California Investigations

The Commissioner may freely investigate all areas of the law in her jurisdiction. The Commissioner may use multiple investigatory tools in her discretion to investigate possible or actual violations of the CFIL in the public interest.[111] DFPI is not required to disclose investigations to anyone, including the subject/franchisor.

1. Investigative Tools

The Commissioner may use traditional forms of discovery, in addition to all forms permitted by the California Administrative Procedures Act and the CFIL. The following tools may be used to investigate matters:[112]

- Taking of formal testimony under oath;
- Witness interviews;
- Taking deposition by issuing a subpoena for appearance before the Commissioner;
- Subpoena *duces tecum* for documents and things;

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[107] CAL. CORP. CODE § 31401(b); 815 ILL. COMP. STAT. 705/31(a); MICH. COMP. LAWS § 445.5136; N.D. CENT. CODE § 51-19-13; RI 19-28.1-26; S.D. CODIFIED LAWS § 37-5B-35; WASH. REV. CODE § 19.100.242; and WIS. STAT. § 553.55. Most other state laws more generally refer to the state agency's right to conduct investigations.

[108] CAL. CORP. CODE § 31401(b); 815 ILL. COMP. STAT. 705/31(a); IND. CODE § 23-2-2.5-33; MD. CODE. ANN., BUS. REG. §14-212; MICH. COMP. LAWS § 445.5136; N.Y. GEN. BUS. LAW § 688; N.D. CENT. CODE § 51-19-13; R.I. GEN. LAWS § 19-28.1-26; S.D. CODIFIED LAWS § 37-5B-37; VA. CODE ANN. § 13.1-567; WASH. REV. CODE § 19.100.245; and WIS. STAT. § 553.55.

[109] *Id*.

[110] *Id.*

[111] CAL. CORP. CODE § 31401.

[112] *Id*. §§31401-31404; *see also* CAL. GOV. CODE § 11500 *et seq.*

- Request for documents;
- Interrogatories;
- Request for admissions;
- Regulatory examination/accounting;
- Informal request for information;
- Review of public, regulatory, and online databases; and
- Internet searches/social media review.

2. Investigative Process

The DFPI counsel uses the above-referenced tools to determine if there is a violation of the CFIL and if enforcement action is in the public interest. The time to respond or provide information varies with each of the above and in each case. Public, regulatory, and commercial databases are also examined within the context of collecting evidence. DFPI counsel engages in complainant interaction, evidentiary review, and legal analysis when all evidence is collected.

DFPI also assigns examiners to cases to work with counsel during the investigation. Examiners may engage in review of any and all regulatory filings, websites, and background information regarding the subject/franchisor. Any evidence found is documented to preserve evidentiary requirements.

B. Washington Investigations

1. Investigative Tools

The DFI enforcement staff gathers information and documents through a variety of sources and means. The most common are:

- Informal letter or oral requests for documents;
- Witness interviews;
- Online searches;
- Review of commercial and public databases; and
- Administrative subpoenas for documents and testimony.[113]

2. Investigative Process

All complainants are routinely notified by DFI that their complaints have been received. When a complaint is received by DFI, it may be set up as a "complaint file" or an investigation. A

[113] WASH. REV. CODE § 19.100.245.

complaint is reviewed initially to determine whether DFI has apparent jurisdiction to act on the complaint, whether the complaint is stale or outside any applicable statute of limitations, and whether there is an appropriate remedy available. If these conditions are not satisfied, the complaint file may be closed immediately and the complainant notified. If it is reasonably clear on the face of the complaint that it is likely to result in a formal enforcement action, the file may be set up as an investigation file rather than a complaint file. There is no substantive difference in how a file is handled based on whether it is initially set up as a complaint or an investigation file. If at any time during the course of reviewing or investigating a complaint file, the Enforcement Unit staff determines that the matter may reasonably require the necessity to issue subpoenas or will result in formal enforcement action, the complaint file may be categorized as an investigation.

After an attorney or examiner has been assigned to review the complaint or investigation file, the complainant is typically contacted for an interview and relevant documents are requested. Background information regarding the subject of the investigation ("the subject") is also gathered using public and commercial databases. If the complaint has been received through a referral from the Registration Unit, another agency, or other means, the investigator generally contacts the subject of the investigation by phone and/or written means. The investigator may send the subject a "warning letter" advising that it has been brought to DFI's attention that the subject may be violating a specific provision of the FIPA and should cease to do so. The investigator may make an informal request for documents and/or interview through a letter, or include them in a warning letter. In some cases, the investigator may initiate the investigation by sending the subject of the investigation an informal request or a subpoena for documents and/or testimony. Typically, a subpoena is issued if the subject does not respond to an informal request for documents. The investigator collects those documents that are germane to the inquiry and interviews the parties who have relevant information. Third-party witnesses may be interviewed informally or compelled to provide testimony and documents through the use of subpoenas. Investigators also make use of questionnaires or surveys if there are a large number of franchisees or witnesses to be contacted. Should there be a possible criminal investigation of a franchise law violation, DFI would have to make a referral to local law enforcement and county prosecutors to obtain records through an Inquiry Judge subpoena, which is the state equivalent of a grand jury subpoena, or obtain records through a county search warrant. How quickly an investigation can be completed is dependent on a variety of factors such as: (1) the investigator's workload; (2) the number of witnesses to be interviewed; (3) the number of documents gathered; (4) the ability to locate witnesses and their availability; and (5) the lack of response to request for documents or the length of time for them to be produced.

VI. STATE ENFORCEMENT POWERS AND REMEDIES

Assuming the state's investigation concludes that one or more violations of the state's franchise law has occurred, the state agency will have to determine what enforcement action it will take against the franchisor. Exhibit A to this paper includes a state-by-state review of enforcement tools. The tools available are generally the same by state, and include:

- Stop orders and cease and desist orders;
- Injunctive relief;
- Rescission;
- Damages;

- Fines and civil penalties;
- Criminal liability; and
- Appointment of a receiver.

While the primary focus of this paper is on alleged violations committed by franchisors, it is important to keep in mind that most state franchise laws impose personal liability on officers and directors of the franchisors, and others involved in the franchise sales process under certain conditions. For example, the Illinois Franchise Disclosure Act makes it clear that it is unlawful for "any person" to commit the different prohibited practices enumerated in the statute,[114] and defines "person" as "an individual, a corporation, [or] a partnership. . . ."[115] California law makes this even clearer, providing that:

> [e]very person who directly or indirectly controls a person liable under Section 31300 or 31301 [sections requiring registrations of franchises], every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, [and] every employee of a person so liable who materially aids in the act or transaction constituting the violation, are also liable jointly and severally . . . .[116]

This fact can be helpful to legal counsel when advising a client, to help focus the client's attention and align priorities on responding to inquiries and resolving questions promptly.

A. State Enforcement Powers and Remedies in California

When DFPI has completed its investigation, a DFPI attorney will summarize the facts and violations for internal consideration. If CFIL violations are found, the Commissioner's CFIL violation findings are then prepared for presentation to the subject/franchisor. The Commissioner's findings also include an assessment of remedies that the Commissioner, on a case-by-case basis, deems as required to resolve the matter in the public interest. The CFIL provides for a number of different enforcement actions that the Commissioner may use to address CFIL violations, such as the following:

- Stop Orders are used to deny, suspend, or revoke franchise registrations;[117]
- Desist and Refrain Orders require recipients to stop any practices or conduct in violation of the CFIL and may be issued summarily. The recipient has a right to an

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[114] 815 ILL. COMP. STAT. 705/5.

[115] *Id*. 705/3(7).

[116] CAL. CORP. CODE § 31302.

[117] *Id*. §§ 31115, 31117, and 31118.

administrative hearing to contest the merits of the Desist and Refrain Order within the prescribed CFIL statutory time limits;[118]

- Conditions of Registration may include a temporary bar from registration, require a financial assurance of performance as a condition of registration, or any other requirement that the Commissioner imposes in the public interest;[119]

- Notices of Violation require the subject/franchisor to issue a Notice of Violation to all franchisees and to allow franchisees to cancel their franchise agreement with the subject/franchisor; and[120]

- Consent Orders and Settlement Agreements[121]

The CFIL allows for a variety of different remedies that the Commissioner may impose upon those who violate the CFIL, such as the following:[122]

- Remedial Education may be required for officers and salespersons of the subject/franchisor;

- Restitution;

- Disgorgement/Refund;

- Monitor for compliance;

- Damages;

- Penalties not exceeding $2,500 per CFIL violation;[123]

- Attorney's fees;

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[118] *Id*. §§ 31402, 31403, and 31406.

[119] CAL CODE REGS. § 310.133.

[120] CAL. CORP. CODE §§ 31300; 31303; CAL. CODE REGS. § 310.303.

[121] CAL. CORP. CODE § 31407.

[122] *Id*. §§ 31115, 31406 and 31408

[123] The Commissioner has the ultimate discretion when assessing remedies and penalties in the public interest. CAL. CORP. CODE § 31406. The Commissioner may assess up to $2,500 per CFIL violation in an administrative law action. *Id*. The DFPI takes CFIL violations extremely seriously. Therefore, it is likely that violations will be assessed at the maximum amount permitted by statute. The following may be considered when determining the assessment of remedies and penalties in the public interest: investor harm; number of violations; egregiousness of violations; franchisor knowledge of the harm; sophistication of the injured party; previous history of enforcement actions with DFPI and other regulatory agencies nationwide; response time to DFPI; age of the violations; treatment of the franchisee by the franchisor; accounting results, and more.

- Administrative costs;
- Investigative expenses; and
- Other relief not expressly stated in the section. The Commissioner has and may issue a claim for ancillary relief including the following:[124]
    - o Bar the franchisor from doing business in California;
    - o Impose of administrative fees (fees for monitoring settlement agreement terms, examinations, and attorney supervision of franchisor); and
    - o Order the offer of cancellation to franchisees.

Nothing in the CFIL prohibits the Commissioner from issuing multiple remedies in any form within her discretion, in the public interest.

B. <u>State Enforcement Powers and Remedies in Washington</u>

At the conclusion of an investigation, the attorney or investigator assigned to the case will prepare a summary of the facts and generally make a recommendation to a supervisor as to whether violations have occurred. If the supervisor concurs that a violation has occurred, then the appropriate actions and remedies are discussed. The supervisor reviews the allegations with the Enforcement Program Manager, who in turn, provides the Securities Administrator with the allegations and recommendations of the supervisor and attorney/investigator. Depending on the facts and circumstances, DFI has a number of potential remedies available in addressing violations, which include, but are not limited to the following:

- Stop Orders, which are used to deny, suspend or revoke the registrations of franchisors and franchise brokers;[125]
- Cease and Desist Orders, which require recipients to stop any practices or conduct in violation of the FIPA; such orders may be done summarily in a Summary Order, but are typically preceded by a Statement of Charges that provides the recipient with notice and opportunity for a hearing to challenge any allegations;[126]
- Consent Orders, which are an agreed order and settlement of DFI allegations that require recipients to stop any practices or conduct in violation FIPA; Consent Orders may have stipulated facts, but frequently allow a respondent to neither

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[124] CAL. CORP. CODE § 31408.

[125] WASH. REV. CODE § 19.100.120.

[126] *Id*. 19.100.248.

admit nor deny the allegations, but remain subject to the order to cease and desist from future violations of FIPA;[127]

- Registration Conditions, which may include a temporary bar from registration or require a financial assurance of performance as a condition of registration;[128]

- Remedial Training, which may be required for officers and salespersons of the franchisor; and

- Criminal Penalties, which include fines up to $5,000 and up to ten years of imprisonment.[129]

The following are civil remedies authorized by the FIPA that have generally not been pursued by DFI: civil penalties;[130] injunctive relief;[131] receivership;[132] fines;[133] recovery of costs and attorney's fees;[134] rescission/restitution;[135] and damages/treble damages.[136]

VII. INVESTIGATIVE OUTCOMES

When the investigative process described above comes to an end the investigating agency must determine what action it will take. The remedies available to the state agencies in enforcing state franchise laws are discussed in the previous section and set out in Exhibit A to the paper. However, how the agencies deploy the tools available to them varies.

A. California

1. Investigation Results

The subject/franchisor will be notified with the Commissioner's findings if violations are found. These are generally final findings as to the investigation. At this time, the franchisor and DFPI may commence negotiation of a consent order to settle the matter to the Commissioner's satisfaction. If the matter is not settled, it will be considered for internal referral to the general Enforcement Division for handling. The Commissioner will not approve any pending franchise

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[127] *Id*. § 19.100.100.

[128] *Id*. § 19.100.050.

[129] *Id*. § 19.100.210(6).

[130] *Id*. § 19.100.210(3).

[131] *Id*. § 19.100.210(1).

[132] *Id*. § 19.100.020(1)

[133] *Id*. § 19.100.140.

[134] *Id.*

[135] See *Id*. § 19.100.190(2).

[136] See *Id*. § 19.100.190(3).

registrations or renewals until all enforcement investigations, matters, and issues relating to the filing franchisor are resolved to the Commissioner's satisfaction.[137]

2. Settlement

Settlement is usually accomplished through entering into a consent order or a settlement agreement.

Consent orders are an agreed order and settlement of DFPI matters regarding CFIL violations that require recipients to stop any practices or conduct in violation of the CFIL. Consent orders may be entered into *before* any formal enforcement action is filed and served, and a hearing request is issued, but they are entered into only after the Commissioner's findings have been presented to the subject/franchisor for resolution. Consent orders include a statement of law, facts, and the Commissioner's findings. The consent order will also set forth the Commissioner's selected enforcement action (usually a desist and refrain order) and remedies. Finally, the consent order may require the subject to desist and refrain from future violations of the CFIL.

DFPI is a government agency and must act in compliance with the statutes it is tasked to enforce. Therefore, DFPI is not able to permit many requested edits or revisions to the settlement agreement language, as many provisions are required by the CFIL, or regulations or directives from the Attorney General. Consent orders are public documents, as are all other actions, settlement agreements, and other documents issued by DFPI, generally.[138] This is a requirement that DFPI, as a government agency that is subject to the California Public Records Act,[139] may not waive. A consent order will include any action and remedies, including, but not limited to a desist and refrain order, penalties, and other action that the Commissioner sees fit in the public interest to resolve the matter. Disclosure of the consent order is required in Item 3 of the franchisor's FDD.[140]

Settlement agreements are used *after* DFPI has issued, filed, and served formal enforcement action. Settlement agreements are an agreement in settlement of all DFPI matters regarding CFIL violations with the subject franchisor. Settlement agreements include a statement of law, facts, and the Commissioner's findings. A settlement agreement will also set forth the Commissioner's selected enforcement action and remedies. The settlement agreement may require the subject to desist and refrain from future violations of the CFIL. Disclosure of the settlement agreement (along with the enforcement action itself) is required in Item 3 of the franchisor's FDD.[141]

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[137] CAL. CORP. CODE § 31115. While in practice the Commissioner is not required to issue a stop order denying the effectiveness of, or suspending or revoking effectiveness of, a registration while an investigation is pending, this is the current practice.

[138] CAL. GOV. CODE § 6252 (e).

[139] *Id*. § 6250 *et seq.*

[140] 16 C.F.R. § 436.5(c).

[141] *Id*.

3. Civil and Criminal

The Commissioner may initiate a civil action to enforce the CFIL. Usually, DFPI will engage in a civil action after all administrative law proceedings have been exhausted, such as temporary or permanent restraining orders. The Commissioner may also use a civil action to enforce a previously-issued administrative law enforcement order that has been violated by a subject. However, the Commissioner does have the power to commence a civil action without needing to wait until all administrative law proceedings are exhausted. The Commissioner may charge up to $10,000 per CFIL violation in a civil action.[142]

The Commissioner may also issue a criminal referral to any law enforcement agency, including, but not limited to the California Attorney General, any California State District Attorney's Office, and the United States Department of Justice. The Commissioner's Office may act as second chair in these criminal proceedings if requested by the enforcement agency. Any person who willfully violates the CFIL or engages in a scheme or artifice to defraud pursuant to the CFIL may be convicted of a crime, be fined not more than $100,000, and/or be imprisoned in the county jail for not more than one year.[143]

B. Washington

1. Investigation Results

At the conclusion of an investigation, the investigator will provide the supervisor with the tentative findings of fact and conclusions of law. If formal enforcement action is recommended, the supervisor will submit a written draft to the chief of enforcement for review. The final draft of a formal action is also reviewed and approved by the Securities Administrator, who is acting on behalf of DFI's Director. If it is determined that no formal enforcement action is warranted, DFI may simply close the file or take informal action such as issuing a warning letter, if one has not already been issued.

2. Settlement

As a practical matter, because of costs and time considerations, DFI has addressed franchise violations using its administrative authority to issue Statements of Charges to Cease and Desist to a franchisor for violations of selected provisions of the FIPA. In the Statement of Charges, the franchisor is notified of the allegations and remedies sought, the remedy being an order to cease and desist in these cases. The Statement of Charges provides a franchisor an opportunity to request an administrative hearing[144] before an independent administrative law judge to contest the allegations.[145]

A franchisor may also enter into a settlement of the allegations by entering into a consent order. The consent order may or may not have agreed facts, but the franchisor must agree and is ordered to cease and desist from further violations of the FIPA as a condition of the consent

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[142] CAL. CORP. CODE §§ 31404, 31410 and 31411.

[143] *Id*.

[144] WASH. REV. CODE § 19.100.248.

[145] *Id*. § 34.05.410 *et seq.*

order. Should the franchisor choose to litigate and lose at the hearing or through the appeals process, DFI will ultimately issue a Final Order to Cease and Desist. In the event, the franchisor prevails at hearing, the administrative law judge and/or the DFI's Director's decision becomes part of the final record.

As noted above in Section VII.A.3, consent orders and final orders are required to be disclosed in Item 3 of a franchisor's FDD. As a general practice, DFI requires a franchisor to reimburse DFI for its investigation costs as a condition to entering into a consent order. DFI will waive or reduce the costs of the investigation upon a showing of financial hardship and by providing a Financial Declaration Form by any persons seeking such relief.

3. <u>Civil and Criminal</u>

Although authorized by the FIPA, DFI has not filed civil actions, but the state Office of the Attorney General ("Attorney General") has filed franchise-related cases.[146] DFI has assisted the Attorney General with those matters. DFI is authorized to refer evidence of criminal violations of the FIPA to the Attorney General or county prosecutor.[147] A finding of a willful violation of FIPA or violation of a DFI rule or order may subject the violator to up to ten years imprisonment and a fine of $5,000.[148]

VIII. ENFORCEMENT CASE EXAMPLES

To provide some color to the types of statutory violations state regulators investigate and bring enforcement actions against, this section of the paper provides examples of some recent actions.

A. <u>Administrative Cease and Desist Order</u>

A Washington State based licensee of AM-PM DOC, LLC ("AMPM"), a Florida based limited liability company, filed a complaint with DFI in early 2021, which alleged that AMPM had sold her an unregistered franchise.[149] The complainant had become an AMPM licensee after responding to an online job posting published by independent contractor Lia Langston ("Langston") d/b/a The WestridgeGroup, LLC and The Westridge Group, Inc. (collectively "Westridge").[150] Langston had been hired by AMPM with the promise of $5,000 for each licensee successfully recruited for AMPM's concierge medical services business.[151]

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[146] *Id* § 19.100.248.

[147] *Id.* § 19.100.260.

[148] *Id.* § 19.100.210(6).

[149] Consent Order, In re AM-PM DOC, LLC and Saffouri, Order No. S-21-3084-21-CO01 (Wash. Dep't Fin. Inst., Sec. Div. Mar. 22, 2022), https://dfi.wa.gov/documents/securities-orders/S-21-3084-21-CO01.pdf.

[150] *Id.* at 2.

[151] *Id.*

A DFI complaint file was created and converted into an investigation shortly after the complaint was received. After documents were obtained from the complainant and an interview conducted, DFI sent a warning letter to AMPM and its principal Ramsey Saffouri, advising them that it appeared that they had offered unregistered franchises and that they should stop offering in Washington without an exemption or having registered. DFI also sent a subpoena that requested them to provide copies of license agreements with Washington licensees and related documents.

DFI sent a letter to Langston and Westridge advising them that it appeared that they were acting as unregistered franchise brokers and that they should stop offering in Washington without an exemption or having registered. DFI sent a subpoena that requested them to provide copies of documents relating to Washington offerees and/or purchasers.

Based on the review of the documents provided by the complainant and AMPM and Saffouri, DFI issued a Statement of Charges against AMPM, Saffouri, and Langston.[152] The Statement of Charges alleged that the respondents had offered an unregistered franchise in the form of an AMPM license agreement for which AMPM collected a $50,000 license fee and required the licensee to make mandatory purchases of business supplies and materials. AMPM granted the licensee the right to use its marks and system and agreed to provide the licensee with training and operational and marketing assistance.[153] DFI alleged that the respondents failed to disclose material facts to the licensee such as the AMPM financial statements, and that they did not provide the licensee with the basis and assumptions regarding claims that an AMPM license afforded the ability to earn between $1,000,000 and $2,000,000 per year.[154]

The Statement of Charges alleged that Langston and Westridge were not registered as a franchise broker in Washington at the time of the offer of the AMPM license agreement opportunity, and that they did not provide the licensee with the basis and assumptions regarding the claims that an AMPM license afforded the ability to earn between $1,000,000 and $2,000,000 per year.

The Statement of Charges was accompanied by a Notice of Opportunity to Defend and Opportunity for Hearing that provided the respondents the opportunity to request an administrative hearing within thirty days of service of the allegations. AMPM and Saffouri requested a hearing and waived the setting of the hearing pending the outcome of settlement discussions. AMPM and Saffouri ultimately settled the Statement of Charges with DFI by entering into a Consent Order in which they neither admitted nor denied DFI's findings of fact and conclusions of law, but agreed and were ordered to cease and desist from future violations of the FIPA. AMPM and Saffouri also reimbursed DFI $7,500 for its investigative costs.[155]

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[152] *Id.* at 1.

[153] *Id.* at 3.

[154] *Id.* at 4.

[155] *Id.*

Langston and Westridge did not timely file a request for a hearing, and DFI issued a Final Order to Cease and Desist.[156] As a result, Langston and Westridge were ordered to cease and desist from acting as an unregistered franchise broker and from violating the anti-fraud provisions of the Franchise Act.[157]

B. Stop Orders

On December 27, 2019, the Securities Commissioner of Maryland ("Commissioner") issued a Stop Order against Burgerim Group USA, Inc. ("Burgerim"), a fast-casual restaurant franchise concept, for filing an incomplete and inaccurate FDD.[158] In the Stop Order, the Commissioner stated that, among other things, Burgerim, in its 2019 FDD, might be misrepresenting the number of franchises that had an outlet terminated, canceled, not renewed, or otherwise ceased to do business and that Burgerim failed to disclose telephone numbers for current franchise outlets and former franchisees.[159] The Commissioner stated that she had previously sent Burgerim a letter advising it to immediately amend its registration to disclose the missing material information. Burgerim ignored the letter.[160] The Commissioner also sent Burgerim a subpoena for documents, and Burgerim failed to comply with the request.[161] Based on alleged violations of Maryland franchise law, the Commissioner suspended Burgerim's franchise registration.[162]

In early 2020, the Commissioner's Stop Order came to DFI's attention.[163] DFI determined that Burgerim had been experiencing serious financial difficulties and had failed to update its registration application and disclosures.[164] Burgerim initially registered with DFI to offer franchises in 2018 and had renewed its registration in February 2019.[165]

Based on Burgerim's failure to amend its registration on file within a reasonable period of time after a material adverse change in its condition and on the information contained in its FDD

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[156] *Id.* at 1.

[157] *Id.* at 5.

[158] Consent Order, In re Burgerim Group USA, Inc., Case No. 2019-0213 (Md. Sec. Comm'r Feb. 5, 2020), https://www.marylandattorneygeneral.gov/Securities%20Actions/2020/Burgerim_Group_Final_Stop_Order_020520.pdf.

[159] *Id.* at 3.

[160] *Id.*

[161] *Id.*

[162] *Id.* at 1.

[163] Stop Order Revoking the Effectiveness of State Registration, In re Burgerim Grp. USA, Inc., Order No.: S-20-2836-20-SO01, at 2 (Wash. Dep't Fin. Serv. Jan. 14, 2020), https://dfi.wa.gov/documents/securities-orders/S-20-2836-20-SO01.pdf.

[164] *Id.* at 1.

[165] *Id.* at 2.

in violation of RCW 19.100.070, DFI issued a Stop Order revoking the effectiveness of Burgerim's franchise registration on January 14, 2020.[166]

Based on Burgerim's failure to timely request a hearing regarding the Stop Order, a Final Order Revoking Effectiveness of Registration Statement was entered against Burgerim on February 13, 2020.[167]

Stop orders may also be issued under less dramatic circumstances than those in the Burgerim matter. For example, a stop order may be issued when a franchisor violates a previously entered consent order. Such was the case when HCC Franchise Corporation ("HCC") violated a consent order entered against it by DFPI.[168] HCC did not timely pay the fine imposed by the previous consent order.[169] A stop order was issued, revoking HCC's previously approved registration to offer and sell franchises in California.[170]

C. <u>Consent Orders</u>

Most investigations result in the parties entering into consent orders. A typical example of a California consent order is the Consent Order between the Commissioner of DFPI and The HomeTeam Inspection Service, Inc., entered into on May 27, 2022.[171] The HomeTeam Inspection Service, Inc. ("HTI"), an Ohio-based franchisor, used Jodi Sue Eramo ("Eramo") and Summit Financial Group, Inc. ("Summit") to perform its audit and prepare the audited financial statements for HTI's FDD.[172] In May 2021, the Ohio State Board of Accountancy issued a cease and desist notice to Eramo ordering her to no longer use her CPA license and to stop advertising Summit.[173] At the time of the cease and desist notice, neither Eramo nor Summit were registered as a public accounting firm in Ohio. It is not expressly stated in the Consent Order, but it appears that the proper registrations had lapsed some time ago, as the Consent Order relates to the HTI FDD from

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[166] *Id*.

[167] Findings of Fact and Conclusions of Law and Final Order Revoking Effectiveness and Registration, In re Burgerim Grp. USA, Inc., Order No.: S-20-2836-20-FO01 (Wash. Dep't Fin. Serv. Feb. 13, 2020), https://dfi.wa.gov/documents/securities-orders/S-20-2836-20-FO01.pdf.

[168] Stop Order, Comm'r of Fin. Prot. & Innovation v. HCC Franchise Corp. (Cal. Dep't. Fin. Prot. & Innovation April 1, 2022), https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/04/Admin.-Action-HCC-Franchise-Corporation-Stop-Order.pdf.

[169] *Id.* at 3.

[170] *Id.*

[171] Consent Order, Comm'r of Fin. Prot. & Innovation v. The HomeTeam Inspection Serv., Inc. (Cal. Dep't. Fin. Prot. & Innovation May 27, 2022), https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/06/HomeTeam-Consent-Order-Eramo.pdf.

[172] *Id.* at 2-3.

[173] *Id.* at 3.

March 25, 2020 and March 12, 2021.[174] HTI had used the financial statements prepared by Eramo and Summit in those FDDs.[175]

The Commissioner found that there were two violations of the CFIL by HTI: (1) the failure to disclose that Summit was not a licensed CPA was an omission of a material fact; and (2) holding out the financial statements prepared by Summit as being audited was an untrue statement of material fact.[176]

The Consent Order with HTI required HTI to desist and refrain from the violations set forth in the order (the use of the "audited" financial statements) and also required HTI to pay a fine of $10,000.[177] Though not expressly stated in the Consent Order, the $10,000 fine is presumably calculated as two violations of CFIL Section 31200 per FDD in which the financial statements prepared by Summit were used.

Consent orders will sometimes result from a franchisor self-reporting. Rabbit Rabbit Co., Ltd. ("Rabbit Rabbit") was a Taiwanese corporation that offered and sold franchises in California starting in November 2017.[178] Rabbit Rabbit did not register to offer or sell franchises in California and it did not provide franchisees with an FDD.[179] At some point, Rabbit Rabbit realized that the CFIL had been violated and self-reported.[180] The franchisor was ordered to desist and refrain from offering and selling franchises without first registering with DFPI and from not timely providing prospective franchisees with the franchisor's FDD.[181]

An example of a consent order resulting from the sale of an "accidental franchise" involves the consent order between DFPI and Nutrishop, Inc. ("Nutrishop").[182] Nutrishop had entered into fifty-eight "license agreements" with California franchisees for the operation of stores using a system prescribed by the franchisor.[183] Nutrishop was not registered to offer and sell franchises in California at the time of those sales and also did not provide the prospective franchisees with an FDD.[184] Upon review, DFPI concluded that the license agreements fit within the definition of

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[174] *Id.* at 3.

[175] *Id.* at 3-4.

[176] *Id.* at 3.

[177] *Id.*

[178] Consent Order, Comm'r of Fin. Prot. & Innovation v. Rabbit Rabbit Co. Ltd. (Cal. Dep't. Fin. Prot. & Innovation May 13, 2021), https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/05/Rabbit-Rabbit-Co.-Ltd.-YSF-LLC-Consent-Order.pdf.

[179] *Id.* at 2.

[180] *Id.*

[181] *Id.* at 3.

[182] Consent Order, Comm'r of Fin. Prot. & Innovation v. Nutrishop, Inc., (Cal. Dep't Fin. Prot. & Innovation Sept. 15, 2021), https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/09/Nutrishop-Inc-Consent-Order.pdf.

[183] *Id.* at 2.

[184] *Id.*

a “franchise” under the CFIL.[185] From August 2018, Nutrishop started registering to offer and sell franchises in California, but failed to disclose the fifty-eight license agreements in its FDD.[186] In addition to being required to cease and desist with all of its violations of the CFIL, the consent order also required Nutrishop to pay administrative penalties in the amount of $95,000.[187]

Franchisors are typically required to register franchise sales advertising materials with DFPI,[188] and failure to do so may also lead to investigations and an eventual consent order. For example, Duck Donuts Holdings, LLC (“Duck Donuts”) not only engaged in discussions with a prospective franchisee and offered a franchise without first being registered with DFPI, it also published an advertisement on its website, thereby offering franchises to California consumers.[189] Duck Donuts never filed a copy of the advertisement with DFPI.[190] Duck Donuts was ordered to desist and refrain from violations of CFIL and administrative penalties were assessed in the amount of $5,000.[191]

IX. FRANCHISOR RESPONSES TO VIOLATIONS

Up to this point, this paper has addressed franchise law investigations and violations primarily from the examiners’ perspective, with a focus on the relevant statutes and regulations. This next section instead looks at the experience of franchisors in enforcement actions, at what franchisors can do to try to avoid those actions, and how to handle such actions when one is initiated against the franchisor.

A. Prevention is the Best Remedy

It is important for franchisors and their counsel to understand that, even when state investigations conclude that no franchise law violation occurred, or otherwise no penalties are enforced against a franchisor, those investigations are not without expense to the franchisor. Investigations of this nature can be time consuming, disruptive, expensive, and negatively impact the franchisor’s reputation. The funds and time that the franchisor spends on investigating the underlying circumstances and handling the investigation itself could be used in a more productive way. Thus, the best approach is for the franchisor to endeavor diligently to avoid any potential franchise law violations before they happen. As discussed below in Section XI. C., this includes developing business policies, practices, and systems designed to help ensure compliance and prevent inadvertent errors. For example, a franchisor could avoid the type of situation that occurred in the HTI case above by requiring its auditors to provide current licensure information

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[185] *Id.*

[186] *Id.* at 3.

[187] *Id.* at 4.

[188] CAL. CORP. CODE §31156.

[189] Consent Order, Comm’r of Fin. Prot. & Innovation v. Duck Donuts Holdings, LLC, (Cal. Dep’t Fin. Prot. & Innovation Jan. 26, 2022), https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/01/Duck-Donuts-Holdings-LLC-Consent-Order.pdf.

[190] *Id.* at 2.

[191] *Id.* at 3.

each year in connection with preparing its audited financial statements. Routine diligence such as this is important to help prevent any number of surprises from arising.

Another important step in avoiding violations is to provide training to the franchisor's personnel, including the training of new hires as well as refresher training for experienced executives. This can ensure that those individuals most likely to be involved in violations understand the law and how it affects their work. If charity starts at home, franchise law compliance starts at the franchisor's office: executives, operating personnel, and sales staff alike need to have fundamental understanding of the franchise laws that affect them and the franchisor. In the era of the "great resignation", staff changes are a frequent occurrence. Consequently, it is more important than ever that franchisors provide franchise law compliance training for their sales staff and executives on an ongoing basis.[192] This means ensuring that the franchisor's executives generally understand the implications of franchise law; that operating staff are aware how changes they make to the franchise system may affect FDD disclosure; and that the sales staff is familiar with disclosure restrictions and requirements. The franchisor must understand what information to disclosed in the FDD, when to update the FDD, and how to share it properly with prospective franchisees. Updating an FDD can be a tedious process, but it is one that, when done properly, can save the franchisor from many future issues. Instituting annual franchise law compliance training, even for those who have previously participated, is an investment that may pay significant dividends in the future.

B. Internal Investigation When a Violation Is Uncovered

It is not unusual for a franchisor to discover a franchise law violation before it has been identified by others. What to do when a violation is discovered depends on several factors, such as the seriousness of the violation, when it was discovered (before or after the sale), what jurisdictions were involved, and the future plans of the franchisor. For example, what would happen if a franchisor believes that one of its sales persons inadvertently shared an unauthorized financial performance representation ("FPR") with a prospective franchisee? The violation is potentially serious. On the other hand, what if a franchise seller form had not been filed in the appropriate state for a person that was involved in one franchise sale in that state? That violation may be analyzed differently by the franchisor.

1. Fact Gathering

When the franchisor suspects a franchise law violation has occurred the first thing to do typically is to engage legal counsel and then gather all relevant information and facts. In the FPR example above, the franchisor may want to start by finding out exactly what information was shared, by whom, and with whom. Things are not always as they seem. For example, if the FPR was shared by a franchisee of the franchisor and not the salesperson, on behalf of the franchisor, there may be no violation at all. Alternatively, maybe the prospect is an existing franchisee and received the information as part of financial data regularly shared with all system franchisees.

However, when a likely or actual violation is discovered, a franchisor may wish to look a bit further. In the FPR example above, is it possible that the salesperson shared the unauthorized financial performance representation with other prospective franchisees? Have other members of its sales team likewise been sharing unauthorized financial performance representations? Is the

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[192] *See, e.g.* Martin Cordell, Theresa Leets, & Warren Lee Lewis, *Responding to Franchise Enforcement Actions*, ABA 43RD ANNUAL FORUM ON FRANCHISING W-23, at 29 (2020).

sales team's knowledge of franchise law compliance generally lacking such as to warrant further review of the franchisor's sales practices?

Each situation will be different, but in general, it behooves the franchisor to take a broad approach in its fact gathering, talking to the persons involved not only about the specific violation but also about whether similar situations may have arisen. Likewise, the franchisor may wish to talk not only to the persons directly involved, but also to other personnel who may have observed or been privy to other potential franchise law violations. If the franchisor has an in-house legal department, one of the lawyers from that department could lead the investigation. If there is no legal department, or if lawyers from that department are potentially implicated as well, the franchisor will likely wish to engage their outside counsel to assist in the investigation. When communicating with the franchisor's personnel who were involved in the matter, counsel should keep legal privilege in mind at each stage.

2. Analyzing Applicable Law

Hand-in-hand with reviewing all relevant facts, the franchisor and its counsel should analyze the applicable law. Franchisors and their counsel often operate based on various best practices, but those best practices may require more than the law actually requires. For example, it may be a best practice that each of the owners of a prospective franchisee receive a copy of the FDD. While that may be desirable, that is arguably not the law.[193] Consequently, what initially may have looked like the failure to disclose a prospective franchisee may not be an issue at all, as long as the FDD was provided to at least one authorized representative of the franchisee as required by the law.[194]

A starting point in the analysis is often the jurisdictional scope of state franchise laws that may have been violated. The jurisdictional scope of these statutes differ and sometimes the results may be surprising. For example, if a Missouri-based franchisor sold a franchise to a Missouri-based prospective franchisee who will open its franchise in Illinois, it is likely that the Illinois franchise statute will not apply, even though the franchise will be operated in Illinois.[195]

Another important aspect of analyzing the law is reviewing available exemptions. Returning to the example of the unauthorized FPR, if there are exemptions available, it is possible that, while the FPR was not authorized by the franchisor, it may not have been illegal to provide it, if the franchise offer and sale fell outside of the scope of the applicable franchise laws.

Finally, especially with violations that happened some time ago, the franchisor will wish to consider if the applicable statute of limitations bars any claims. In analyzing statutes of limitations under state franchise laws, it is very important to pay attention to the exact scope of those limitation periods, as they may vary based on whether the potential action is administrative (which

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[193] *See*, 16 C.F.R. §§ 436.1(r), 436.2(a) (The FDD is required to be furnished to the "prospective franchisee." A "prospective franchisee" is defined as the person that approaches the franchise seller to discuss the sale of a franchise, but also includes any agent, representative or employee of that person. State franchise laws will have their own provisions regarding who an FDD must be furnished to and should also be reviewed.).

[194] *Id.*

[195] *See* 815 ILL. COMP. STAT. 705/10.

may have no statute of limitations), civil, or criminal, as well as the nature of the claim or action itself. The analysis of the applicable statutes of limitations can be quite complicated, especially if the franchisor is concerned about action both by the state agency and the impacted franchisees. Different types of actions are typically available to franchisees and state agencies, and as alluded to above, the statutes of limitations will differ, depending on the type of action.[196] For an overview of applicable statutes of limitations, see Exhibit A.

3. Timing of the Discovery of a Possible Violation

Timing of the discovery of a possible violation can have a significant impact on the franchisor's response to the violation. If the potential violation occurred early in the sales process, often it can be remedied by taking the appropriate steps. For example, if it turns out that the FDD provided to a prospective franchisee is not up to date, it may be possible for the franchisor to halt the sales process and re-disclose the prospective franchisee before the sale goes forward. In the unauthorized FPR example above, it may be hard to remedy the unauthorized disclosure, but the franchisor may simply decide not to proceed with the sale, thereby avoiding most potential enforcement consequences. On the other hand, if the violation is only discovered after the sale occurred, the franchisor is going to have to take other measures.

C. Whether to Self-Report

From the franchisor's perspective, even when a violation has been confirmed and there are no exemptions or procedural bars for the violation to be pursued by the franchisee or a state examiner, this does not necessarily mean that the franchisor will self-report, or that it should do so immediately.[197]

For violations that are minor and technical in nature, the franchisor may choose not to report at all, especially if the violation was not widespread and the affected franchisees are happy. For example, if the sales team miscalculated the number of days between FDD disclosure and signing of a franchise agreement and signed the agreement 13 days after disclosure, the franchisor may choose not to report. This is an assessment of legal risk should always be done with counsel.

Many other factors may also weigh into the franchisor's decision whether to self-report. If the violation is not obvious from the FDD itself, if the violation occurred in a notice filing state, or if the franchisor is planning to stop selling franchises in the affected state and not register there anymore, it may be very tempting to decide not to report. However, franchisors should consider with their counsel the other factors involved, including the benefits of self-reporting.

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[196] The statute of limitation may even differ for the same type of action. It is common that a franchisor's offer of rescission will significantly shorten the limitations period for a franchisee to bring an action for such remedy. *See, e.g.*, 815 ILL. COMP. STAT. 705/27 (reduces the statute of limitation from three years to 90 days if the franchisor offers rescission).

[197] The assumption in this section is that there is a violation of state franchise disclosure or relationship law. The violation of the FTC Franchise Rule may be just as serious, but without a private cause of action under the Rule and the FTC having limited resources to investigate, isolated violations might never be investigated. Before a franchisor dismisses violations in states without state franchise laws as inconsequential, however, it should review if the state may have a "Little FTC Act" or similar consumer fraud statutes that give private parties an ability to enforce the FTC Franchise Rule. *See* John G. Parker & Angela M. Fifelski, *Claims Under Little FTC Acts*, ABA 28TH ANNUAL FORUM ON FRANCHISING W-4 (2005).

A franchisor that self-reports has several benefits over the one that does not and is later caught up in an investigation. Maybe most importantly, the franchisor gets a chance to prepare for the investigation and lay out its own story. Before even approaching the state franchise examiners, the franchisor will have the opportunity to remedy the issues, or at least mitigate them. The franchisor may reach out to the affected franchisees and try to find a solution on its own to the violation. It may work with its staff to ensure that they are properly trained and that future violations are thereby avoided.

Self-reporting and taking remedial measures on its own initiative demonstrates the franchisor's good faith and desire to comply. State regulators may be more likely to treat a franchisor who admits a mistake differently than one that appears to have hidden its mistakes. This does not mean that the franchisor will be relieved of any liability by the state regulator, or even necessarily that the penalty will be less, but it is likely that the investigative process will be shorter and less contentious.

D. <u>Setting the Franchisor's Expectations</u>

Franchisors and state franchise regulators often take a different approach to franchise law violations. The franchisor's view of a violation is often centered on whether any actual harm occurred. The state regulator's perspective may instead be focused on enforcing a consumer protection law that the legislature in the state believed necessary for the protection of all investors (franchisees), irrespective of the level of harm in a particular instance. Consequently, franchisors should not be dismissive of the importance of a violation from the regulator's point of view and underestimate the likely outcome of an investigation. Franchisor's counsel should prepare their client for the likely investigation and the different perspective that regulators will have. This includes explaining the law and the remedies at the regulator's disposal, but also the process itself. For example, in the course of an investigation most state regulators will request information from the franchisor about the alleged violation *and* information about any similar cases or circumstances that tend towards additional violations yet to be discovered. Counsel should also advise their client and set the right expectations regarding the likely remedies to be enforced.

X. INTERACTING WITH REGULATORS – BEST PRACTICES

When a violation is discovered by the franchisor, one way of beginning the interaction with the relevant state regulators is through a call on an exploratory basis from the franchisor's counsel. Counsel may be able to discuss with the regulator how they see the violation, without disclosing the franchisor's identity. The regulator will typically not be able to give counsel any definitive guidance without knowing all the facts, but such initial calls can be helpful to set expectations on both sides. The tone of the discussion is usually amicable. If this type of call results in the determination that the franchisor should self-report, then an initial dialogue has already been established with the regulator, and it will be easier for all parties to work their way through the investigation process and keep an open dialogue regarding the consequences and cost of enforcement.

Adopting the mantra "regulators are people too" is something that is strongly recommended, especially when the investigation is not self-reported. Some franchisors and their lawyers will react strongly and defensively to inquiries. State regulators are tasked by their states with enforcing franchise laws, and remembering that the investigative process is not a personal attack on the franchisor, but an attempt to ensure that consumers are treated in accordance with those laws, can be helpful when emotions are running high. Just as when a franchisor wishes to self-report, an initial phone call to the regulator can be used to lay the groundwork for a cooperative and, hopefully, smooth process.

California's DFPI in particular has observed in the last few years a more lax view regarding the severity of CFIL violations and related investigations by franchisors. It should be noted that DFPI's current position is making rigorous consumer protection a priority. CFIL violations are considered very serious violations of the law that cause substantial and material harm to consumers.

Prompt and attentive communication is highly recommended when dealing with the DFPI Commissioner's Office and counsel. Returning emails, requests for information, or responses issued by DFPI promptly or by the prescribed due date issued by counsel will lay the foundation for a good relationship between the franchisor and the regulator. Further, attempting to resolve the matter quickly with DFPI will be beneficial to the franchisor, as there are many other cases that counsel must oversee. Counsel should inform their clients to do their best to make themselves available to confer regarding offers, counter-offers, and other matters made by the DFPI. The DFPI Commissioner does not meet in person with subjects/franchisors with regard to enforcement matters, and any request to do so will be denied. Department Counsel is the Commissioner's representative. Therefore, any and all matters that the subject/franchisor wish to present for the Commissioner's consideration may be brought before Department Counsel. The Commissioner does not approve any pending franchise registrations or renewals until all enforcement investigations, matters, and issues relating to the filing franchisor are resolved to the Commissioner's satisfaction.[198]

In the state of Washington, a significant percentage of DFI's enforcement actions involve the sale of unregistered franchises that are "discovered" when the franchisor files its initial registration application. Many franchisors will point out in the cover letter to the application that this "may be an issue." By self-reporting a potential violation well-before filing the registration application, a franchisor may avoid additional time delays to the registration application process. Well-prepared franchise applications that are ready to have a permit issued can be held up a significant length of time waiting for an investigation to be completed. Typically, a finding of a violation will result in a settlement in the form of a consent order that must be disclosed in Item 3 of the FDD.[199]

Counsel should anticipate that the client will be requested to provide DFI with the contact information for offerees and purchasers, marketing materials, FDDs, contracts, and correspondence. A franchisor's officers, employees, and agents may be interviewed by DFI enforcement staff. Franchisors should produce requested information and documents in a complete and timely manner. Communicating the need for additional time to produce requested items will assist DFI enforcement staff in budgeting and scheduling their time and be appreciated.

XI. MANAGING OUTCOMES

Once a violation has occurred there is little a franchisor can do with respect to the identified violation, other than take the steps outlined above: look into the facts, carefully review applicable law, and work with the state regulators to reach a, hopefully, swift resolution of the matter. By

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[198] CAL. CORP. CODE § 31115.

ensuring that the franchisor understands the process and likely outcomes, franchise counsel can help shape the investigative and enforcement process, making it an easier and more predictive experience for both franchisor and the investigating regulator.

A. Managing Expectations Regarding the Investigation

At the outset of the investigation, outside and in-house counsel should ensure that their clients understand both the process involved in the investigation and its potential consequences. Whether or not a violation occurred, the investigation is likely to take time, and legal fees will be incurred. If the violation is of a nature that is likely to have happened repeatedly, such as failure to properly provide the FDD to prospective franchisees, investigators are likely to want to explore not only the specific violation at issue, but also surrounding facts and circumstances. This will be done in an effort to ensure that all violations are addressed. But for the franchisor, it may mean expanding its own investigation of the facts, producing more documentation than just that relating to the issue being initially investigated, and, in all, more time and money.

B. Managing Expectations Regarding Remedies Likely to Be Imposed

Counsel should also make sure that their clients understand what the likely outcome is of an investigation. Unless the investigation results in a finding that no violation was committed, some fines and/or other remedies are likely to be enforced. While the maximum fines for single violations are relatively minor, those fines can quickly multiply if multiple violations are involved, or if multiple franchisees are involved, leading to significant fines. For example, if the fine for a failure to properly disclose a franchisee is $2,500 per violation, the total fine will quickly increase if the franchisor disclosed many franchisees.

If the violation affected existing franchisees of the franchisor, for example, the franchisor needs to understand that it may be required to offer rescission. If possible, the franchisor may wish to prepare itself for rescission by determining what specific franchisees may be affected by the violation and what their likely response to a rescission offer will be. Happy and financially successful franchisees will likely wish to continue in the system, so a rescission offer becomes more of a technicality for the franchisor than an issue. However, if some of the franchisees are likely to be looking for a way of exiting the system, an offer of rescission will be a much bigger issue for the franchisor.

C. Managing Expectations about Long-Term Consequences

Even after the state investigation is concluded and any required remedies have been addressed, there are additional consequences of an investigation that must or should be addressed. The one "must" is typically to update Item 3 of the FDD to disclose the consent order or other action or order regarding the violation.[200] Note that consent orders often contain restrictive orders that are continuous in nature, and the inclusion of the order is often permanent.[201]

The other action recommended is for the franchisor to review its internal processes and procedures to reduce the risk for future franchise law violations. There are several relatively easy

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[200] 16 C.F.R. § 436.5(c).

[201] *Id*. § 436.5(c)(iii)(2).

steps that can potentially save the franchisor from future difficulties and help ensure compliance going forward.

One such step is to create internal processes and procedures that will help avoid future violations. For example, the creation of sales-related checklists can help assure that the sales team always checks to make sure that: the FDD is registered in the state where the prospective franchisee lives and where they are interested in opening their location; a final franchise agreement is not sent out for signature before the fourteen- and seven-day requirements under the FTC Franchise Rule have been satisfied; and that signed FDD receipt pages are obtained from the necessary parties.

A second step in prevention is developing processes and procedures to ensure proper recordkeeping relating to franchise sales. Maintaining proper records will make it easier to show that alleged violations did not take place, or will at least cut back on the amount of time and effort spent in responding to any future investigations. It should be noted that, both the FTC Franchise Rule and state franchise laws require franchisors to maintain books, records, and related documents for franchises offered and sold.[202] By way of example, if a franchisor does not have such information available for the regulator upon issuance of a request for documents or subpoena, it is considered a violation of the CFIL and an administrative penalty may be assessed by the Commissioner.[203] Even without the potential threat of administrative penalties, keeping good records will simplify and speed up investigations.

A third step, which has already been mentioned above, is the need to educate the franchisor's management and sales teams. Education is not a one-time event. Both new and existing team members need to be educated and have refresher trainings. Franchise laws change and develop, and the franchisor's franchise program also changes and develops, meaning new franchise law issues may arise.

Finally, spending some time on ensuring that the FDD is properly updated is always good advice. Some franchisors see the FDD as a necessary evil and franchise disclosure as a burden in the sales process; however, understanding the importance and value of FDD disclosure can help shift attitudes more positively towards the document and the disclosure obligations and pay dividends in the long run.

XII. FUTURE TRENDS

As the technology evolves, so does commerce and the business models people rely on to make their living. As the gig economy grows, so do the number of independent contractors. Inevitably there will arise the question as to whether some these "independent contractors" are franchisees, business opportunity purchasers, employees, or something else? As already discussed in this paper, state franchise laws broadly define what constitutes a "franchise." Many of the agreements for these new business models may be considered franchise agreements under state laws, even though the contracting parties did not think of their arrangement in such terms. As a result, investigations and enforcement actions may follow.

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[202] See, e.g. 16 C.F.R. §§ 436.6(h), (i); CAL. CORP. CODE § 31150; 815 ILL. COMP. STAT. 705/36; IND. CODE § 23-2-2.5-21; MD. CODE. ANN., BUS. REG. § 14-224; MICH. COMP. LAWS § 445.1520; N.Y. GEN. BUS. LAW § 683.14(a); and WASH. REV. CODE § 19.100.150.

[203] CAL. CORP. CODE § 31406.

XIII. CONCLUSION

While there are differences in the various state franchise laws, the basic regulatory framework is consistent across the franchise registration states. The biggest enforcement challenge faced by all of these states is ensuring that all franchisors are registered and/or providing prospective franchisees with current and meaningful disclosure that complies with the state laws and NASAA Franchise Disclosure Guidelines. Second after that, is policing those franchisors who make unsubstantiated financial representations, misrepresentations, or omit material facts in their disclosures. The diligent franchisor can avoid the potential pitfalls of becoming the subject of a regulatory investigation by being proactive in making sure all appropriate franchisor staff are trained about the registration and disclosure requirements. In the event that a franchisor finds itself the subject of an investigation, it may be able to mitigate the consequences of any violations by proactively reaching out to its franchisees and the regulators. Understanding what the regulators need and expect in the course of an investigation and its conclusion can lead to less time consuming and expensive proceedings.

BIOGRAPHIES

MARTIN CORDELL

Martin is a Financial 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's (NASAA) Corporate Finance Training Committee and Professional Development Committee. He received his J.D. and B.A. degree in English from the University of Washington.

BEATA KRAKUS

Beata Krakus is a partner of Greensfelder, Hemker & Gale, P.C., and part of the firm's Franchising & Distribution Practice Group. She works with franchisor clients in domestic and international franchise transactional matters, as well as related areas such as distribution and sales representative arrangements, and other commercial contracts. She has advised, structured, and prepared franchise programs for many different franchise concepts including real estate brokerages, hotels, restaurants, and fitness and personal health systems.

Prior to joining Greensfelder, Ms. Krakus was an associate with Sonnenschein Nath & Rosenthal LLP. She also practiced in Warsaw, Poland with the Swedish law firm of Magnusson Wahlin.

Ms. Krakus recently finished her second term as a member of the Governing Committee of the ABA Forum on Franchising. She has previously served as the organization's Marketing Officer, Technology Officer and Information Officer. She was an Associate Editor for *The Franchise Lawyer*, has herself written articles for the *Franchise Law Journal* and other franchise law publications, and has spoken repeatedly at the ABA Forum on Franchising and International Franchise Association Legal Symposium. She is recognized by International's Who's Who of Franchise Lawyers and by Chambers USA.

MARISA I. URTEAGA-WATKINS

Marisa I. Urteaga-Watkins is Counsel at the California Department of Financial Protection and Innovation (Department), Securities Regulation in the Sacramento Office. Ms. Urteaga-Watkins spent 14 years as a litigator in the Department's Enforcement Division, with a broad case load covering all areas of the law within the Department's jurisdiction. Ms. Urteaga-Watkins also worked with federal and state criminal government agencies to successfully prosecute the subjects in her securities law enforcement cases. Ms. Urteaga-Watkins now handles both transactional and enforcement matters at the Department, specializing in California securities and franchise law violations. Ms. Urteaga-Watkins holds a specialty Intellectual Property Juris Doctorate from McGeorge School of Law.

Exhibit A

Statutory Reference List

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

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
California Cal. Corp. Code § 31300 et seq.	§ 31402 – desist franchise offer § 31403 – desist selling under exemption § 31406 – desist after violation of order	§ 31400 (examiner)	§ 31405 civil: $10,000/violation – assessed through civil action § 31406 administrative: $2,500/violation – through citation.	§ 31300 (F) only for willful violations § 31408 rescission, restitution, damages on behalf of injured party (examiner) § 31400 restitution (examiner)	§ 31300 (F) § 31400 (examiner)	§ 31302, § 31400.	§ 31404 commissioner can refer to DA § 31410 willful violation $100,000, imprisonment 1 yr or both § 31411 fraud $100,000, imprisonment 1 yr or both	§ 31400 receiver	§ 31303: § 31300 actions: 4 yrs from act or 1 yr from discovery, 90 days after notice of disclosure or registration violation.
Hawaii Haw. Rev. Stat. § 482E-1 et seq.	§ 482E-8 – stop sell franchises § 482E-10.7 – cease and desist unlawful action	§ 482E-10.7	§ 482E-10.5 $100,000 max (examiner)	§ 482E-9 (F)	§ 482E-9 (F)	§ 482E-9	§ 482E-10.6: Class B felony	§ 482E-10.7 receiver	§ 482E-10.5 For civil damages: 5 yrs from violation or 2 yrs discovery. § 482E-10.6 5 yrs for criminal penalty

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
Illinois 815 Ill. Comp. Stat. 705/1 et seq.	§ 705/23 – stop order if in public interest		§ 705/24 $50,000/violation	§ 705/26 rescission (F) §705/22 restitution	§ 705/26 (F)	§ 705/26	§ 705/25 class 2 felony		§ 705/24 For civil penalty: 3 yrs § 705/27 3 yrs, but 90 days from f-or's notice
Indiana Ind. Code § 23-2-2.5-1 et seq.	§§ 14 & 34 – for registration violations or other violations § 35 – exemption violations	§ 32		§ 34 rescission and restitution	§ 28	§ 29	§ 36 – refer to DA §37 Class C felony		§ 30 3 yrs
Maryland Md. Code, Bus. Reg. § 14-201 et seq.	§ 14-210 cease and desist, receiver § 14-221 stop order (summarily)	§ 14-210 injunction, dissolution (court)	§ 14-228 (willful actions) $10,000	§ 14-210 restitution (court) § 14-227 rescission and restitution (F)	§ 14-210 damages (court) § 14-227 (F)	§ 14-227 (fee)	§ 14-211 §§14-228 – 14-232 $10,000, 5 yrs imprisonment	§ 14-210 receiver	§ 14-210 3 yrs § 14-211 3 yrs
Michigan Mich. Comp. Laws § 445.1501 et seq.		§ 445.1535 injunction, receiver (court action)	§ 445.1538 $10,000	§ 445.1531 (F) rescission §445.1535 restitution	§ 445.1531 (F)	§ 445.1532	§445.1537 fine $10,000, 7 yrs imprisonment		§ 445.1533 4 yrs

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
Minnesota Minn. Stat. § 80C.01 et seq.	§ 80C.12		§ 80C.16 $2,000/violation, failure to comply with final order $25,000	§ 80C.17 (F) rescission	§ 80C.17 (F)	§ 80C.17 (civil liability)	§ 80C.16 willful violation $10,000, 5 yrs imprisonment		
New York N.Y. Gen. Bus. Law § 680 et seq.				§ 691 (F) rescission § 692 restitution			§ 690 class A misdemeanor, $1,000 fine	§ 689 receiver	§ 691(4) 4 yrs
North Dakota N.D. Cent. Code § 51-19-01 et seq.	§ 51-19-09, § 51-19-13 (cease and desist)	§ 51-19-13, injunction, receiver	§ 51-19-13 $10k/violation	§ 51-19-12	§ 51-19-12 (F)	§ 51-19-12 (civil liability)	§ 51-19-14 Class B felony	§ 51-19-13 receiver	§ 51-19-12 5 yrs, or offer before action § 51-19-13 5 yrs
Oregon Or. Rev. Stat § 650.050 et seq.		§ 650.065		§ 650.020 (F) rescission	§ 650.065	§ 650.020		§ 650.065 receiver	§ 650.020 3 yrs
Rhode Island R.I. Gen. Laws § 19-28-1-1 et seq.	§ 19-28.1-18 stop order, cease and desist	§ 19-28.1-18 injunction	§ 19-28.1-18 $50,000 (action), administrative fine $5,000/violation	§ 19-28.1-21 (F) rescission	§ 19-28.1-21 (F)	§ 19-28.1-21 (civil liability)	§ 19-28.1-20 - felony	§ 19-28.1-18 receiver	§ 19-28.1-18 (for admin fines 4 yrs) § 19-28.1-22 4 yrs, 90 days rescission offer

Jurisdiction	Stop Order/Cease and Desist	Injunctive Relief	Fines	Rescission	Damages	Personal Liability	Criminal Liability	Other	Statute of limitation
South Dakota S.D. Codified Laws § 37-5B-1 et seq.	§ 37-5B-41 and § 37-5B-42 cease and desist		§ 37-5B-43 $5,000/violation	§ 37-5B-49 (F)	§ 37-5B-49 (F) treble	§ 37-5B-49 (F)			§ 37-5B-50 (1-2 yrs)
Virginia Va. Code § 13.1-557 et seq.		§ 13.1-568	§ 13-.1-570 $25,000 civil penalty	§ 13-1-570 restitution (examiner)	§ 13.1-571 (F)		§ 13.1-569 Class 4 felony		
Washington Wash. Rev. Code § 19.100.010 et seq.	§ 19.100.248	§ 19.100.191, § 19.100.248	§ 19.100.191 $2,000 /violation	§ 191.100.190 (F)	§ 19.100.190 (F)		§ 19.100.191 $5,000, 10 yrs imprisonment	§ 19.100.191 receiver	
Wisconsin Wis. Stat. § 553.01 et seq.	§ 553.28	§ 553.54		§ 553.51 rescission (F) § 553.54 restitution	§ 553.51 (F)	§ 553.51 (F)	§ 553.52 $5,000, 5 yrs imprisonment		§ 553.51 (F) 3 yrs./90 days rescission notice

Exhibit B

State Agencies and Where to Find Enforcement Actions

State Agency	Website
California Department of Financial Protection and Innovation	See https://dfpi.ca.gov/actions-and-orders-listed-by-month/ for an overview of actions. Search for actions at: https://dfpi.ca.gov/actions-orders-and-administrative-hearing-decisions/
Hawaii Department of Commerce & Consumer Affairs	https://cca.hawaii.gov/sec/enforcement_actions/
Illinois Attorney General's Office, Consumer Fraud & Franchise Bureau	https://apps.ilsos.gov/adminactionssearch/
Indiana Office of the Secretary of State, Securities Division	https://securities.sos.in.gov/admin-actions-search/
Maryland Office of the Attorney General, Division of Securities	https://www.marylandattorneygeneral.gov/Pages/Securities/index.aspx
Minnesota Department of Commerce	https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showSearchParameters&searchType=new
New York Office of the Attorney General, Investor Protection Bureau	No online access to enforcement actions.
North Dakota Securities Commission	https://www.securities.nd.gov/department-information/enforcement-actions
Rhode Island Department of Business Regulation	https://dbr.ri.gov/insurance-banking-securities-and-charitable-organizations/securities-and-charities/securities-0#FranchisesRegulation
South Dakota Division of Securities	https://dlr.sd.gov/securities/admin_actions.aspx
Virginia State Corporation Commission, Division of Securities & Retail Franchising	http://www.scc.virginia.gov/docketsearch#search
Washington Department of Financial Institutions, Securities Division	https://dfi.wa.gov/securities-enforcement-actions/securities2022

Wisconsin Department of Financial Institutions	https://www.wdfi.org/newsroom/admin_orders/dos_default.htm

Exhibit C

California Department of Financial Protection and Innovation (Department) Enforcement Appendix[204]

I. California Franchise Investment Law[205] (FIL) Enforcement Complaints and Investigations

A. Investigation "Triggers"/ Complaints

The Commissioner is vested by the Legislature to enforce and uphold the FIL. The Commissioner's powers are vast and unfettered when used in the public interest. The Department is required to investigate possible and actual violations of the FIL. The Department commences enforcement investigations when the Department has knowledge of possible (however remote) FIL violations. The Department may be apprised of potential FIL violations in California through the following methods:

- Investor Complaints Filed with the Department
- Franchisor v. Franchisor
- Franchisee v. Franchisor
- "Whistleblower" Third party
- Department Internal Referrals from other Department Divisions
- Review of Franchise Registrations/Renewals
- Referrals from Other State Regulators

Complaints may be filed online at www.dfpi.ca.cov. A complaint may be made by writing to the Department as well.

The Department is not able to disclose any complaints or the identification of complainants as this information is confidential, pursuant to the California Public Records Act (Gov. Code, § 6250 et seq.).

[204] All sections reference the California Corporations Code.

[205] The FIL mirrors the California Securities Law of 1968. (Corp. Code §31001). The purpose of the FIL is to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. (Id.). The intent of the FIL is to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor and franchisee by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship. (Id.).

B. Investigation

1. Tools

The Commissioner may freely investigate and use multiple investigatory tools in her discretion to investigate possible or actual violations of the FIL, in the public interest.

Section 31401 (Investigation by the Commissioner/Subpoena).

(a) The Commissioner may in his discretion

(1) make such public or private investigations within or outside of this state as he deems necessary to determine whether any person has violated or is about to violate any provision of this law or any rule or order hereunder or to aid in the enforcement of this law or in the prescribing of rules and forms hereunder, and

(2) publish information concerning the violation of this law or any rule or order hereunder.

(b) For the purpose of any investigation or proceeding under this law, the Commissioner or any officer designated by him may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the Commissioner deems relevant or material to the inquiry.

(c) In case of contumacy by, or refusal to obey a subpoena issued to, any person, the superior court, upon application by the Commissioner, may issue to the person an order requiring him to appear before the Commissioner, or the officer designated by him, there to produce documentary evidence, if so ordered, or to give evidence touching the matter under investigation or in question. Failure to obey the order of the court may be punished by the court as a contempt.

(d) No person is excused from attending and testifying or from producing any document or record before the Commissioner, or in obedience to the subpoena of the Commissioner or any officer designated by him, or in any proceeding instituted by the Commissioner, on the ground that the testimony or evidence (documentary or otherwise) required of him may tend to incriminate him or subject him to a penalty or forfeiture; but no individual may be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he is compelled, after validly claiming his privilege against self-incrimination, to testify or produce evidence (documentary or otherwise), except that the individual testifying is not exempt from prosecution and punishment for perjury or contempt committed in testifying.

The Commissioner may use traditional forms of discovery, in addition to all forms permitted by the Administrative Procedures Act and the FIL: The following may be used to investigate matters:

- Taking of Formal Testimony Under Oath
- Taking Deposition by Issuing a Subpoena for Appearance before the Commissioner
- Subpoena Duces Tecum for Documents and Things
- Request for Documents
- Interrogatories
- Request for Admissions
- Regulatory Examination

2. Investigation Results

The subject/franchisor will be notified with the Commissioner's findings. These are generally final findings as to the investigation. At this time, the subject/franchisor may commence negotiation of a consent order to settle the matter to the Commissioner's satisfaction. The Commissioner is not able to approve any pending franchise application or amendments until all enforcement investigations, matters, and issues relating to the filing franchisor are resolved to the Commissioner's satisfaction.

C. Points to Note

- Complaint/Case Updates:
  - The Department is not able to provide case or complaint updates. The most that Counsel may do is advise whether there is an open or closed enforcement investigation.
- Consent Orders:
  - Used to settle a matter <u>before</u> formal enforcement action is filed and served and a hearing request is issued.
  - The Department is a quasi-law enforcement agency. Therefore, the Department is not able to permit many requested edits or revisions to the settlement agreement language as many provisions are required by statute or the Attorney General.
  - Public document, as are all other actions, settlement agreements, and other documents issued by the Department, generally. This is a requirement that may not be waived due to the Department's quasi-law enforcement agency status.
  - Will include any action and remedies, including, but not limited to a desist and refrain order, penalties, and other action that the Commissioner sees fit in the public interest to resolve the matter.
  - Disclosure in FDD is required in Item 3.

- Settlement Agreements:
  - Used to settle a matter <u>after</u> an enforcement action is filed and served and a hearing request is issued.
  - Same as above.

II. California Franchise Investment Law (FIL) Enforcement Actions

A. Common FIL Violations

<u>Section 31110 (Offer/Sale without Registration; May Also be Section 31119 Violation(s)).</u>

It shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered under this part or exempted under Chapter 1 (commencing with Section 31100) of this part.

<u>Section 31119 (Failure to Provide an FDD 14 Days before Taking Consideration or Execution of Agreement(s)).</u>

(a) It is unlawful to sell any franchise in this state that is subject to registration under this law without first providing to the prospective franchisee, at least 14 days prior to the execution by the prospective franchisee of any binding franchise or other agreement, or at least 14 days prior to the receipt of any consideration, whichever occurs first, a copy of the franchise disclosure document, together with a copy of all proposed agreements relating to the sale of the franchise.

(b) Nothing in this division shall be construed to prevent a franchisor from providing copies of the franchise disclosure documents to prospective franchisees through electronic means pursuant to any requirements or conditions that may be imposed by rule or order of the commissioner.

<u>Section 31123 (Failure to File Amendment to Registration Violation(s)).</u>

A franchisor shall promptly notify the commissioner in writing, by an application to amend the registration, of any material change in the information contained in the application as originally submitted, amended or renewed. The commissioner may by rule further define what shall be considered a material change for such purposes, and the circumstances under which a revised offering prospectus must accompany such application.

<u>Section 31200 (Misrepresentation to the Commissioner Violation(s)).</u>

It is unlawful for any person willfully to make any untrue statement of a material fact in any application, notice or report filed with the commissioner under this law, or willfully to omit to state in any such application, notice, or report any material fact which is required to be stated therein, or fail to notify the commissioner of any material change as required by Section 31123.

<u>Section 31201 (Misrepresentation to the Investor/Franchisee Violation(s)).</u>

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communication not enumerated in Section 31200 which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

<u>Section 31202 (Misrepresentation and Omission Regarding Section 31101).</u>

It is unlawful for any person willfully to make any untrue statement of a material fact in any statement required to be disclosed in writing pursuant to Section 31101, or willfully to omit to state in any such statement any material fact which is required to be stated therein.

<u>Section 31203 (Violation of Commissioner’s Order).</u>

It is unlawful for any person to violate any order of the commissioner or condition to the effectiveness of the registration of the offer or sale of franchises.

<u>Section 31204 (Obstruction).</u>

(a) It is unlawful for any person to knowingly alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the administration or enforcement of any provision of this division.

(b) It is unlawful for any person to knowingly make an untrue statement to the commissioner during the course of licensing, investigation, or examination, with the intent to impede, obstruct, or influence the administration or enforcement of any provision of this division.

Section 31220 (Franchisor Restricts/Prohibits Free As Association Among Franchisees Violation(s)).

It shall be a violation of this division for any franchisor, directly or indirectly, through any officer, agent or employee, to restrict or inhibit the right of franchisees to join a trade association or to prohibit the right of free association among franchisees for any lawful purposes. Notwithstanding Section 31410, a violation of this section shall not constitute a crime.

Section 31150 (Books and Records Violation(s)).

Every franchisor or subfranchisor offering franchises for sale in this state shall at all times keep and maintain a complete set of books, records, and accounts of such sales.

Section 31156 (Failure to Approve Advertising Violation(s)).

No person shall publish in this state any advertisement offering a franchise subject to the registration requirements of this law unless a true copy of the advertisement has been filed in the office of the commissioner at least three business days prior to the first publication or such shorter period as the commissioner by rule or order may allow, or unless such advertisement has been exempted by rule of the commissioner.

Section 31157 (False or Misleading Advertisement Violation(s)).

No person shall publish any advertisement concerning any franchise in this state after the commissioner finds that the advertisement contains any statement that is false or misleading or omits to make any statement necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading and so notifies the person in writing. Such notification may be given summarily without notice of hearing. At any time after the issuance of a notification under this section, the person desiring to use the advertisement may in writing request that the order be rescinded. Upon the receipt of such a written request, the matter shall be set down for hearing to commence within 15 business days after such receipt unless the person making the request consents to a later date. After such hearing, which shall be conducted in accordance with the provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, the commissioner shall determine whether to affirm and continue or to rescind such order, and the commissioner shall have all the powers granted under such act.

People v. Simon – Intent: There is no specific intent required to commit a violation of the FIL. The term “willful” in the California Franchise Investment Law (FIL) does not require any specific intent to violate the FIL. All that is required is that the person acted intentionally in the sense that he/she was aware of the act being committed, not the end result. For instance, if someone gets hit in the face, all that is required is that the offending party intended to lift his/her arm – not intend to hit someone in the face. As the FIL was drafted to mirror the California Securities Law of 1968 (CSL), please see the California Supreme Court case People v. Simon, (1995) 9 Cal. 4th 493 and People v. Clem, (1974) 39 Cal. App. 3d 539.

B. ENF Procedure - Stop Order (Issued On Its Own or Issued In A Consent Order/Settlement Agreement).

Section 31115 (Commissioner May Issue Stop Order Denying the Effectiveness or Suspending or Revoking Effectiveness of Any FIL Registration).

The Commissioner may summarily issue a stop order denying the effectiveness of or suspending or revoking effectiveness of any registration if the Commissioner finds:

(a) That there has been a failure to comply with any of the provisions of this law or the rules of the Commissioner pertaining thereto.

(b) That the offer or sale of the franchise would constitute misrepresentation to, or deceit or fraud of the purchasers, or that, in the case of a franchise other than a subfranchise, a major inducement to prospective franchisees is fees or other compensation from participation in the sale of additional franchises.

(c) That the applicant has failed to comply with any rule or order of the Commissioner issued pursuant to Section 31113.

(d) That any person identified in the application or any officer or director of the franchisor, whether or not identified in the application, meets one or more of the following conditions, and the involvement of this person in the sale or management of the franchise creates an unreasonable risk to prospective franchisees:

> (1) Has been convicted of a felony, or pleaded nolo contendere to a felony charge, or held liable in a civil action by final judgment if the felony or civil action involved fraud, embezzlement, fraudulent conversion, or misappropriation of property.
>
> (2) Is subject to any currently effective order of the Securities and Exchange Commission or the securities administrator of any state denying registration to or revoking or suspending the registration of the person as a securities broker or dealer or investment adviser or is subject to any currently effective order of any national securities association or national securities exchange (as defined in the Securities Exchange Act of 1934) suspending or expelling the person from membership in the association or exchange.
>
> (3) Is subject to any currently effective order or ruling of the Federal Trade Commission.
>
> (4) Is subject to any currently effective injunctive or restrictive order relating to business activity as a result of an action brought by any public agency or department, including, without limitation, actions affecting a license as a real estate broker or sales person.

Section 31117 (Administrative Hearing Right When Commissioner Issues Stop Order).

Upon the entry of a stop order under Section 31115 the Commissioner shall promptly notify the applicant that it has been entered and of the reasons therefor and that upon receipt of written request the matter will be set down for hearing to commence within 15 business days after such receipt unless the applicant consents to a later date. If no hearing is requested within 30 days after receipt of the notice and none is ordered by the Commissioner, the order will remain in effect until it is modified or vacated by the Commissioner. If a hearing is requested or ordered, the Commissioner, after notice and hearing in accordance with the provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, in connection with which the Commissioner shall have all of the powers granted thereunder, may modify or vacate the order or extend it until its final determination.

Section 31118 (Cause to Vacate Stop Order).

The Commissioner may vacate or modify a stop order if he or she finds that the conditions which caused its entry have changed or that it is otherwise in the public interest to do so.

C. ENF Procedure - Desist and Refrain Order (Issued On Its Own or Issued In A Consent Order/Settlement Agreement).

Section 31402 (Desist and Refrain Order for Offer/Sale Of Unregistered Franchise/ Violation of Section 31110).

If, in the opinion of the Commissioner, the offer of any franchise is subject to registration under this law and it is being, or it has been, offered for sale without the offer first being registered, the Commissioner may order the franchisor or offeror of that franchise to desist and refrain from the further offer or sale of that franchise unless and until the offer has been duly registered under this law. If, after that order has been made, a request for a hearing is filed in writing within 60 days from the date of service of the order by the person to whom the order was directed, a hearing shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, and the Commissioner shall have all of the powers granted under that chapter. Unless that hearing is commenced within 15 business days after the request is made (or the person affected consents to a later date), the order shall be deemed rescinded. If that person fails to file a written request for a hearing within 60 days from the date of service of the order, the order shall be deemed a final order of the Commissioner and shall not be subject to review by any court or agency, notwithstanding Section 31501.

Section 31110 (Offer/Sale without Registration; May Also be Section 31119 Violation(s)).

It shall be unlawful for any person to offer or sell any franchise in this state unless the offer of the franchise has been registered under this part or exempted under Chapter 1 (commencing with Section 31100) of this part.

Section 31403 (Desist and Refrain Order For Any Exempt Franchise Not In Compliance with Said Exemption or Section 31201).

If, in the opinion of the Commissioner, the offer of any franchise exempt from registration under this law is being or has been offered for sale without complying with Section 31201, or any other provision that provides an exemption from Chapter 2 (commencing with Section 31110) of Part 2, the Commissioner may order the franchisor or offeror of the franchise to desist and refrain from the further offer or sale of the franchise unless and until the offer is made in compliance with this law. If, after that order has been made, a request for a hearing is filed in writing within 60 days from the date of service of the order by the person to whom the order was directed, a hearing shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code and the Commissioner shall have all of the powers granted under that chapter. Unless that hearing is commenced within 15 business days after the request is made, or the person affected consents to a later date, the order shall be deemed rescinded. If that person fails to file a written request for a hearing within 60 days from the date of service of the order, the order shall be deemed a final order of the Commissioner and shall not be subject to review by any court or agency, notwithstanding Section 31501.

<u>Section 31201 (x2 Misrepresentation and Omission to Investor).</u>

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communication not enumerated in Section 31200 which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

<u>Section 31406. (Desist and Refrain Order for Any FIL Violation In A Citation).</u>

(a) If, upon inspection or investigation, based upon a complaint or otherwise, the Commissioner has cause to believe that a person is violating any provision of this division or any rule or order promulgated pursuant to this division, the Commissioner may issue a citation to that person in writing describing with particularity the basis of the citation. Each citation may contain an order to desist and refrain and an assessment of an administrative penalty not to exceed two thousand five hundred dollars ($2,500) per violation and shall contain reference to this section, including the provisions of subdivision (c). All penalties collected under this section shall be deposited in the State Corporations Fund.

(b) The sanctions authorized under this section shall be separate from, and in addition to, all other administrative, civil, or criminal remedies.

(c) If within 60 days from the receipt of the citation, the person cited fails to notify the Commissioner that the person intends to request a hearing as described in subdivision (d), the citation shall be deemed final.

(d) Any hearing under this section shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

(e) After the exhaustion of the review procedures provided for in this section, the Commissioner may apply to the appropriate superior court for a judgment in the amount of the administrative penalty and order compelling the cited person to comply with the order of the Commissioner. The application shall include a certified copy of the final order of the Commissioner and shall constitute a sufficient showing to warrant the issuance of the judgment and order.

<u>Section 31407. (Order to Discontinue Conducting Business/Business Practices In Violation of the FIL – Same As Desist and Refrain).</u>

(a) If, after examination or investigation, the Commissioner has reasonable grounds to believe that any person is conducting business in violation of any provision of this division or related rule or order binding upon it, the Commissioner may, by written order addressed to the person, direct the discontinuance of the violation. The order shall be effective immediately, but shall not become final except in accordance with subdivision (b).

(b) An order issued pursuant to this section shall not become final except after notice to the affected person of the Commissioner's intention to make the order final and of the reasons for the finding. The Commissioner shall also notify the person that upon receiving a request the matter shall be set for hearing to commence within 15 business days after receipt of the request. The person may consent to have the hearing commence at a later date. If no hearing is requested within 60 days after the mailing or service of the required notice, and none is ordered by the Commissioner, the order may become final without a hearing and that person shall immediately discontinue the practices named in the order. If a hearing is requested or ordered it shall be held in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, and the Commissioner shall have all of the powers granted under that chapter. If, upon the conclusion of the hearing, it appears to the Commissioner that the person is violating any provision of this division or any related rule or order binding upon it, the Commissioner shall make the order of discontinuance final and the person shall immediately discontinue the practices named in the order.

D. ENF Procedure - Notice of Violation (NOV) (Issued On Its Own or Issued In A Consent Order/ Settlement Agreement).

The Department may require a franchisor to issue a NOV. Please see below in Civil Actions section 31300, 31303, and Code of Regulations, Title 10, Title 10, §310.303.

E. ENF Procedure - Registration Conditions.

The Commissioner may impose conditions upon registrations as enforcement action.

F. Office of Administrative Hearings - Administrative Law Action.

If any person is entitled to a hearing for any enforcement action under the FIL, they shall be granted an Administrative Procedures Act hearing with the Office of Administrative Hearings.

Section 31513 (Administrative Hearing).

Whenever a person is entitled under this law to a hearing in accordance with the provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code, a formal hearing before the Department of Business Oversight[206] may be substituted with the consent of such person and of the commissioner for such hearing before an independent hearing officer; and in that case after such hearing before the Department of Business Oversight such person shall not be entitled to any further administrative remedy.

Section 31408. (Remedies May Be Granted in Administrative Action).

(a) If the Commissioner determines it is in the public interest, the Commissioner may include in any administrative action brought under this division, including a stop order, a claim for ancillary relief, including, but not limited to, a claim for rescission, restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the administrative law judge shall have jurisdiction to award additional relief. The person affected may be required to attend remedial education, as directed by the Commissioner.

[206] Effective September 29, 2020, the Department of Business Oversight changed its name to the Department of Financial Protection and Innovation (Department or DFPI). The CFIL and CSL statutes still note the former name of the Department.

(b) In an administrative action brought under this part the Commissioner is entitled to recover costs, which in the discretion of the administrative law judge may include any amount representing reasonable attorney's fees and investigative expenses for the services rendered, for deposit into the State Corporations Fund for the use of the Department of Business Oversight.

G. Civil Action

The Commissioner may institute a civil action in a California Superior Court against a subject/franchisor after exhausting all administrative actions before the Office of Administrative Hearings, and Superior Court Writ of Mandamus Appeal Division. The Commissioner may also refer matters out to the California Attorney General's Office – Civil Division for handling.

Section 31406e (Commissioner May Apply to Superior Court For A Judgement Compelling Compliance)

(e) After the exhaustion of the review procedures provided for in this section, the Commissioner may apply to the appropriate superior court for a judgment in the amount of the administrative penalty and order compelling the cited person to comply with the order of the Commissioner. The application shall include a certified copy of the final order of the Commissioner and shall constitute a sufficient showing to warrant the issuance of the judgment and order.

Section 31400 (Commissioner May Bring Cases in Superior Court TRO/PRO; Disgorgement, Ancillary Relief, Restitution; Damages).

(a) Whenever it appears to the Commissioner that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this law or any rule or order hereunder, the Commissioner may in the Commissioner's discretion bring an action, or the Commissioner may request the Attorney General to bring an action in the name of the people of the State of California, in the superior court to enjoin the acts or practices or to enforce compliance with this law or any rule or order hereunder. Upon a proper showing a permanent or preliminary injunction, restraining order or writ of mandate shall be granted and a receiver or conservator may be appointed for the defendant or the defendant's assets.

(b) If the Commissioner determines it is in the public interest, the Commissioner may include in any action authorized by subdivision (a) a claim for ancillary relief, including, but not limited to, a claim for restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the court shall have jurisdiction to award that additional relief.

Section 31400.1 (Civil Proceeding Under Section 31400 Prohibit Acting As Officer/Director).

In any proceeding under Section 31400, the court may prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated Section 31200, 31201, or 31202 from acting as an officer or director of any franchisor if the person's conduct demonstrates unfitness to serve as an officer or director of the franchisor.

Section 31300 (Civil Liability of Franchisor to Franchisee/ Notice of Violation).

Any person who offers or sells a franchise in violation of Section 31101, 31110, 31119, 31200, or 31202, or in violation of any provision of this division that provides an exemption from the provisions of Chapter 2 (commencing with Section 31110) of Part 2 or any portions of Part 2, 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, in the case of a violation of Section 31200 or 31202, the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he or she had exercised reasonable care, would not have known, of the untruth or omission.

Section 31303 (Statute of Limitations for Civil Actions ONLY for Section 31300/ NOV).

No action shall be maintained to enforce any liability created under Section 31300 unless brought before the expiration of four years after the act or transaction constituting the violation, the expiration of one year after the discovery by the plaintiff of the fact constituting the violation, or 90 days after delivery to the franchisee of a written notice disclosing any violation of Section 31110 or 31200, which notice shall be approved as to form by the Commissioner, whichever shall first expire.

- **Code of Regulations, Title 10, §310.303 NOV Form of Notice/Requirements**

  Please see Code of Regulations, Title 10, section 310.303 for form requirements, any other information regarding NOV.

Section 31301 (Civil Liability of Franchisor to Franchisee for Section 31201 Violations).

Any person who violates Section 31201 shall be liable to any person (not knowing or having cause to believe that such statement was false or misleading) who, while relying upon such statement shall have purchased a franchise, for damages, unless the defendant proves that the plaintiff knew the facts concerning the untruth or omission or that the defendant exercised reasonable care and did not know, (or if he had exercised reasonable care would not have known) of the untruth or omission.

Section 31201 (x2 Misrepresentation and Omission to Investor).

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communication not enumerated in Section 31200 which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Section 31302 (Civil Liability for Control Person/Person Giving Material Aid Section 31300 or 31301).

Every person who directly or indirectly controls a person liable under Section 31300 or 31301, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aids in the act or transaction constituting the violation, are also liable jointly and severally with and to the same extent as such person, unless the other person who is so liable had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.

Section 31302.5 (Civil Liability for Any Person who Violates Section 31220).

(a) Any person who violates Section 31220 may be sued in the superior court in the county in which the defendant resides or where a franchise affected by the violation does business, for temporary and permanent injunctive relief and for damages, if any, and the costs of suit, including reasonable attorneys' fees. A plaintiff shall not be required to allege or prove that actual damages have been suffered in order to obtain injunctive relief.

(b) No action shall be maintained to enforce any liability created under Section 31220 unless brought before the expiration of two years after the violation upon which it is based or the expiration of one year after the discovery by the plaintiff of the facts constituting such violation, whichever occurs first.

Section 31220 (Franchisor Restricts/Prohibits Free As Association Among Franchisees).

It shall be a violation of this division for any franchisor, directly or indirectly, through any officer, agent or employee, to restrict or inhibit the right of franchisees to join a trade association or to prohibit the right of free association among franchisees for any lawful purposes. Notwithstanding Section 31410, a violation of this section shall not constitute a crime.

Section 31304 (Civil Liability Statute of Limitations For Section 31201 or Section 31202).

No action shall be maintained to enforce any liability created under Section 31301 unless brought before the expiration of two years after the violation upon which it is based, expiration of one year after the discovery by the plaintiff of the facts constituting such violation, or 90 days after delivery to the franchisee of a written notice disclosing any violation of Section 31201 or 31202 which notice shall be approved as to form by the Commissioner, whichever shall first expire:

Section 31201 (x2 Misrepresentation and Omission to Investor).

It is unlawful for any person to offer or sell a franchise in this state by means of any written or oral communication not enumerated in Section 31200 which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Section 31202 (Misrepresentation and Omission Regarding Section 31101).

It is unlawful for any person willfully to make any untrue statement of a material fact in any statement required to be disclosed in writing pursuant to Section 31101, or willfully to omit to state in any such statement any material fact which is required to be stated therein.

Section 31306 (Limits to Civil Liability).

Except as explicitly provided in this chapter, no civil liability in favor of any private party shall arise against any person by implication from or as a result of the violation of any provision of this law or any rule or order hereunder. Nothing in this chapter shall limit any liability which may exist by virtue of any other statute or under common law if this law were not in effect.

Section 31405 (Civil Penalty- Not To Exceed $10,000 Per Violation).

(a) Any person who violates any provision of this law, or who violates any rule or order made under this law, shall be liable for a civil penalty not to exceed ten thousand dollars ($10,000) for each violation, which shall be assessed and recovered in a civil action brought in the name of the people of the State of California by the Commissioner in any court of competent jurisdiction.

(b) As applied to the penalties for acts in violation of this division, the remedies provided by this section and by other sections of this division are not exclusive, and may be sought and employed in any combination to enforce the provisions of this division.

(c) No action shall be maintained to enforce any liability created under subdivision (a) unless brought before the expiration of four years after the act or transaction constituting the violation.

H. Criminal Action

The Commissioner may issue a criminal referral regarding the acts of a subject/franchisor to any law enforcement agency, including, but not limited to the California Attorney General, the United States Department of Justice, and any California State District Attorney's Office. The Commissioner's Office may act as second chair in these criminal proceedings if requested by the enforcement agency:

Section 31404 (The Commissioner May Make Referrals).

The Commissioner may refer evidence that is available concerning any violation of this law or of any rule or order hereunder to the district attorney of the county in which the violation occurred, who may, with or without such a reference, institute appropriate criminal proceedings under this law. Upon request of the district attorney, the Commissioner and the counsel, deputies, or assistants of the Commissioner may assist the district attorney in presenting the law or facts at the trial.

Section 31410 (Criminal Liability for Any Person Who Violates The FIL/Fine and Imprisonment).

Any person who willfully violates any provision of this law, or who willfully violates any rule or order under this law, shall upon conviction be fined not more than one hundred thousand dollars ($100,000) or imprisoned pursuant to subdivision (h) of Section 1170 of the Penal Code, or in a county jail for not more than one year, or be punished by both that fine and imprisonment; but no person may be imprisoned for the violation of any rule or order if he or she proves that he or she had no knowledge of the rule or order.

Section 31411 (Criminal Liability for Fraudulent Scheme/Artifice).

Any person who willfully employs, directly or indirectly, any device, scheme, or artifice to defraud in connection with the offer or sale of any franchise or willfully engages, directly or indirectly, in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the offer, purchase, or sale of any franchise shall upon conviction be fined not more than one hundred thousand dollars ($100,000) or imprisoned pursuant to subdivision (h) of Section 1170 of the Penal Code, or in a county jail for not more than one year, or be punished by both that fine and imprisonment.

I. Points to Note

- **After An Investigation:**
  - The Department will contact the subject/franchisor with the Commissioner's findings and violations, if any. Settlement negotiations will then commence to resolve the matter with a Consent Order prior to the filing of a formal Department enforcement action.

- **Disclosure:**
  - Disclosure of the enforcement action, consent order, settlement agreement or other action taken for FIL violations are required to be in Item 3 of FDD.

- **Consent Orders:**
  - Used to settle a matter **<u>before</u>** formal enforcement action is filed and served and a hearing request is issued.
  - The Department is a quasi-law enforcement agency. Therefore, the Department is not able to permit many requested edits or revisions to the settlement agreement language as many provisions are required by statute and/or the Attorney General.
  - Public document, as are all other actions, settlement agreements, and other documents issued by the Department, generally. This is a requirement that may not be waived due to the Department's quasi-law enforcement agency status.
  - Will include any action and remedies, including, but not limited to a desist and refrain order, penalties, and other action that the Commissioner sees fit in the public interest to resolve the matter.
  - Disclosure in FDD is required in Item 3.

- **Settlement Agreements:**
  - Used to settle a matter **<u>after</u>** an enforcement action is filed and served and a hearing request is issued.
  - Same as above.

- **Pending Franchise Registrations/Renewals:**

  The Commissioner is not able to approve any pending franchise applications or amendments until all enforcement investigations, matters, and issues relating to the filing franchisor are resolved to the Commissioner's satisfaction.

- **Case Handling:**
  - Prompt and attentive communication is highly recommended when dealing with the Commissioner's Office and counsel. Please return emails, requests for information or responses issued by the Department promptly.
  - Please be mindful of deadlines imposed by the Commissioner.
  - Please attempt to resolve the matter quickly with the Department as there are many other cases that counsel must oversee.
  - Please refrain from disrespectful or inattentive behavior when dealing with the Commissioner's Office and counsel.
  - The Commissioner does not meet with subjects/franchisors with regard to enforcement matters. Any request to do so will be denied. Department Counsel is the Commissioner's representative. Therefore, any and all matters that the

subject/franchisor wish to present for the Commissioner's consideration may be brought before Department Counsel.

III. California Franchise Investment Law (FIL) Remedies

A. In General

The Commissioner may not be hampered in her right to enforce the FIL or assess penalties and remedies pursuant to the FIL. It is understood that remedies not only make the investor whole again after a transaction gone wrong, but they serve as a deterrent from the future commission of FIL violations. The Commissioner makes all enforcement and assessment of penalties and remedies in the public interest.

B. Remedies In Section 31408

The Commissioner may issue a Stop Order pursuant to section 31408 and section 31115. The Commissioner may also issue a claim for ancillary relief which includes the following:

- Rescission
- Restitution
- Disgorgement/Refund
- Damages
- Remedial Education
- Attorney's Fees
- Investigative Expenses

Section 31408 allows for the Commissioner to issue other relief not expressly stated in the section. The Commissioner has and may issue a claim for ancillary relief including the following:

- Bar Franchisor from Doing Business In California
- Administrative Fees
- Appoint a Monitor to Review Compliance
- Order the Offer of Cancellation to Franchisees

31408 (Stop Order, Claim for Ancillary Relief Including Rescission, Restitution, Disgorgement/Refund, Damages, Remedial Education, Attorney's Fees, Investigative Expenses, Administrative Fees, and Offer of Cancellation to Franchisees).

(a) If the Commissioner determines it is in the public interest, the Commissioner may include in any administrative action brought under this division, including a stop order, a claim for ancillary relief, including, but not limited to, a claim for rescission, restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the administrative law judge shall have jurisdiction to award additional relief. The person affected may be required to attend remedial education, as directed by the Commissioner.

(b) In an administrative action brought under this part the Commissioner is entitled to recover costs, which in the discretion of the administrative law judge may include any amount representing reasonable attorney's fees and investigative expenses for the services rendered, for deposit into the State Corporations Fund for the use of the Department of Business Oversight.

C. Penalties

The Commissioner may assess up to $2,500 per violation. There may be multiple violations in the same set of facts. The Commissioner is not limited in the total amount of penalties she may charge in any action. The Commissioner generally assesses $2,500 per violation as it is her discretion to do so. It is unlikely that the Commissioner will charge less than $2,500 for each FIL violations given the Department's position on rigorous investor protection. FIL violations are considered very serious violations of the law that cause substantial and material harm to investors.

At the time of payment of penalties, the Department will provide a subject/franchisor with wire transfer instructions or other payment instructions to pay penalties. Request for the installment payment of penalties are not generally granted by the Commissioner. If, in the off chance, that a subject/franchisor requests a payment plan, the subject/franchisor must provide the Department with financial statements and balance sheets to establish a financial hardship case and they are not able to pay the penalty payment in one lump sum.

Section 31406. (Penalties Up To $2,500 Per Violation).

(a) If, upon inspection or investigation, based upon a complaint or otherwise, the Commissioner has cause to believe that a person is violating any provision of this division or any rule or order promulgated pursuant to this division, the Commissioner may issue a citation to that person in writing describing with particularity the basis of the citation. Each citation may contain an order to desist and refrain and an assessment of an administrative penalty not to exceed two thousand five hundred dollars ($2,500) per violation and shall contain reference to this section, including the provisions of subdivision (c). All penalties collected under this section shall be deposited in the State Corporations Fund.

(b) The sanctions authorized under this section shall be separate from, and in addition to, all other administrative, civil, or criminal remedies.

(c) If within 60 days from the receipt of the citation, the person cited fails to notify the Commissioner that the person intends to request a hearing as described in subdivision (d), the citation shall be deemed final.

(d) Any hearing under this section shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code.

(e) After the exhaustion of the review procedures provided for in this section, the Commissioner may apply to the appropriate superior court for a judgment in the amount of the administrative penalty and order compelling the cited person to comply with the order of the Commissioner. The application shall include a certified copy of the final order of the Commissioner and shall constitute a sufficient showing to warrant the issuance of the judgment and order.

D. Factors Considered When Issuing Remedies/Penalties

The Commissioner has the ultimate discretion when assessing remedies and penalties in the public interest. The following may be considered when determining the assessment of remedies and penalties in the public interest. Please note that the following are only some of the many considerations which are all in the public interest:

- Investor Harm
- Type of Violation
- Number of Violations
- Sophistication of Injured Party
- Previous History of Enforcement Actions
- Response Time to the Department
- Age of Violations
- Self-Reporting
- Transparency of the Franchisor
- Treatment of the Franchisee by the Franchisor
- Examination Results
- Financial Stability
- Early Contact with the Department
- Investor Protection
- Franchisor's Willingness to Correct Violations/Wrongs

E. Points to Note

- Prompt and attentive communication is highly recommended when dealing with the Commissioner's Office and counsel. Please return emails, requests for information or responses issued by the Department promptly.
- Please be mindful of deadlines imposed by the Commissioner.
- The Commissioner has no limitations on the amount of penalties that may be issued in a matter, except that she may only charge up to $2,500 per violation. It is not advisable to tell the Commissioner that the Commissioner may not do the very thing that the law allows her to do, such as assessing penalties per violation.
- Disclosure of the issuance of remedies by the Department for FIL violations is required in Item 3 of FDD.