Crouching Tiger

Franchise Regulators Pounce on Franchisors

By Rochelle Spandorf

Elsewhere in this issue of *Business Law Today*, experienced members of the franchise bar have recommended that competent franchise counsel be engaged to represent the parties in franchising transactions and to advise in the ongoing operations of a franchise system. These same authors have identified the powers that franchise regulators have and their willingness to use those powers. I want to make believers of all of you, and for that reason I present this cautionary, real-life tale.

Place: California. *Time*: 2009. *White Knight*: the California Department of Corporations (DOC). *No Good-Doer*: two affiliated franchisors and their executives, Play N Trade Franchise, Inc., a video game retailer, and Yakety Yak Wireless, Inc., a retailer of cell phones, accessories, and wireless services. *Synopsis*: DOC accuses franchisors of multiple violations of California's Franchise Investment Law for not telling new franchisees that Yakety Yak and Play N Trade were affiliates and had (1) initially sold Yakety Yak franchises without registering the offering with the state; (2) been sued by a former marketing director of both companies who accused the operators of running a house of cards; (3) recently terminated three area developers; and (4) repeatedly sold franchises at discounted fees without informing later prospects about the negotiated sales, a disclosure duty peculiar to California. *Resolution*: Franchisors and their executives get the book thrown at them for seemingly technical disclosure mistakes without any showing of injury to franchisees.

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Severe Penalties

The most remarkable aspect of this real-life regulatory tale is the punishment. The compounding of multiple omissions by the same operators infecting two different franchise systems led the DOC to impose heavy fines (for which the franchisor's principals were potentially personally liable), revoke each franchisor's right to sell franchises in California, and demand that the operators offer all of their franchisees the chance to rescind their franchise agreement and receive their franchise fees and entire investment back even if the franchisee had not relied on a disclosure document suffering from all of the defects. No other federal or state enforcement case comes to mind where such a stiff penalty was meted out for disclosure violations not involving illegal earnings claims, unregistered franchise sales, or more serious allegations of fraud. The DOC's punishment could cripple the remains of these two franchise programs and thereby punish those franchisees who might prefer not just to continue operating under the brand, but see their chain grow.

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Enforcement Background and Rationale

Regardless of whether the punishment of Yakety Yak and Play N Trade fits the crime, no one should question the authority of state regulators to bust franchisors and their principals for not complying with disclosure requirements even when omissions or deficiencies involve something less than active fraud. To be inattentive to the technical rules for selling franchises is risky business.

Unlike other private consensual business arrangements, franchises are highly regulated relationships. Franchise sales in the United States are subject to federal and state regulation. Depending on where the parties reside, where they do business, or, in some states, where the offer or acceptance is directed to or from, a single franchise sale may be regulated by more than one jurisdiction.

In 1970, California was the first jurisdiction to enact a franchise sales law requiring franchisors to make detailed presale disclosures and register with a state agency before offering or selling franchises in the state. The federal law adopted eight years later regulates franchise sales in all 50 states, including wholly intrastate transactions, by requiring presale disclosure, but not registration with the federal agency. Fourteen states have franchise sales laws modeled after California's, although, overall, little regulatory uniformity exists. Besides regulating franchise sales, many states also restrict the conditions under which a franchise may be terminated or not renewed and some states dictate substantive terms for the franchise relationship. A franchisee cannot waive statutory protections even if it wants to.

Nonfranchise competitors of franchise companies operate without comparable legal constraints. Consequently, manufacturers, product suppliers, and trademark licensors will often investigate if structuring alternatives will allow them to accomplish their distribution goals without tripping the statutory definition of a franchise. Many times, though, a distribution program cannot be restructured without sacrificing critical business objectives. Ignoring franchise sales laws or taking calculated risks that the laws do not apply to a particular distribution program can backfire, as enforcement actions will attest.

Franchise sales laws are strict liability consumer protection statutes that render a franchisor's excuse for noncompliance immaterial. Violations carry significant penalties even if the franchisor's operators had no knowledge of, or intent to violate, the law. Franchise regulators can freeze assets, order restitution, issue cease-and-desist orders, ban violators from selling franchises, and recover substantial penalties without having to prove that the franchisee relied on defective disclosures. Regulators can prosecute a franchise sales violation as a felony and, just like federal securities laws, hold the franchisor's key management jointly and severally personally liable for a company's willful violations.

Additionally, franchise sales violations can give rise to civil liability for damages. Additionally, by showing that the franchisor's violation of state law was willful, an injured franchisee can rescind the franchise contract and get its entire investment back. Willfulness requires nothing more than proof that the franchise seller intended to commit the act or make the omission referred to; it does not require knowledge of the law or intent to violate the law, injure another, or acquire any advantage. Consequently, even franchisees who admit they never read the disclosure document may be able to rescind a franchise transaction. The franchisor's lawyer who drafts a defective disclosure document also may be liable to an injured franchisee, who can sue for malpractice despite the lack of an attorney-client relationship.

A Technical Minefield

Most franchisors intend to comply with federal and state disclosure and registration obligations. However, even the best-intended franchisors can easily slip up given all of the technicalities involved. Highly detailed disclosure rules require current information about a broad swath of topics ranging from background about the franchisor, its parents, and certain affiliates, to the conditions and terms of franchise fees, costs, sourcing restrictions, territorial rights, the franchisor's support obligations, franchisee statistics, and a summary of key terms in the franchise agreement. As the franchise program evolves, inconsistencies between the disclosure document and the franchisor's actual program can easily creep up, especially when company turnovers leave compliance duties to someone with little institutional memory. Franchise sales violations also may arise when disclosure documents are not furnished within statutory delivery periods, sales close after a franchisor's registration lapses, or brokers engage in discussions with prospects but are not registered as the company's franchise sales agent. An examination of a hundred different franchise transactions might very well reveal some number suffering from disclosure mistakes or other statutory infractions.

The most well-known enforcement stings and regulatory examples involve flagrant and repeated incidents of fraud, illegal earnings claims, or unregistered franchise sales. By comparison, Yakety Yak's and Play N Trade's misdeeds seem technical. Neither franchisor was found to have conned any investor into a sham deal. The DOC's orders do not identify a single franchisee who lost money because of the disclosure defects. One may even take issue with the DOC's conclusion that Yakety Yak and Play N Trade had a duty to disclose all of the information cited as material omissions.

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By describing Yakety Yak's and Play N Trade's misdeeds as "technical," I do not mean to trivialize the disclosure mistakes. Even a technical violation can deprive an investor of information essential to an investment decision. "Technical" is meant solely to distinguish the disclosure defects from the kinds of egregious violations, like illegal earnings claims made outside of the disclosure document or falsified disclosures, that typify enforcement cases.

Technical or not, as the guardian of a strict liability statute, franchise regulators need only prove a willful violation. The bar on proving willfulness is incredibly low, requiring little more than proof that the actor had a beating pulse. Regulators have total discretion to prosecute whatever type of infraction they find, technical or otherwise. Once a willful violation is shown, regulators may mete out any, or all, of the penalties identified in the franchise statute. In the case of Yakety Yak and Play N Trade, California's regulators did not have to prove a causal link between the disclosure mistakes and a franchisee's injury, the kind of showing that a private plaintiff must make to recover damages.

The Risks of Risk Taking

Whether or not the Yakety Yak and Play N Trade franchisors gave any thought to the possibility of regulatory enforcement, many franchise companies, especially start-up concepts, seldom weigh the risk of getting into hot water with franchise regulators, especially for technical disclosure mistakes. Operators may bank on cash-strapped states to conserve their limited budgets for the most egregious kinds of infractions.

Franchisors may not realize that regulatory investigations sometimes start with a complaint from a competing franchise system, unhappy franchisee, or disgruntled former employee with an axe to grind. It was the latter that apparently sparked the Yakety Yak and Play N Trade investigations. Franchise regulators also are known to go undercover at franchise trade shows to catch loose-lipped franchise sellers willing to share information constituting an unregistered earnings claim, or identify unregistered franchisors or their sales agents. Regulators surf the Internet and comb through franchise opportunity ads to scope out unregistered franchise advertising, illegal earnings claims, and unsubstantiated claims about franchise programs. Additionally, franchise regulators across the country network with each other, share information, and tip off counterparts in other jurisdictions when they discover violations or red flags.

A franchisor that succeeds in registering its franchise program in a state requiring registration earns no defense to a later challenge by the same state agency over the completeness or accuracy of its disclosure document. Both Play N Trade and Yakety Yak Wireless were registered franchisors in California when the California regulators issued their citation and orders. State franchise laws require franchisors prominently to disclaim on the first page of their franchise disclosure document that registration in the state is not an endorsement or recommendation of the franchise offer nor a guarantee that the franchise offer does not violate state law. State registration in one state is also no defense to an enforcement action by another state.

The cost of legal compliance with franchise sales laws is not trivial, particularly for a start-up franchisor that must make the investment before selling the first franchise. Plenty of franchisors cut corners. Franchise disclosure documents are public documents, making it easy for a start-up to find plenty of templates and exemplars to cut and paste from or rip off. For a nominal fee, anyone can obtain any franchise system's disclosure document through FRANdata, a franchise information service. Online packagers also advertise money-saving franchise forms, which are tempting to a franchise entrepreneur, a classic do-it-yourselfer, who may see little reason to pay for personalized and professional legal advice about how to structure the franchise relationship. Business owners who hire a nonlawyer consultant to draft and register their disclosure documents may not realize they are asking the consultant to engage in the unauthorized practice of law, which may result in the consultant's independent, direct liability to franchisees for unfair and deceptive practices. Choosing a nonlawyer to provide legal advice leaves the franchisor with nothing of legal value and substantial risk of being in regulatory noncompliance.

Compounding Risks

Retaining experienced franchise counsel, as the Yakety Yak and Play N Trade operators did, is no defense to liability. While it is franchise counsel's job to educate the client about the complexities and nuances of franchise sales laws, lawyers are not private investigators. Not infrequently, a business owner may ask his or her lawyer to shepherd the owner through the state registration process but direct the lawyer not to bother reviewing the content of the franchise disclosure document, which the client may have drafted itself or had a business consultant prepare. A client who puts blinders on his or her lawyer is not interested in education and cannot expect the lawyer who accepts representation to insulate the client from the consequences of its own willfulness.

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Because every franchise system's disclosure documents are easy to obtain and enforcement actions are not always well publicized, some within the franchise community perceive franchise disclosure and registration practice to be commodity work that any lawyer, including ambulance chasers, can handle and for which a franchisor should not need to pay much to

secure. Franchisor entrepreneurs who buy services on the cheap from inexperienced lawyers get what they pay for. For lawyers who specialize in the area, the Play N Trade and Yakety Yak enforcement actions could not supply better marketing material.

No Trivial Matter

If the Yakety Yak and Play N Trade enforcement actions have a message, it is that franchise sales laws should not be trivialized. In calculating reasonable risks to take in expanding one's business, forgoing the engagement of competent and well-informed counsel to assist in legal compliance is not one of them. Federal and state franchise agencies may be cash-strapped, but they are not closed for business. Regulators intend for their selective enforcement cases to send a jolt to the entire franchise community. Indeed, pending federal legislation would strengthen the FTC's authority to prosecute unfair and deceptive practices and, if enacted, would result in the FTC's most significant expansion since the agency's inception. A reinvigorated FTC might portend a new day for franchise sales enforcement activity.

Conclusion

Franchisors who walk the tightrope between business expansion and legal compliance without a safety net court disaster. A franchise lawyer well versed in the technicalities of franchise sales regulations and trusted with full disclosure by the client is the net that permits the act to go on, the performance to be executed with style. Just as a cited driver cannot squirm his way out of a speeding ticket by claiming to be traveling no faster than the rest of traffic, a franchisor that gets pulled over by franchise regulators receives no leniency by identifying other franchisors equally guilty of similar disclosure mistakes. Starting and running a franchise is risky enough; compounding business risks with legal ones by not hiring knowledgeable franchise counsel is foolish. Clients need only be reminded of the real-life tale in California and, in that same vein, the message in the Coasters' golden oldie with the same Yakety Yak name:

> If you don't scrub that kitchen floor
> You ain't gonna rock and roll no more
> Yakety yak (don't talk back).