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Forum on Franchising**

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**Keeping the Enforcers at Bay – Handling an FTC or  
State Franchise Investigation**

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## I. INTRODUCTION

The process by which the Federal Trade Commission (the "FTC" or "Commission") and comparable state authorities evaluate, commence and undertake an investigation of a franchisor's alleged wrongdoing is the subject of much speculation and misperception. The purpose of this article is to shed some light on the process and provide constructive suggestions on what to do if your franchisor client is the subject of an investigation or your franchisee client believes that its franchisor violated the Federal Trade Commission Act (the "Act" or "FTC Act") or a state equivalent.<sup>1</sup>

## II. FTC INVESTIGATIONS<sup>2</sup>

### A. Section 5 of the FTC Act / FTC Franchise Rule

The FTC was created in 1915 pursuant to the FTC Act, 15 U.S.C. §§ 41 *et seq.* The Commission is responsible for administering a number of statutes that are generally intended to promote fair competition and protect the public from "unfair and deceptive acts or practices" in or affecting the advertising and marketing of goods and services. Unfair and deceptive acts or practices are deemed "unlawful" pursuant to Section 5(a)(1) of the FTC Act (15 U.S.C. § 45(a)(1)) and, in appropriate circumstances, may give rise to equitable remedies, consumer redress and/or civil penalties. *See* 15 U.S.C. § 45(m) -- civil penalties; § 53(b) -- equitable relief, including a permanent injunction and ancillary remedies (e.g., monetary damages); and § 57b(b) -- consumer redress, including rescission and restitution.

The Commission is comprised of a number of units, including the Bureau of Consumer Protection which is responsible for, among other things, investigating and prosecuting franchisors for potential violations of Section 5 of the FTC Act. Pursuant to the authority granted to it under the FTC Act, the Commission has promulgated a number of trade regulation rules, including the FTC Franchise Rule (16 C.F.R. § 436.1, "the Franchise Rule" or "the Rule").<sup>3</sup> The Franchise Rule governs pre sale disclosures by a franchisor and prohibits a franchisor from making an earnings claim unless it is (i) set forth in its disclosure document or Uniform Franchise Offering Circular, and

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<sup>1</sup> This article represents the collective views and opinions of the authors, and does not in any way represent the opinions of the Federal Trade Commission or any individual Commissioner, the office of the Attorney General of Maryland, the North American Securities Administrators Association, Inc., or Bartko, Zankel, Tarrant & Miller.

<sup>2</sup> This article includes excerpts from and expands on a previously published article regarding issues confronting a franchisor when it is the target of an FTC investigation. *See* C. Towle, *Representing a Franchisor in an FTC Investigation*, 16 Franchisor L.J., Spring 1996.

<sup>3</sup> These trade regulation rules are found in the first volume of Title 16 of the Code of Federal Regulations. *See* 16 C.F.R. §§ 0-999.

(ii) "substantiated." See 16 C.F.R. § 436.1(b)-(e). A violation of the Franchise Rule is a *per se* violation of Section 5 of the FTC Act. See 15 U.S.C. § 57a(d)(3).

The trade regulation rules found in Title 16 of the Code of Federal Regulations and various provisions of the FTC Act set forth the general policies and procedures which guide the Bureau of Consumer Protection in its investigation and prosecution of franchisors. Additional guidance is provided by the FTC Operating Manual.<sup>4</sup>

## **B. Why, How and When?**

Franchisors, franchisees and lawyers alike often ask why, how and when does the FTC initiate an investigation of the business practices of a franchisor. An investigation may be commenced for any number of reasons, including complaints from current/former franchisees or employees of the franchisor, or upon the request of a governmental agency (federal or state), the Attorney General's office, Congress or the President. The Commission may also commence an investigation on its own initiative. In addition to targeted investigations, the FTC may -- and periodically does -- undertake industry-wide investigations.

Historically, there were two levels to an FTC investigation -- an "initial phase" and, if warranted, a "full phase." As a matter of practice, however, the Commission has done away with the distinction.

Decisions to initiate an investigation of a franchisor are typically made at the Division level, with the filing of a Matter Initiation Notice, which is approved by the Associate Director of the Division of Marketing Practices. Among other things, the notice identifies the franchisor to be investigated, as well as the potential law violation.<sup>5</sup> The overriding consideration in determining whether to open an investigation is whether the alleged wrongdoing falls within the Commission's jurisdiction and, assuming that it does, whether pursuing the matter would be in the public interest.

Not every complaint submitted to the Commission involves an alleged violation of the FTC Act or the Franchise Rule. For example, franchisee complainants often raise issues such as the failure of the franchisor to register in a particular state, or the interpretation of a specific agreement term or condition. Similarly, other complainants

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<sup>4</sup> The Operating Manual is in the process of being substantively revised. At this time, there is no expected completion date.

<sup>5</sup> Industry-wide investigations and investigations involving First Amendment issues (such as an investigation of a publisher) must be approved by the Commission.

express dissatisfaction with franchise purchase and seek to cancel the franchise agreement or to obtain a refund.<sup>6</sup> These types of complaints fell outside the FTC's purview.

Once it is decided that a complaint or other information presented to the Commission raises a potential violation of the FTC Act and/or Franchise Rule, the Commission staff must then determine whether an investigation would be in the public interest. In making this determination, the FTC staff may consider, among other things, (i) the subject matter of the complaint; (ii) whether the subject matter of the complaint appears to be an isolated event or part of a pattern or practice; (iii) the potential level of injury; and (iv) whether there is likely to be a meaningful remedy.<sup>7</sup>

In determining whether to initiate an investigation, the FTC staff will, of course, consider the subject matter of the complaint. Because FTC investigations are nonpublic, the Franchise Program Review does not provide any statistical data on the type of alleged wrongdoing that is most likely to lead to an investigation. However, certain inferences can be drawn about what type of conduct the FTC is most likely to investigate based on the allegations made in enforcement actions. As part of the Franchise Program Review, the Commission staff analyzed allegations raised in both franchise and business opportunity law enforcement actions. The most common Rule violation allegation (127 allegations) was the making of earnings claims without substantiation or without providing the required earnings claims document (*i.e.*, a violation of Item 19).<sup>8</sup> The failure to provide any disclosure document was the second most common, with 113 complaint allegations. Where a disclosure document was furnished, the most common deficiency was the failure to disclose complete and accurate franchisee statistical or background information (11 allegations), followed up by the failure to disclose complete and accurate litigation history (6 allegations).<sup>9</sup>

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<sup>6</sup> See generally Franchise and Business Opportunity Program Review 1993-2000: A Review of Complaint Data, Law Enforcement and Consumer Education (June 2001) ("Franchise Program Review"). A copy of the Franchise Program Review is attached to this article and is also available on the FTC's website ([www.ftc.gov](http://www.ftc.gov)). Among other things, the Franchise Program Review reveals that there were many instances where complainants either did not state a specific allegation or made allegations that did not violate any law enforced by the Commission. For example, 37 franchise complaints submitted to the Commission contained no specific allegation; 11 complaints raised state law (and not FTC) issues; 14 complaints alleged contractual issues; and 39 complaints sought cancellation of the franchise agreement. See Franchise Program Review at p. 43.

<sup>7</sup> The Commission's Sentinel database, as discussed below in section III(B), is an increasingly important source of data that is considered by the FTC in determining whether to initiate an investigation.

<sup>8</sup> See Franchise Program Review at p. 38.

<sup>9</sup> *Id.*

For law enforcement actions filed under Section 5 of the FTC Act, the making of false earnings claims generated 94 allegations.<sup>10</sup> This was by far the most common Section 5 allegation. The next most prevalent false or deceptive representation pertained to testimonials and references (28 allegations), followed by profitability and availability of locations for vending machines or other devices (24 allegations) and support and assistance claims (17 allegations).<sup>11</sup>

Because the Commission is charged with acting in the public interest, it typically looks for patterns or practices of violations of the FTC Act and/or Franchise Rule. As a matter of policy, the Commission does not represent individual consumers. While a number of franchisee complaints regarding a particular franchisor is likely to draw the Commission's attention, a single, well-documented complaint setting forth a pattern of Rule violations, for example, may suffice to trigger an investigation. The Franchise Program Review reveals that the Commission opened an investigation regarding every franchisor that was the subject of at least five complaints. No franchisor received more than eight complaints. The staff opened an additional 11 investigations in which the franchisor was the subject of four or fewer complaints, including eight investigations of companies with only one complaint.<sup>12</sup>

The number of complaints and the level of injury will also guide the Commission staff in determining whether to initiate an investigation. The Franchise Program Review shows that 30% of business opportunity and franchise complainants allegedly suffered injuries of less than \$1,000, while 5% allegedly suffered injuries of \$20,000 or more. The most frequent level of reported injury was between \$2,500 and \$20,000, making up more than 50% of the known total.<sup>13</sup>

The FTC staff also considers whether there is likely to be any meaningful remedy as a result of the investigation. Specifically, the staff may consider whether the franchisor has gone out of business, or whether the franchisor is likely to have assets with which to pay consumer redress or a civil penalty.

Finally, the staff may take into account other practical considerations in deciding whether an investigation is warranted. These may include whether the alleged law violation is within the applicable statute of limitations; whether franchisees are able to

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<sup>10</sup> *Id.* at p. 39.

<sup>11</sup> *Id.*

<sup>12</sup> See Franchise Program Review at p. 42. The FTC staff also noted that 74% of the complaints it analyzed represented a single, isolated complaint against a company. Less than 6% of the companies analyzed were the subject of six or more complaints. *Id.* at p. 13.

<sup>13</sup> See Franchise Program Review at p. 15. For franchises specifically, the \$2,500 to \$20,000 range of injury is predominant, but there are more instances of injury exceeding \$20,000 than reported for business opportunities. *Id.* at p. 16.

resolve their dispute through state common law, fraud, misrepresentation, or breach of contract actions; and whether the same matter is being pursued by other law enforcement agencies.

### C. The Investigational Process/Procedures

Like most government investigations, FTC investigations are nonpublic. *See* 15 U.S.C. § 57b-2(f); 16 C.F.R. §§ 4.9, 4.10 and 4.11. Thus, the FTC may not reveal to the public that a particular franchisor is the subject of an ongoing investigation.<sup>14</sup> Nor, with certain limited exceptions, may the Commission disclose the identity of any person who provides information to the FTC before or during an investigation without the permission of such person. 5 U.S.C. § 552(b)(7)(D); 16 C.F.R. § 2.2(d). Accordingly, the identity of a complaining party (*e.g.*, a franchisee) will not be disclosed to a franchisor under investigation. One exception to the confidentiality of an FTC investigation is a request for information or documents from a committee or subcommittee of Congress. 15 U.S.C. § 57b-2(b)(3)(C); 5 U.S.C. § 552(d). In addition, in the event an action in a United States district court is commenced -- or in the unlikely event that an administrative action is commenced -- some, but not all, of the information gathered by the FTC during an investigation may be obtained by the defendant(s) through discovery or otherwise disclosed in connection with such proceedings.

Having made the decision to initiate an investigation, the Commission may undertake to gather information by so-called "non-compulsory" and/or "compulsory" procedures. The "non-compulsory" investigational procedures -- to the extent they are utilized to affirmatively obtain information from a party under investigation or a potential witness -- are, as the name suggests, voluntary. The "compulsory" investigational procedures are, on the other hand, mandatory and may be enforced in federal court.

#### 1. *Non-Compulsory Procedures*

The FTC has available to it a variety of "non-compulsory" investigational procedures, including (i) a letter to the franchisor requesting that it voluntarily provide the Commission with documents, materials and information regarding various aspects of the franchisor's operations (*a.k.a.* as an "access letter"); (ii) informal or formal surveys or questionnaires sent to prospective, current or former franchisees, and/or other persons; (iii) interviewing persons with knowledge of the areas of the franchisor's business that are being investigated; or (iv) "shops" of the franchisor's trade show presentations or other "sting" operations.

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<sup>14</sup> The Commission may publicize that it is conducting an industry-wide investigation. However, the identity of the individual industry members being investigated generally remains nonpublic.



a. Access Letters

Typically, a franchisor discovers that it is the subject of an FTC investigation by receiving an access letter. In such cases, the Commission is required to include in the access letter a statement notifying the entity and/or person(s) under investigation of the "purpose and scope" of the investigation, as well as the general nature of the "conduct constituting the alleged violation which is under investigation and the provision of law applicable to such violation." 16 C.F.R. § 2.6. For better or worse, the "notice" that must be provided by the FTC may not be particularly illuminating. For example, the access letter may simply indicate that the purpose of the Commission's inquiry is to determine whether or not the franchisor and one or more of its employees has engaged in "unfair or deceptive acts or practices" in connection with the sale of franchises. Given that a broad spectrum of conduct rises to the level of an "unfair or deceptive act or practice" within the meaning of Section 5 of the FTC Act -- including a violation of any of the provisions of the Franchise Rule -- this provides little meaningful information to the franchisor. In certain instances, the nature of the documents and information being sought by the Commission may shed some light on the principal focus of the investigation. However, in the event the FTC is seeking documents and information on a number of subjects, it may be difficult to discern what really is at issue. Needless to say, this makes it extremely difficult for a franchisor to either assess its potential exposure or develop a strategy for dealing with the investigation.

After receiving an access letter, one of the first issues that a franchisor will need to grapple with is whether it must or should disclose in its Uniform Franchise Offering Circular the fact that it is the subject of an investigation by the Commission. This issue is potentially more complicated than it might seem at first blush. Neither the Franchise Rule nor the Uniform Franchise Offering Circular Guidelines adopted by the North American Securities Administrators Association ("NASAA") require that a franchisor disclose that it is the subject of a FTC investigation. A compelling case can be made that a franchisor is under no obligation to disclose the fact that it is the subject of an FTC investigation. For example, depending on the stage of the investigation, the franchisor may not know what specific "act(s)" or "practice(s)" are being investigated. Alternatively, the franchisor may simply be part of an industry-wide investigation and the FTC has no evidence or even complaints of wrongdoing by the franchisor. Nonetheless, an attorney representing a franchisee may argue that the existence of an FTC investigation is "material" and that the franchisor was obligated to disclose the pendency of such an

investigation during the pre-sale process under the common law or “antifraud” provisions contained in a state’s franchise laws.<sup>15</sup>

The franchisor is not required to provide information to the FTC in response to an access letter. That being said, it is difficult to think of any legitimate reason not to cooperate with the FTC’s investigation. A refusal to cooperate or respond to an access letter is simply inviting heightened scrutiny and will likely cause the Commission to seek documents, information, etc., through one or more of the available compulsory procedures. However, in the event the FTC is seeking a large number of documents regarding a variety of subjects, the franchisor should consider seeking to narrow the scope of the documents and information it is being asked to provide. In addition, the franchisor may also want to ask for additional time in which to produce the requested materials. If the documents requested by the FTC are particularly voluminous or the FTC is gathering information as part of an industry-wide investigation, the franchisor should also consider requesting that it be reimbursed for all or part of its copying costs.

#### b. Questionnaires and Surveys

Although not as common as access letters, the FTC regularly utilizes questionnaires and/or surveys to gather information as part of an investigation. The information sought by way of a questionnaire is typically general in nature (*e.g.*, background). Questionnaires may be sent to (i) potential respondents (*e.g.*, a franchisor under investigation); (ii) prospective, current or former franchisees; and/or (iii) prospective witnesses, competitors and/or customers. Surveys, on the other hand, are typically sent to current or former franchisees and are more likely to be used to develop evidence for use in litigation. As such, it is important that the survey be prepared and undertaken in accordance with generally accepted survey techniques.

During the pendency of an investigation, the questionnaire and survey results obtained by the Commission are nonpublic and, thus, not available to the franchisor. *See* 15 U.S.C. § 57b-2(f); 16 C.F.R. § 410(a)(8). However, should the FTC initiate an

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<sup>15</sup> *See, e.g.*, Cal. Corp. Code § 31201 (“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 . . . omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”); N.Y. Gen. Bus. Law § 687.2 (“It is unlawful for a person, in connection with the offer, sale or purchase of any franchise, to directly or indirectly . . . omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”).

enforcement action, such documents should be discoverable in the event the Commission seeks to rely on them in meeting their evidentiary burden.<sup>16</sup>

#### c. Interviews

As in any investigation, the FTC regularly conducts interviews of potential witnesses as part of an investigation of a franchisor. There are no set procedures for when or how such interviews may be conducted. However, it is the policy of the Commission that any interview be memorialized in a written report summarizing the interview.

Interview reports, like questionnaires and survey results, are also nonpublic. Furthermore, even if the FTC has initiated an enforcement action, interview reports are generally immune to discovery pursuant to the work product privilege. However, the work product privilege is qualified and may, in certain circumstances, be overridden by the respondent's demonstrated "need" for the information set forth therein.

#### d. Trade Show "Shops" and Other "Sting" Operations

Additionally, the Commission may -- on its own or in conjunction with other federal or state governmental organizations -- "shop" a particular franchisor or conduct a "sweep" if the franchisor falls within an industry that is the subject of an investigation. In these situations, an FTC investigator or attorney may pose as a prospective franchisee and attempt to determine if a franchisor is, for example, making impermissible earnings claims or otherwise violating Section 5 of the FTC Act or the Franchise Rule. These "shops" and "sting" operations are often taped. The Commission staff may also review trade show promotions, newspaper advertisements, as well as surf franchisor websites.

### 2. *Compulsory Procedures*

In addition, or as an alternative, to the voluntary means of gathering information in connection with a pending investigation, the FTC may also resort to so-called "compulsory" procedures. However, prior to resorting to compulsory process, the Commission must first authorize such procedure by an investigational resolution. 16 C.F.R. § 2.7(a). The resolution may take the form of (i) a special resolution authorizing an investigation into the acts or practices of a particular entity(ies) and/or individual(s); (ii) an omnibus resolution providing for an industry-wide investigation to ascertain whether corrective enforcement proceedings by the FTC are warranted; or (iii) a blanket resolution directed at the investigation of certain types of practices in

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<sup>16</sup> For example, in order to obtain injunctive relief based on a franchisor's oral and unsubstantiated earnings claims, the FTC must affirmatively establish that such claims were "widely disseminated." The Commission may attempt to meet its burden, in whole or part, by the results of a survey. In such event, the franchisor should be permitted to discover the completed surveys.

general -- *e.g.*, a general investigation of unfair or deceptive acts or practices in violation of Section 5 of the FTC Act (rather than of a particular entity or industry).

The only type of compulsory process available in an investigation regarding potential violations of Section 5 of the FTC Act by a franchisor -- *i.e.*, unfair or deceptive acts or practices on the part of a franchisor -- are civil investigative demands ("CID"). 15 U.S.C. § 57b-1(b); 16 C.F.R. § 2.7(b).<sup>17</sup> The authority to issue an investigational CID rests with the Commission or a Commissioner and cannot be delegated to, for example, a Regional Director or even the Director of the Bureau of Consumer Protection. 16 C.F.R. § 2.7(a). There are four types of CIDs: (i) a request for production of documents; (ii) a request for production of tangible things; (iii) written reports or answers to questions (*i.e.*, interrogatories); or (iv) the giving of oral testimony (*i.e.*, a deposition). *Id.* The CID must specifically state the "nature of the conduct constituting the alleged violation which is under investigation and the provision of law applicable to such violation." 15 U.S.C. § 57b-1(c)(2).

The receipt of an investigational CID raises several important issues that a franchisor should consider. In the event the franchisor has already voluntarily provided information to the Commission, it is reasonable to conclude that the FTC believes that it has discovered at least some evidence of wrongdoing on the part of the franchisor and, more importantly, believes that any harm to the public caused by such wrongdoing is sufficiently egregious so as to warrant a more comprehensive investigation. If the franchisor or its counsel has not previously done so, this is the time to engage in a serious discussion with the FTC attorney responsible for the investigation. If possible, the franchisor should attempt to learn what specific acts or practices are being investigated and what, if any, concrete evidence of wrongdoing the Commission has discovered. Although this may seem both relatively obvious and only fair, the FTC is not required to disclose this information to a franchisor. In the appropriate circumstances, the franchisor may also want to consider broaching the subject of settlement by way of a negotiated cease and desist order (if warranted) and/or consent agreement.

In addition, the franchisor must decide whether it wishes to challenge the CID. In the event the franchisor believes that the CID is burdensome or overbroad, it should first attempt to narrow the scope of the information it is being required to provide and/or extend the time it has in which it must produce documents or respond to the questions. If these efforts are unsuccessful, the franchisor may elect to petition to limit or quash the CID. *See* 15 U.S.C. § 57b-1(f); 16 C.F.R. § 2.7(d).

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<sup>17</sup> The other compulsory procedures available to the FTC -- (i) subpoenas; (ii) access orders, and (iii) so-called special Section 6b FTC Act reports -- cannot be used in investigations involving alleged unfair or deceptive acts or practices.

15 U.S.C. § 57b-1(b); 16 C.F.R. §§ 2.7(b), 2.11(a) and 2.12(a). The FTC can also hold investigational hearings. 16 C.F.R. § 2.8. However, such hearings are rarely, if ever, conducted.

A petition to limit or quash a CID must be filed with the Secretary of the Commission within 20 days after service of the CID.<sup>18</sup> Similar to a motion for a protective order, the petition must set forth the factual and legal reasons why the CID should be limited or quashed, as well as a statement by counsel confirming that he/she conferred with counsel for the Commission in a good faith effort to resolve the dispute. Provided that the petition was filed in a timely manner, the time for complying with the portion of the CID is stayed pending a ruling on the petition. 15 U.S.C. § 57b-1(f)(2); 16 C.F.R. § 2.7(e). An individual Commissioner is designated by the Commission to consider petitions to limit or quash CIDs and will rule on the matter unless he/she refers the petition to the full Commission for determination. One downside to seeking to limit or quash a CID is that the petition is part of the public record. The franchisor's right to appeal the designated Commissioner's decision is restricted to asking the full Commission to review the ruling.

Should a franchisor fail to comply with the CID, the Commission may petition a district court of the United States for an order that the CID be enforced. 15 U.S.C. § 57b-1(e). If the district court orders that the franchisor comply with the CID and the franchisor fails or refuses to do so, the Commission may initiate a civil contempt proceeding. 16 C.F.R. § 2.13(b)(4). The franchisor is also subject to criminal prosecution. 15 U.S.C. § 50.

The procedural and substantive rules regarding a CID are, for all intents and purposes, virtually identical to those governing discovery in civil litigation. For example, each CID for the production of documents or answers to questions must be sufficiently definite and certain so that it is clear what information is being requested. 16 C.F.R. § 2.7(b). Similarly, the responding party must confirm in writing and under oath that all applicable information in its possession, custody, control or knowledge is being submitted in response to each CID. *See* 15 U.S.C. §§ 57b-1(c)(11), (12) and (13); 16 C.F.R. § 2.7(b). However, in appropriate circumstances, the franchisor may withhold documents or information on the basis of a privilege. 16 C.F.R. § 2.8A. In such case, the franchisor must provide the Commission with a privilege log. The Commission is required to pay for the reasonable cost of copying any documents being produced pursuant to a CID, but it is not required to pay for the cost of searching for and gathering the documents. Any person required to appear pursuant to a CID for the giving of oral testimony may be represented and advised by an attorney. As in a deposition, the attorney may object to questions and instruct his or her client not to answer any question on the grounds of privilege. However, notwithstanding a refusal to answer a question on the grounds of self-incrimination, a person *may* be compelled to provide such testimony under a grant of immunity pursuant to 18 U.S.C. § 6004. *See* 15 U.S.C. § 57b-1(c)(14)(D)(iii); 16 C.F.R. § 4.16.

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<sup>18</sup> The Commission may, but is not required to, consider requests for an extension of time in which the petition must be filed. 16 C.F.R. § 2.7(d)(3).

## D. Disposition of Investigations

After having obtained whatever information it deems necessary, the Commission may dispose of an investigation in one of several ways. If an investigation reveals that the franchisor has not violated Section 5 of the FTC Act or the Franchise Rule, or for other good reason(s), the investigation will be closed. Ordinarily, the Associate Director of the Division of Marketing Practices (or Regional Office Director) has the authority to close an investigation, unless the investigation was originally authorized by the Commission or compulsory process was authorized. In such cases, the Commission must authorize the closing of an investigation. Once a determination has been made to cease an investigation, the staff may, but are not required to, send a letter to the franchisor under investigation advising it of this fact. Unlike the information gathered in connection with the investigation, the "closing" letter is part of the public record. *See* 16 C.F.R. § 4.9(b)(4)(ii). In some cases, an investigation may be closed despite some evidence of a technical violation of the Franchise Rule or other wrongdoing. For example, an investigation may be closed because the cost of continuing the investigation is prohibitive, other investigations are of a higher priority, or the practice being investigated has been discontinued.

In the event the investigation establishes that there has been one or more violations of Section 5 and/or the Franchise Rule *and* the Commission believes that corrective action is appropriate, the FTC may either: (i) offer the franchisor an opportunity to enter into a consent order agreement;<sup>19</sup> (ii) refer the franchisor to the Alternative Rule Enforcement Program administered by the National Franchise Council ("NFC"); (iii) initiate adjudicative proceedings before an Administrative Law Judge;<sup>20</sup> or (iv) file a complaint in a United States district court seeking civil penalties, injunctive relief and/or consumer redress.<sup>21</sup> Where a franchisor has been notified of an investigation through an access letter, FTC staff will almost always provide the franchisor with an opportunity to enter into a consent order agreement before recommending to the Commission that it commence an adjudicative proceeding or an action in the district court. 16 C.F.R. § 2.31; *see also* 5 U.S.C. 554(c).

### 1. Consent Order Agreement

As a practical matter, if an investigation discloses that there is merit to the Commission's allegations of wrongdoing, a franchisor should generally attempt to resolve the matter by entering into a consent order agreement. This course of action usually makes business sense and is consistent with the Commission's policy to secure compliance with Section 5 and/or the Franchise Rule by a consent order agreement whenever possible. 16 C.F.R. § 2.31. One drawback, however, to entering into a consent

<sup>19</sup> *See generally* 16 C.F.R. §§ 2.31-2.34.

<sup>20</sup> *See generally* 16 C.F.R. §§ 3.1-3.83. The Commission rarely commences an adjudicative proceeding before an Administrative Law Judge.

<sup>21</sup> *See generally* 15 U.S.C. §§ 45(m), 53(b) and 57b(b).

order agreement is that it is a matter of public record and must be disclosed in the Uniform Franchise Offering Circular. *See generally* 16 C.F.R. § 2.34. Nonetheless, as a general rule, the benefits of quickly resolving a matter by agreeing to a consent order far outweigh the disadvantages.

The procedure by which a consent order agreement is finalized differs depending on whether the matter is in the investigatory stage or in an adjudicative posture (*i.e.*, after the Commission has voted to issue a complaint or a complaint has been issued). *See* 16 C.F.R. §§ 2.31-2.34; 3.25. The following discussion addresses the procedure by which a consent order agreement is entered into while an investigation is pending. The procedures for entering into a consent order agreement *after* an adjudicative proceeding has been commenced can be found in 16 C.F.R. § 3.25.

At any time during an investigation, a franchisor may elect to submit an executed consent order agreement to the Commission containing certain enumerated items. 16 C.F.R. §§ 2.31 and 2.32. Because it may not always be clear what specific acts/practices the FTC is particularly interested in or what evidence of wrongdoing the Commission has discovered, the better practice is to indicate a general willingness to enter into settlement discussions and invite the Commission to prepare a proposed consent order agreement in the appropriate form.

A consent order agreement will typically include, among other things, (i) a preamble identifying the parties to the agreement; (ii) a recital regarding jurisdiction (*i.e.*, XYZ corporation is involved in the sale of franchises “in or affecting commerce”); (iii) a requirement that an individual signing the agreement notify the Commission of any change of business or employment; (iv) a requirement that any corporation signing the agreement notify the FTC of a change in corporate structure; (v) specific procedures and timing for compliance with the agreement; and (vi) procedures for distribution of the agreement. 16 C.F.R. § 2.32. In addition, the agreement will usually identify specific practices that the franchisor has agreed to discontinue (*e.g.*, making oral and unsubstantiated representations as to the profitability of its franchisees) and may, in the Commission’s discretion, be accompanied by a report signed by the franchisor (and/or individual) setting forth in detail the manner in which it has ceased the offending activity (*e.g.*, distributing allegedly misleading advertising) or will comply with the consent order if entered. 16 C.F.R. § 2.33.

A number of other items may also be included in the consent order agreement. For example, the agreement may provide for the payment of money to the Commission. If possible, the franchisor should negotiate for the inclusion of a provision to the effect that it has entered into the agreement “for settlement purposes only” and that by signing the agreement the franchisor is not admitting that it has violated any laws. 16 C.F.R. § 2.32. In some instances, the consent order agreement may also expressly reserve the Commission’s right to seek consumer redress.

A consent order agreement entered into by the FTC staff is *not* binding on the Commission until it has been accepted by the full Commission. 16 C.F.R. § 2.34. After

receiving a proposed consent order agreement, the Commission may (i) either accept the agreement as is; (ii) condition its acceptance upon certain revisions to the agreement; (iii) return the agreement to the FTC staff with directions that they enter into further negotiations with the franchisor; (iv) reject the agreement and issue a complaint; or (v) close the investigation.

In the event the Commission accepts the agreement, it is placed on the public record for comment for a period of 30 days or such other period as the Commission deems appropriate. 16 C.F.R. § 2.34(c) and (d). In addition to the agreement, a proposed complaint (which is attached to and incorporated into the consent order agreement), an analysis regarding the investigation (the purpose of which is to advise the public of the nature of the alleged violations, the results of the investigation and the implications of the consent order agreement), a news release, and, if applicable, an initial compliance report are also made part of the public record. *Id.* During the comment period, any member of the public may submit written comments to the Commission regarding the consent order agreement. At the conclusion of this period, the FTC staff submits a memorandum to the Commission advising it of the nature of any comments made by the public, as well as a recommendation to accept, modify or reject the agreement. The Commission may then (i) withdraw its acceptance of the agreement; (ii) issue a decision and order, which includes the terms of the consent order agreement; or (iii) decide that the decision and order should be modified. 16 C.F.R. § 2.34(e). In the event the franchisor does not consent to the proposed modification, the Commission may initiate a proceeding pursuant to 16 C.F.R. § 2.51 to re-open and modify the decision and order. *Id.*

## 2. *NFC Alternative Rule Enforcement Program*

In 1998, the Commission adopted on a trial basis the NFC's Alternative Rule Enforcement Program ("the Program"). As a result, in the event an investigation has revealed "lesser" violations of the Franchise Rule (*i.e.*, not involving fraud), the FTC *may* offer a franchisor the opportunity to participate in the Program as an alternative to an enforcement action.<sup>22</sup> If the franchisor elects to participate in the Program, it will not be required to enter into a consent order agreement. This, of course, is an obvious benefit to the franchisor. To date, the FTC has referred nine franchisors to the Program.

The Program consists of compliance training and *may* also include monitoring of the franchisor's disclosure documents and/or advertising. The compliance training is administered on site using the NFC's Franchise Disclosure Law Compliance Manual and includes, among other things, a review of (i) the law governing franchising and the sale of franchises; (ii) the Franchise Rule and applicable state laws; and (iii) requirements and restrictions regarding the franchise sales process. The onsite compliance training typically lasts one day and currently costs \$2,500. If additional training is necessary, the franchisor must pay a fee of \$500 per additional day of training.

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<sup>22</sup> Additional information regarding the Alternative Rule Enforcement Program can be found at the NFC's website -- [www.nationalfranchisecouncil.org](http://www.nationalfranchisecouncil.org).



In addition to the onsite compliance training, the FTC may, at its discretion, direct the NFC to monitor the franchisor's disclosure documents and advertising materials. If the franchisor fails to make required changes to the disclosure documents and/or advertising materials or otherwise violates the Franchise Rule, the NFC is required to so advise the Commission.

As a condition of a referral to the Program, the FTC may also require that the franchisor notify potentially affected franchisees that it may have violated the Franchise Rule, and is willing to negotiate and/or mediate with any franchisee who files a claim with the CPR Institute for Dispute Resolution ("CPR") alleging that he/she suffered damages as a result of such violation(s).

The negotiations and, if necessary, mediations are conducted in accordance with the procedures of the National Franchise Mediation Program and are independently administered by the CPR. Franchisors will receive notice from the CPR of any franchisees who claim that they have suffered damages as a result of the franchisor's potential failure to comply with the Franchise Rule. A franchisor that is unable to negotiate a resolution with the franchisee(s) will then be required to mediate with such franchisee(s).

An administrative fee of \$1,500 will be charged by CPR in connection with any mediation. In addition to this administrative fee, the mediator selected by the parties will charge an hourly or daily fee. Although the costs of the mediation are typically split equally between the franchisor and the franchisee(s), the FTC may require that the franchisor pay for more than 50% of the cost of the mediation as a condition of the referral to the Program.

The identity of the franchisors and individuals that participate in the Program are not made public by the NFC or the Commission. However, a Freedom of Information Act request filed with the FTC may lead to the release of information on the participants.

### *3. Commencement of an Enforcement Action*

The decision to file a lawsuit in the United States District Court seeking civil penalties, injunctive relief and/or consumer redress is made by the Commission pursuant to a resolution. In deciding whether to file a lawsuit, the Commission considers a number of factors, including: (i) the nature and duration of the alleged violations of Section 5 and/or the Franchise Rule; (ii) the type and degree of injury caused by the alleged wrongful practices; (iii) whether the practices are continuing or, if not, whether such practices are likely to be resumed; (iv) the proposed respondent's ability to pay consumer redress and/or civil penalties; and (v) the likelihood of prevailing. The vast majority of the complaints filed by the Commission against a franchisor involve improper earnings claims (*i.e.*, either the earnings claims were unsubstantiated/false or the franchisor failed

to provide the required disclosure documents) or a failure to provide the required disclosure documents.<sup>23</sup>

### III. HANDLING A STATE FRANCHISE INVESTIGATION

Each state with franchise enforcement authority has the ability to investigate franchisors that do business in the state. The structure and staffing of the state franchise agencies are very different, but each handles investigations and enforcement actions in much the same way. Although franchisors rarely expect to find themselves the subject of a state investigation, they should nevertheless be prepared for that possibility. Franchisors who are familiar with how state authorities investigate potential franchise law violations invariably fare better in the resolution of an enforcement action than those franchisors who are not prepared. This portion of the article discusses how and why states open a franchise investigation, how an investigation evolves into a formal law enforcement action, and how states resolve those enforcement actions. It also discusses the circumstances under which franchisees and their counsel should consider turning to state authorities for assistance, and offers some predictions about how states may investigate franchise law violations in the future.

The sources for the information set forth below include state franchise laws and interviews with state law enforcement attorneys and franchise administrators from current and former franchise registration jurisdictions.

#### A. Initiation Of A State Franchise Investigation

States franchise registration and disclosure laws give the state franchise administrator the authority to investigate in or outside the state to determine whether any person has violated the state's franchise law or any regulation or order passed under it. *See, e.g.*, § 31401 of the California Franchise Investment Law (the "California Franchise Law"), Cal. Corp. Code § 31000, *et seq.*; § 14-208 of the Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. § 14-201, *et seq.* (the "Maryland Franchise Law"); § 19.100.242 of the Washington Franchise Investment Protection Act (the "Washington Franchise Act"), Wash. Rev. Code § 19.100.000, *et seq.*

In the vast majority of cases, state franchise administrators initiate a franchise investigation as a result of receiving one or more complaints from existing franchisees. In other cases, the franchise administrator may open an investigation based on concerns from other sources. For example, states may send undercover investigators to franchise trade shows to pose as potential franchisees. States also review franchise advertising in

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<sup>23</sup> During the period covered by the Franchise Program Review, the FTC opened a total of 59 investigations regarding the activities of a franchisor (versus 273 investigations regarding business opportunities). During the same period, the FTC filed 22 lawsuits against a franchisor alleging violations of Section 5 and/or the Franchise Rule (versus 148 cases filed against business opportunity promoters). *See* Franchise Program Review at p. 30.

newspaper classified sections and, increasingly, on the Internet. States may hear about potential problems in a franchise system from other state franchise authorities or the FTC. States may also be alerted to potential problems in a franchise system by the franchisor's competitor, by former employees, and even by ex-spouses of a franchisor's officer.

When evaluating whether to open an investigation in response to a franchisee complaint, a state generally considers: the nature of the complaint and the number of complaints from franchisees complaining about similar issues. With regard to the nature of the complaint, state franchise administrators often receive inquiries from franchisees about purely contractual issues in a franchise system. Typically, these issues are not actionable unless the contractual issue implicates some fraud or misrepresentation traceable to the original offer and sale of the franchise. In contrast, all states have authority to investigate and take action in cases of franchise fraud or misrepresentations. For this reason, states are more likely to initiate an investigation in response to a complaint that alleges some presale misrepresentation by the franchisor, such as an unlawful "earnings claim," gross understatement of the initial investment, or failure to provide a disclosure statement. On the other hand, states are unlikely to open an investigation in response to a complaint that a franchisor has failed to provide some good or service under an existing franchise agreement.

The criteria that states use to determine whether to initiate an investigation in a franchise case are fact-specific. In this regard, states generally consider the same factors as those considered by the FTC. Those factors include the number of complaints, the nature of the complaint, and the chances for success in litigation. In one instance, however, the states differ from the FTC. Many states report that they generally do not consider whether the franchisee complainant is represented by a private attorney or is in the process of filing its own private lawsuit. Most states indicate that knowledge that a franchisee may file a lawsuit against a franchisor does not add or detract significantly in determining whether the state will initiate an investigation or file a formal enforcement action. Other states concede, however, that this knowledge may, in limited circumstances, influence the states' response to complaints against a franchisor.

Increasingly, some states may decide to defer action against a franchisor unless the state receives multiple complaints about that franchisor or its franchise system. The reason for this limitation is purely economic. In many instances, state franchise authorities do not possess the resources to formally investigate each franchisee complaint, even when that complaint alleges a potential violation of the state's franchise law. When a franchise administrator receives an isolated complaint, the administrator may attempt to resolve that complaint informally, or it may note the complaint in the state's complaint records for future reference. Nearly every state reports that it will open a formal investigation when a state franchise enforcement agency receives multiple complaints about a franchisor.

In recent years, states have obtained access to complaint information they did not formerly have. The FTC maintains an Internet-based database of complaints from around the U.S. and the world. The complaints are gathered from a number of official sources,

including the FTC, state franchise agencies, consumer protection agencies, and law enforcement offices. This database, called Consumer Sentinel, is available only to law enforcement personnel. The Consumer Sentinel database includes a specific file for "franchise complaints." The database allows state law enforcement personnel to search complaints by company name, franchise trade name, or state of residence of the complaining person. The Consumer Sentinel database is being used more frequently by government agencies, including state franchise enforcement personnel. Some states have begun to search on Consumer Sentinel whenever the state receives complaints about a franchisor as a preliminary matter, in order to determine whether other franchisees have complained about similar issues. Through the use of the Consumer Sentinel database, states can more readily determine whether a specific complaint about a franchise system is isolated or whether other franchisees have made similar allegations.

## **B. State Investigative Tools**

Once a state decides to open an investigation of a franchisor, the state has a number of resources available to it to gather information and evidence of a law violation. One of the most important tools in a state investigation is the ability to issue subpoenas for testimony and documents. *See, e.g.*, § 688 (3) of the New York Franchise Law ("New York Franchise Law"), N.Y. Gen. Bus. Law § 680, *et seq.*; §553.55 of the Wisconsin Franchise Investment Law ("Wisconsin Franchise Law"), Wis. Stat. § 553.01, *et seq.* States often issue subpoenas for documents and testimony as part of their investigative tools. Other states report that they attempt to obtain information informally first, and resort to the issuance of a subpoena only if informal requests for information are unsuccessful.

As part of any state franchise investigation, especially in the beginning stages, state investigators will interview franchisees. The state may contact franchisees based on information received from a complainant or from the list of franchisees contained in the franchisor's offering circular. States may send out form "surveys" or "questionnaires" to existing and former franchisees in the target franchise system. These surveys may request information relating to a specific complaint, or may seek general information about the entire franchise system. These survey responses can serve two purposes: (i) provide information to the state about specific issues raised by a complainant; and (ii) alert other franchisees with knowledge about potential law violations that a state is looking into the activities of the franchisor. Some states note, however, that the use of surveys has not yielded the responses expected or the type of information they had hoped to obtain. Those states report that, in the future, they are more likely to contact complainants and potential complainants by telephone or e-mail than through the use of mass mailing surveys.

During a franchise investigation where fraudulent activity is alleged, states report that the information they gather is kept strictly confidential, even from the target franchisor. Many states will not even confirm the existence of an ongoing investigation. Some of this information eventually may become available to the franchisor after the filing of a formal action in the course of discovery. A state's policy regarding what it will

and will not disclose appears to depend, in part, on whether the franchise administrator is part of a state law enforcement agency, such as an attorney general's office, or a state administrative agency, such as the secretary of state or state corporation commission. A franchise administrator that is part of a law enforcement agency is more likely to maintain the confidentiality of sources.

When a franchisor is not under investigation, some states will freely disclose the existence of specific complaints about a franchisor. Other states will limit disclosure to the name of the franchisor that is the subject of the complaint and, in general terms, the substance of the facts alleged in the complaint. Those states generally will not disclose any identifying information about the person who filed the complaint, preferring to maintain confidentiality of their sources. In Maryland, for example, the franchise administrator is part of the Office of the Attorney General of Maryland. That agency generally will not disclose any information about a complaining franchisee without the express permission of that person.

### **C. Suggestions For Responding To A State Franchise Investigation**

Overwhelmingly, state law enforcement personnel report that they will give favorable consideration to a franchisor who seeks to cooperate with an investigation, except in those cases involving allegations of serious fraud. What constitutes cooperation is usually understood by all sides. In some cases, however, a franchisor under investigation may not recognize that its actions may be viewed as less than cooperative.

States recognize that a franchisor has every right to defend itself vigorously in cases when it does not believe it committed a violation of state law. In other cases, the franchisor is well aware that it has violated the law and seeks not to defend, but to resolve the matter by negotiation and settlement. In those latter cases, the franchisor's cooperation with state authorities appears to have a positive effect on the final resolution of the investigation.

The following are suggestions that a franchisor should consider if the franchisor seeks to cooperate with a state investigation in an effort to obtain the most favorable resolution.

#### **1. *Respond Fully and Promptly to all Requests for Information***

Although this suggestion would appear to be obvious, it is surprising the extent to which states report that some franchisors fail to respond fully and promptly to valid requests for information. Most state enforcement authorities concede that they are less likely to resolve an investigation on terms favorable to a franchisor if that franchisor failed to provide the expected information, unreasonably delayed production of documents, or otherwise sought to undermine the state's ability to obtain and review information. In some states, the failure to provide information in response to a formal request may result in serious sanctions. For example, under Virginia law, any business entity that fails or refuses to obey any order of the Virginia Corporation Commission may

be fined \$10,000 for each day the failure or refusal continues. See Va. Code Ann. § 12.1-13. The Virginia Corporation Commission interprets this authority to extend to a business entity's failure to respond to a Commission subpoena.

In other instances, a franchisor's failure to provide a complete and accurate response to a state subpoena request may have an indirect negative effect. In a case handled by one state, the state enforcement authorities received information that a franchisee had received a copy of a franchise offering circular that was not the same document registered by the state administrator and was, on its face, very misleading. When the state sent an undercover investigator, posing as a prospective franchisee, to the franchisor's home office, a franchise salesperson gave the state investigator a similarly misleading and unregistered form of offering circular. Yet when the state authorities issued a subpoena for all franchise offering circular distributed in the state, the franchisor produced only the form registered in the state. The franchisor was either unaware that its salespersons were distributing the wrong form of offering circular or it was attempting to mislead the enforcement authorities. In either case, the failure to provide the information that the state expected to receive did not bode well for the franchisor's expectation of a prompt and accommodating resolution to the investigation.

In some cases, a franchisor may have a legitimate reason for failing to produce information sought by a state enforcement agency within the time requested or designated. For example, the franchisor may have a limited staff to assist it in reproducing documents or the franchisor may have concerns that information sought by the state should be treated confidentially. In these cases, the state should be made aware of the franchisor's concerns. Often, the state has encountered similar issues in the past. Most states are willing to accommodate the franchisor's concerns. For example, in almost every case, a state will extend the due date for production of documents upon reasonable request or for good cause shown.

2. *Once a Franchisor Becomes Aware of a State Law Violation, Immediately Bring the Violation to the Attention of the State Franchise Enforcement Agency*

In other words, confession is good for the soul and for negotiating better settlement terms. Almost every state franchise enforcement agency reports that it will take into account the fact that a franchisor has alerted the state to the violation, rather than having the state discover the violation. For example, when a franchisor advises a state agency that the franchisor may have violated the state's franchise law, the state may resolve the matter informally rather than through imposition of an order, or it may reduce or even waive the imposition of civil monetary penalties.

In cases of unregistered franchise sales, many states take affirmative steps to uncover potential violations. Some states routinely attend franchise trade shows and have investigators respond to franchise advertising. Other states report that they inquire about sales activities during unregistered periods as a regular part of their review of registration applications. While it is possible for a franchisor that has committed a registration

violation to avoid detection indefinitely, the odds of avoiding detection are not favorable enough to overcome the benefit of self-reporting.

3. *After the Franchisor Becomes Aware of a State Franchise Law Violation, Take Adequate Steps to Ensure That the Violation is Not Repeated*

Most franchise enforcement authorities report that they are unlikely to resolve an investigation informally if the franchisor has repeatedly committed the same violation of the state's franchise law, especially when the violations occur *after* the franchisor has been notified by the state of the problem. Yet surprisingly, many states report that they have experienced situations when franchisors continue to violate the franchise law after being notified of the potential violation. States report that they have uncovered this problem in cases involving offers and sales of unregistered franchises, failures to provide the appropriate disclosure document, and failures to place initial fees in an escrow account when ordered to do so.

For example, one state reported that, while attempting to negotiate a resolution in a case involving unregistered franchise sales, the state discovered that the franchisor was continuing its sales activities in the state using a slightly modified form of "license agreement." The franchisor had previously represented to the state that it had ceased all sales activity in the state pending the outcome of the state's investigation. When the state discovered that this representation was false, it decided not to resolve the investigation informally and promptly filed a formal order to cease and desist.

In some cases, the continuing violation is inadvertent. It may result from a failure of communication between the franchisor's management or counsel and the franchisor's salespersons or brokers. In rare instances, the continuing violation may indicate that other serious problems exist in the franchise system. In any event, a state will be less likely to accept a franchisor's assertions that it will comply with state laws in the future when that franchisor cannot ensure compliance in the present, even after being notified that it is the subject of a state investigation.

4. *Review the Provisions of the State Franchise Law Under Which the Investigation is Proceeding*

All franchise counsel seeking to resolve a state investigation should immediately familiarize himself or herself with the state's franchise law and the potential remedies provided under that law. Yet in some instances, states report that all too often counsel is not familiar with the provisions of the applicable state franchise law. Although many of the state franchise laws are very similar, some differences exist. It would be a mistake for franchise counsel seeking to respond to a franchise investigation to fail to review the most updated versions of the state franchise law and regulations.

A number of states also report that some franchisors pursue a number of defense strategies that serve little purpose in resolving an open investigation. For example,

franchisors often attempt to mitigate their culpability by blaming a franchise law violation on a former attorney, officer or employee. In most cases, states may be sympathetic to the franchisor in this situation, but they will not allow the explanation to excuse the franchisor's violation of an applicable franchise law provision.

#### **D. The Forum For Franchise Enforcement Actions**

Many states that decide to bring a franchise enforcement case generally have the option of filing the case as a state court action or as an administrative action. Where to bring the case depends, in part, on the type of relief the state seeks to obtain. If a state seeks any equitable relief, such as an injunction, restitution, the appointment of a receiver or termination of the franchisor's authority to do business in the state, the state must file the case in state court. Some states, such as Virginia, have authority only to file administrative actions before a state corporation or securities commission. In contrast, other states, such as New York, have the authority only to file formal lawsuits in state court.

Even in those cases where states have the choice about where to file an action, many states will opt to file the action in an administrative setting. In most instances, the relief requested by a state can be obtained by filing an administrative order, either a Stop Order or a Summary Order to Cease and Desist. Both types of orders may be issued by a state franchise administrator. Both direct a franchisor to immediately stop some activity that the state franchise agency finds to constitute a specific violation of the state's franchise law. A Stop Order is authorized when the state seeks to revoke or suspend the franchisor's registration in the state. *See, e.g.,* California Franchise Law, § 31115; Maryland Franchise Law, § 14-221; Washington Franchise Law, § 19.100.120. The Summary Cease and Desist Order is authorized when a state finds that a person has violated a provision of the state's franchise law and seeks to halt that violation immediately. *See* California Franchise Law, § 31211; Maryland Franchise Law, § 14-210; Washington Franchise Law, § 19.100.248. Under the Uniform Franchise Offering Circular Guidelines, administrative orders, if resolved in favor of the state, must be disclosed by the franchisor in any future franchise disclosure document.

Because a state may obtain immediate relief through the issuance of an administrative order, the franchisor that is the subject of the order has a right to a hearing within a very short amount of time after issuance of the order. In some cases, if the subject of the order requests a hearing, the franchise administrator conducts the evidentiary hearing and issues a proposed ruling on the facts and law alleged in the order. In other cases, the dispute is referred to an independent administrative law judge, who conducts a hearing and issues a proposed decision to the state franchise administrator, who, in turn, can adopt the decision or reject it. The administrator may choose, however, to delegate final decision making authority to the administrative law judge.

States may seek to pursue an enforcement action administratively because that method is quicker and simpler for all parties. In most cases, administrative hearings are held within a relatively short period of time. The rules of evidence often are relaxed in



the administrative forum. The only reason a state may seek to pursue in state court is if the relief that state seeks is not available through an administrative action.

#### **E. Circumstances When Franchisees And Their Counsel Should Turn To Their State Franchise Authorities For Assistance**

State franchise enforcement authorities have an interest in working with franchisees and their counsel to ensure compliance with state franchise laws. Although state enforcement attorneys do not represent individual franchisees and should never be used in place of private counsel, states often can take steps that assist franchisees to obtain certain relief. Franchisees most often -- and quite naturally -- are interested in recovering monetary damages. In contrast, state franchise enforcement attorneys are primarily concerned with stopping ongoing violations of the law and remedying past violations to the extent possible.

Franchisees, therefore, should be aware of what state enforcement authorities can and cannot do in response to franchisee complaints. The following represents actions that states may take to assist franchisees who choose to bring their own private litigation as well as those franchisees who choose not to do so.

##### *1. Informal Attempts to Mediate Complaints*

In some cases, states may attempt to resolve disputes between franchisors and franchisees informally. In this regard, the state acts as an unofficial mediator. States generally do not undertake this role in response to complaints that allege fraud, misrepresentations, or serious violations of state law. In those cases, the state's more appropriate role is to investigate the alleged violation and initiate an enforcement action if warranted. In some cases, states report that they have some success in resolving disputes between franchisors and franchisees without filing any formal action.

States review and record all complaints sent to the state franchise agency. If the state enforcement personnel determines that the complaint does not merit opening a formal investigation, the state can, if it chooses, try to resolve the complaint. One way that a state can assist in a potential resolution is by contacting the franchisor about the complaint and requesting that the franchisor respond to the allegations. Most franchisors will respond to a state franchise agency's request for information.

Franchisors also may be more amenable to resolving a complaint that has been brought to the attention of a state franchise agency, even if the franchisor is fairly comfortable that the state will not initiate an enforcement action in response to the complaint. States may not divulge the names of a person complaining against a franchisor, but most states will acknowledge when they have received a complaint against a franchisor and discuss the nature of the allegations in the complaint. State franchise agencies often receive inquiries from prospective franchisees inquiring about the complaint history of specific franchisors. For this reason, franchisors have an interest in ensuring that they maintain a fairly clean complaint history with any state franchise

agency. Franchisors and franchisees should be aware, however, that some states will not or cannot undertake the role of mediator on issues that are not clearly within their jurisdiction. In addition, states differ on the issue of whether a complaint, once made, may be withdrawn by the complaining franchisee.

## *2. States Franchise Agencies as a Source of Information*

Franchisors may be more responsive to requests for information when that request is made by a state enforcement agency rather than by a franchisee. In addition, states may already have information about a specific franchisor in the form of complaint data and registration records. Franchisees can obtain certain useful information from state franchise agencies through the use of a state's public information act. All states are required to make their records reasonably available to the public under their respective counterparts to the Federal Freedom of Information Act.

State enforcement attorneys, as well as attorneys from the FTC, have acknowledged that one important factor they consider in determining whether to bring an enforcement action is whether numerous franchisees have filed complaints against the franchisor. In addition, private franchisee litigants may benefit from pooling their resources with other franchisees with similar claims. In that regard, it is extremely beneficial for franchisees in a dispute with their franchisor to determine if other franchisees have filed similar complaints. One way to discover this type of information is by contacting state franchise enforcement agencies and inquiring into whether other franchisees have filed similar complaints. Some states may not freely divulge the name of a complaining franchisee while an investigation is ongoing, but all states will disclose this information with the consent of the complaining franchisee.

In addition, franchisees may benefit from viewing the franchisor's offering circulars as they are filed over time and in different states. All states grant access to franchise registration records to the public, although states vary on the applicable procedure and fees.

## *3. Amicus Briefs and Serving as Expert Witnesses*

In certain circumstances, a state enforcement agency may be willing to file an amicus curiae brief in support of a franchisee's position in an ongoing lawsuit if that lawsuit involves issues that the franchise agency believes are important. This action is appropriate only in a limited number of circumstances. In most cases when a state franchise agency has jurisdiction over a dispute that involves issues of interest to that agency, the state will be more likely to take a formal action rather than intervene as amicus curiae. However, states have filed these briefs in the past and, in doing so, contributed their expertise and their authority on behalf of the franchisee's side in a dispute.

In addition, in some cases, state franchise administrators may be available to offer evidence in an ongoing lawsuit or arbitration through affidavit or even direct testimony.

Some government agencies categorically refuse to allow state personnel to serve as expert witnesses in private lawsuits; other agencies are more amenable to offering this form of assistance, under appropriately compelling facts. Some state administrators have allowed their staff to submit detailed affidavits outlining the registration records of a specific franchisor. These affidavits may be drafted to provide additional information that may be useful to help prove a franchisee's factual allegations and legal theories of a dispute.

The most likely cases in which states will file an affidavit or amicus brief on behalf of a franchisee in private litigation are disputes involving unlawful earnings claims or where a franchisee seeks to challenge the legality of a waiver or integration clause. Many state franchise administrators and attorneys find broad waiver provisions to be especially unfair and onerous, since they prohibit the franchisee from even making a claim of wrongdoing and because they involve contractual provisions that are or may be unlawful under several state franchise laws.

#### 4. *Formal Enforcement Action*

In many cases, a franchisee may complain to a state franchise agency and request that the state bring a formal action on the franchisee's behalf. The franchisee usually seeks some type of monetary relief in the form of rescission or damages and wishes to utilize the resources of a state agency to obtain that relief against a franchisor whom the franchisee believes has committed some type of law violation, usually in the nature of misrepresentation. A state cannot bring an enforcement action on behalf of any individual. In certain circumstances, however, a state's formal enforcement action may lead to a positive benefit to an individual franchisee. In other instances, however, the franchisee may prefer that the state not pursue an enforcement action.

In a typical case, a franchisee complains to a state enforcement agency that a franchisor has violated some provision of the state's franchise law. The franchisee may have private legal counsel, although most franchisees who complain to a state do not have counsel. The complaining franchisee may have already discovered that bringing a lawsuit against a franchisor is both costly and time-consuming. The state's action against the franchisor costs the franchisee nothing. However, unlike the franchisee who has private legal counsel, the franchisee who relies on the state enforcement action to obtain a remedy has no control over the timing or substance of the state's action or the ultimate resolution of that case. In addition, once the franchisee has made a complaint to the state enforcement agency, the franchisee may not be able to withdraw that complaint, even if the franchisor is willing to settle the case with the franchisee in exchange for that withdrawal.

The most common type of action that states assert against a franchisor is one alleging a registration violation. These actions are generally relatively easy for states to bring and to prove. The state franchise agency maintains the records relating to a franchisor's registration, so the critical facts needed to prove this violation are under the state's control. If a franchisee has reason to believe that it purchased a franchise during a period when the franchisor was not registered as required under state law, the state

generally will be willing to pursue an action against the franchisor and seek a rescission offer for the affected franchisees.

The standard remedy that states seek for a franchise registration violation is rescission of the franchise agreement. States routinely seek rescission whether they pursue a formal enforcement action or agree to enter into a consent order. However, in many instances, franchisees and franchisors have widely differing interpretations of what constitutes "rescission," especially in those cases where the franchisee has already received training, assistance, or has actually opened a franchised business. States generally try to take a middle ground in their calculation of rescission -- taking the position that the franchisee should be placed in the position it would have been in before buying the franchise but not receive a "windfall" and retain any benefits from the franchise without compensating the franchisor. See *Cusamano v. Norrell Heath Care, Inc.*, 239 Ill. App.3d 648, 653, 607 N.E. 2d 246 (1992), quoting *Felde v. Chrysler Credit Corp.*, 219 Ill.App.3d 530, 542, 580 N.E.2d 191 (1991); *Bagel Enterprises, Inc. v. Baskin & Sears*, 56 Md. App. 184, 201, 467 A.2d 533 (1983), cert. denied, 299 Md. 136, 472 A.2d 999 (1984).

For example, in one case, the Maryland Securities Division attempted to mediate a dispute between a franchisor and franchisee who had been operating a franchise for several years. The franchisor calculated the value of a rescission offer to the franchisee to be approximately \$40,000. The franchisee, on the other hand, calculated its rescission damages to be at least \$1,000,000. The franchisee argued that the franchisor should reimburse it for all fees, losses, and other damages, including its liability on a long term lease for the franchised location. As is typically the case with mediation, the actual rescission offer the franchisor eventually made was somewhere between the rescission amounts argued for by both sides.

In some cases, a franchisee in a dispute with a franchisor may choose not to involve the state at all. The franchisee and its counsel may prefer to bring the case on their own or as part of a class action in order to retain control over the litigation. The franchisee may hope to recover attorneys' fees as part of its damages. The franchisee may intend to use the threat of filing a state complaint as leverage in settlement negotiations, or may offer to sign a confidentiality agreement with the franchisor in exchange for more favorable settlement terms.

In most cases, franchisees and their counsel can work together with state enforcement attorneys to seek a satisfactory result for all parties. However, at times, the franchisee may not be satisfied with a state's determination of an appropriate rescission offer. The state may choose, therefore, to resolve an enforcement action against a franchisor on terms that the franchisee finds unacceptable. The franchisee is free, then, to pursue its own private right of action against the franchisor and to try and obtain a more favorable form of rescission, although the franchisee may choose to settle for the less favorable calculation to save the added expense and time involved in filing its own private lawsuit.

Some states have sought to resolve franchise disputes through alternative methods of enforcement. For example, at least two states, New York and Rhode Island, have participated in the National Franchise Council's Alternative Rule Enforcement Program. Under that program, government agencies may refer a franchisor to the NFC for mediation and training. The program is limited to "technical" law violations, such as a franchisor's inadvertent failure to provide certain required disclosures. The program allows the government agency the choice to respond to the law violation without bringing a formal law enforcement action. In most cases, franchisors who participate in the NFC program agree to undergo training on franchise laws, and mediate disputes with affected franchisees. Not all states refer franchisors to the NFC program. Some states have formal or informal policies that prevent them from resolving law violations through any method other than by entering a formal, discloseable order.

#### **F. Likely Future Trends In State Franchise Enforcement Actions**

Clearly, one of the biggest challenges that states face in bringing effective franchise enforcement actions is the lack of resources at the state level. Litigation is expensive and time-consuming in even the most ideal circumstances. Franchise litigation can be extremely complex. In some cases, states may not have the personnel or money to undertake a complex investigation and engage in protracted litigation.

Many state law enforcement attorneys bring actions in a number of different areas, including those dealing with securities, investment advisors, broker dealers, business opportunities, and multi-level marketing. State enforcement agencies may be tempted to pursue actions in other areas, where the issues are not as complex or where fraud may be more easily proven. Alternatively, states may be required to use more creative means for effectively pursuing actions in the franchise arena. In this regard, some states have taken steps to conduct joint investigations with other states and the FTC. Many of the issues and problems raised in franchisee complaints exist in a number of different states. When states work together to investigate these matters, the states can make better use of their limited resources. The same result occurs when the states work together with the FTC. As individual state law enforcement personnel mature, those individuals develop relationships with personnel from other state and federal agencies. These informal contacts can and most likely will develop into more formal agreements to pursue actions jointly.

Many states have participated in multi-state enforcement actions in other areas, including consumer protection, antitrust and multi-level marketing. These joint actions have yielded significant results through a relatively cost effective approach. To date, states have not taken advantage of this form of cooperation in the franchise area. In the future, states will likely seriously consider the benefits of pursuing joint law enforcement actions, both with other states and with federal agencies.

#### **IV. CONCLUSION**

A full-scale investigation by the FTC or state equivalent is a serious matter. From the franchisor's perspective, the specter of an expensive and time-consuming investigation is anything but good news. Understanding the process and policy concerns of the government, however, increases the likelihood of resolving the matter in an expeditious and favorable manner. From the perspective of the franchisee, the FTC and state equivalents play a valuable role in policing the franchise industry and insuring compliance with the applicable franchise laws. The government is not, however, a replacement for private counsel and a franchisee should understand the limitations of the governments' authority.



# **Franchise and Business Opportunity Program Review 1993-2000**

**A Review of Complaint Data, Law Enforcement and  
Consumer Education**

## **PROGRAM REVIEW**

**Prepared by the Staff of the Bureau of Consumer Protection**

**June 2001**



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# **Program Review**

This report analyzes the Federal Trade Commission's franchise and business opportunity program from 1993 through 2000. The report is divided into three sections. The first section is a statistical analysis of franchise and business opportunity complaints. It draws from the Consumer Information System (CIS), the Commission's general complaint database. This complaint information includes consumer complaints brought to the Commission's attention directly from consumers, as well as complaints referred to the Commission by external organizations, such as state law enforcement agencies.

The second section is a statistical analysis of Commission franchise and business opportunity law enforcement activities. It includes an examination of Commission investigations and cases, a breakdown of allegations charged in Commission law suits, as well as a description of the correlation between complaints and investigations.

The third section is a review of Commission consumer education activities pertaining to franchises and business opportunities. It includes the number of publications distributed, web accesses and outreach efforts.

The report's Appendix includes additional information regarding several metrics, including tables of raw numbers.

# Complaint Data

This section presents an analysis of franchise and business opportunity-related complaint data from 1993 through June 1999 that are currently available in the Commission's CIS system. It does not purport to represent a precise accounting of all correspondence that was possibly submitted to the Commission during the relevant time period. This is particularly true of data prior to 1997. Before 1997, complaint information, especially via telephone calls, was not routinely captured in a centralized database. In 1997, the Commission created the Consumer Response Center (CRC), which standardized complaint handling. At the same time, the Commission began accepting complaint data from non-FTC sources, such as from state law enforcement agencies and from regional offices of the Better Business Bureau. In addition, in the summer of 1998, the Commission established a toll-free number, and in October 1998 the Commission introduced an online complaint form. For these reasons, data submitted after 1996 is the most complete. Nonetheless, the CIS is the single best source of complaint data both before and after 1997.

## Methodology

### Initial Data Entry

An initial query of franchise and business opportunity-related complaints in the CIS generated 6,468 records. For a test period 1998-1999, these complaints represented between 3.3% and 3.6% of the total number of consumer complaints in the CIS. FTC staff entered information from all 6,468 records into a separate Microsoft Access database ("primary database") according to the protocol described below.

Every complaint record, even if a duplicate or mischaracterized as a franchise or business opportunity, was entered. The primary database included 41 different data fields, designed to capture all relevant information from each complaint. These fields included the date of the complaint; the state of the consumer and company; whether the company offered a franchise, business opportunity, or other venture; the amount of alleged injury; how the offering was advertised; the product or service involved; and the specific complaint allegations. Because many complaints did not have sufficient information to address each of the 41 fields, frequently some fields were left blank on individual records, indicating that no data were available.

### Franchise and Business Opportunity Database

FTC staff subsequently reviewed the primary database to determine whether each complaint raised a franchise or business opportunity issue. The review process paid particular attention to verifying the characterization of each record as either a "Franchise," "Business Opportunity," "Multi-Level Marketing (MLM)," "Money-Making Scheme (MMS)," "Miscellaneous Scheme," or "Mischaracterized." Complaints verified as "Mischaracterized" – including, for example, requests for information, complaints about copyright infringement, and various others – were removed. Complaints that could be accurately identified as concerning MLMs or MMSs were removed. "Miscellaneous schemes" – those where insufficient information was provided to permit a more specific characterization – were retained in the database. This review produced a final set of 4,512 complaint records. The 4,512 records generated as a result of this filtering process form the Commission's Franchise and Business

Opportunity Database ("FBOD"). This section of the report exclusively concerns the FBOD data.

## Report Organization

The statistical analysis of franchise and business opportunity complaint data is divided into five sections, as described below. Each section includes a summary, applicable charts, and analysis.

**Overview:** The overview section describes the FBOD generally, characterizing, to the extent known, each complaint as either a franchise complaint or a business opportunity complaint, the source of each complaint, and the complaint dates.

**Companies:** This section breaks down information on the companies identified in the complaints, including company location and complaints per company.

**Consumers:** This section highlights information about complainants, including geographic distribution and amount of injury per complainant.

**Delivery and Goods:** This section details the offerings and the sales process, including how offerings were advertised, what products or services appeared most frequently, and specific complaints about the goods offered.

**Expectations, Disclosures, and Post-Sale Issues:** This section identifies various other problems the complainant encountered in the course of the business interaction, including earnings claims, misrepresentations about support or training, disclosure issues, or refund disputes.

## General Observations

Several results of the FBOD analysis merit mention at the outset. Perhaps most significant is the breakdown of business opportunity complaints relative to either franchise complaints or miscellaneous schemes. Of the 4,512 complaints, 3,392 complaints – more than 75% – involved business opportunities, while only slightly more than 6% were traditional franchise arrangements. Similarly, complaints were lodged against 949 business opportunity sellers, but against only 197 franchisors. This result tends to be consistent with our analysis of consumer injury. The majority of identifiable consumer injury was under \$10,000, and more than 92% of the complaints where injury could be determined involved injury under \$20,000. Injury over \$100,000 was extremely rare.

Second, most complaints involved isolated incidents: where the company could be identified from the complaint, 74% of the records represented a single complaint against a company. Only a few companies appeared to exhibit any pattern of problematic behavior.

Third, there generally has been a steady increase in the number of complaints over time. During the period 1997 through 1999, the period for which the most complete complaint data is available, the number of complaints rose from 1,013 in 1997 to more than 1,600 (extrapolating for the rest of 1999 based on the pace through June of that year). This observation does not necessarily imply an increase in the actual number of potential law violations. Rather, the growing numbers of complaints submitted directly from consumers via the Commission's online complaint form and use of the Commission's toll-free number suggest an increasing public awareness of the FTC (in concert with

other consumer protection agencies) as a forum for addressing complaints of this type. For example, while the Commission's online complaint form generated 210 franchise and business opportunity complaints during all of 1998, it generated 208 complaints during the first half of 1999 alone.

Fourth, the number of complaints as distributed by both the company locations and consumer locations tended to correspond to state population, such that more heavily populated states (FL, CA, TX, NY) usually led in both company complaints and consumer residency. One noticeable aberration was a relatively high number of complaints against Utah companies, placing the state in the top five in that category.

Finally, most franchises and business opportunities apparently continue to be advertised by mail and print media; these media represented more than half of the complaints where the advertising type was identified, and the combination of mail, print and telephone comprised almost two-thirds of the known total when the advertising medium was stated in the complaint. The Internet's role, in both advertising and as the subject of the offerings themselves, was less significant. Offerings advertised via the Internet represented less than 10% of the complaints, and offerings where the Internet was an integral part of the business proposal made up less than 5% of complaints where such subject information was available.

## Overview

The Overview addresses some of the general metrics identified in the FBOD, including complaint type, complaint date, and how the complaint came to the FTC's attention.

### Findings

1. More than 75% – 3,392 of the 4,512 FBOD complaints – concerned business opportunities, while only slightly more than 6% concerned traditional franchise arrangements. The overwhelming majority of the complaints submitted to the Commission, therefore, involved some form of business opportunity.
2. More than 12% of complaints appear to involve vending machine schemes.
3. Most complaints in the FBOD were recorded by the FTC or its Regional Offices. More than 60% of all the complaints were recorded by those two sources, by consumers using the FTC's online complaint form (public users), or via the FTC's toll-free number. The Better Business Bureaus and the National Consumer League together contributed more than a third of the complaints.
4. There appears to be a general increase in the number of complaints over time, if total 1999 complaints are predicted based on the pace through June 1999. This trend persists when franchises and business opportunity complaints are observed separately. Considering the sparse complaints available for earlier years, this observation does not necessarily imply an increase in the number of actual Franchise Rule violations being committed. The recently growing numbers of public user complaints and use of the FTC's toll-free number at least suggest an increasing public awareness of the FTC (in concert with other consumer protection agencies) as a forum for addressing complaints of this type.

## Supporting Data and Analysis

Chart A.1

### Type of Complaint

This chart presents the breakdown of the three possible complaint types for records in the FBOD. Each of these three categories followed a "Yes/No" protocol, but no record fell into more than one category. The vast majority of these complaints involved the sale of business opportunities.

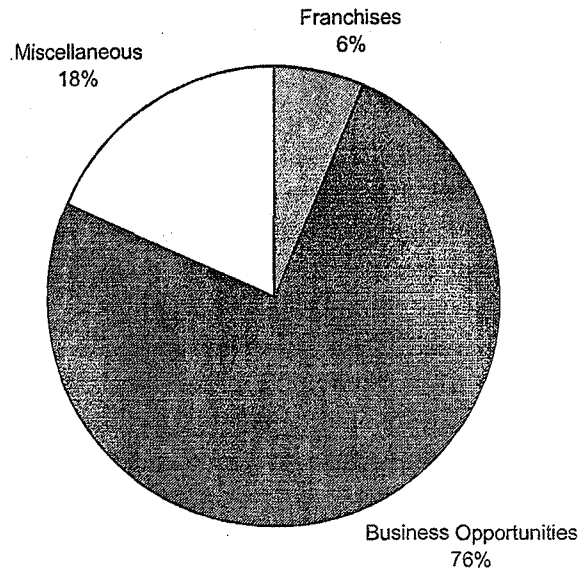


Chart A.2

### Complaint Count by Year

Chart A.2 tracks the FBOD complaints by time, as entered into the date field. All but eight of the FBOD records noted the year the record was created. The chart indicates a general increase in complaints (except for an upsurge in 1995), a trend that 1999 complaints were, through June, on pace to continue.

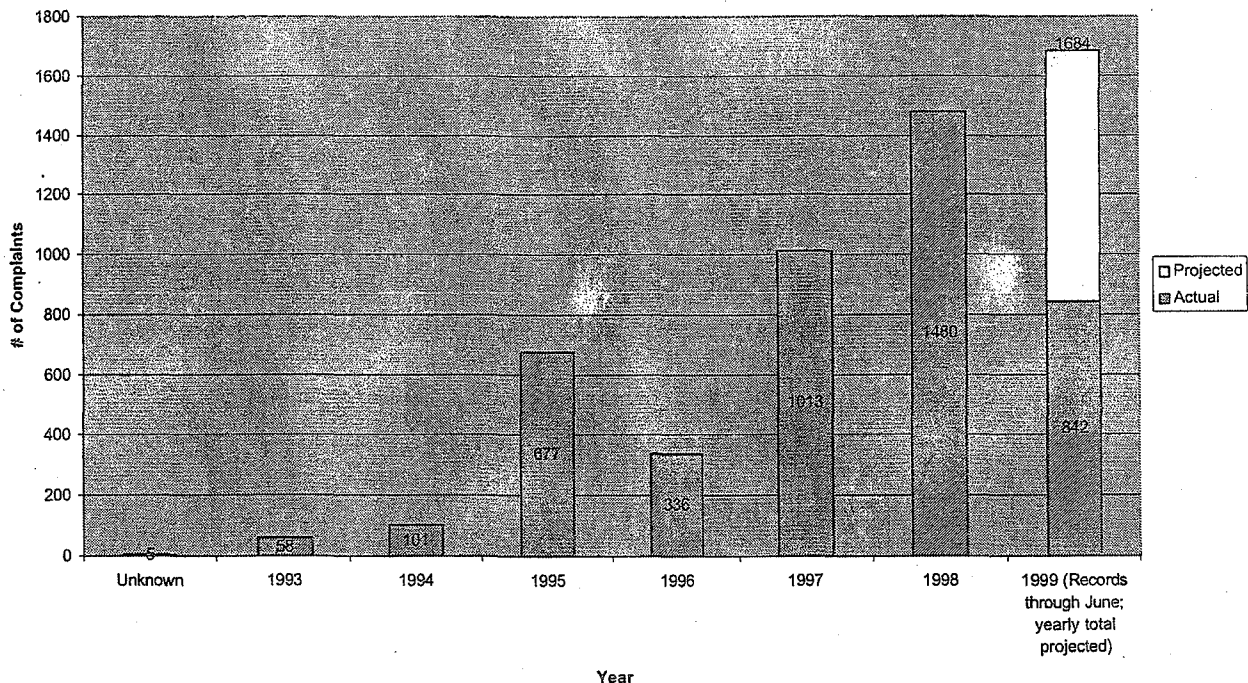


Chart A.3  
**Franchise Complaints by Year**

Similar to Chart A.2, franchise complaints indicate a general increase by year.

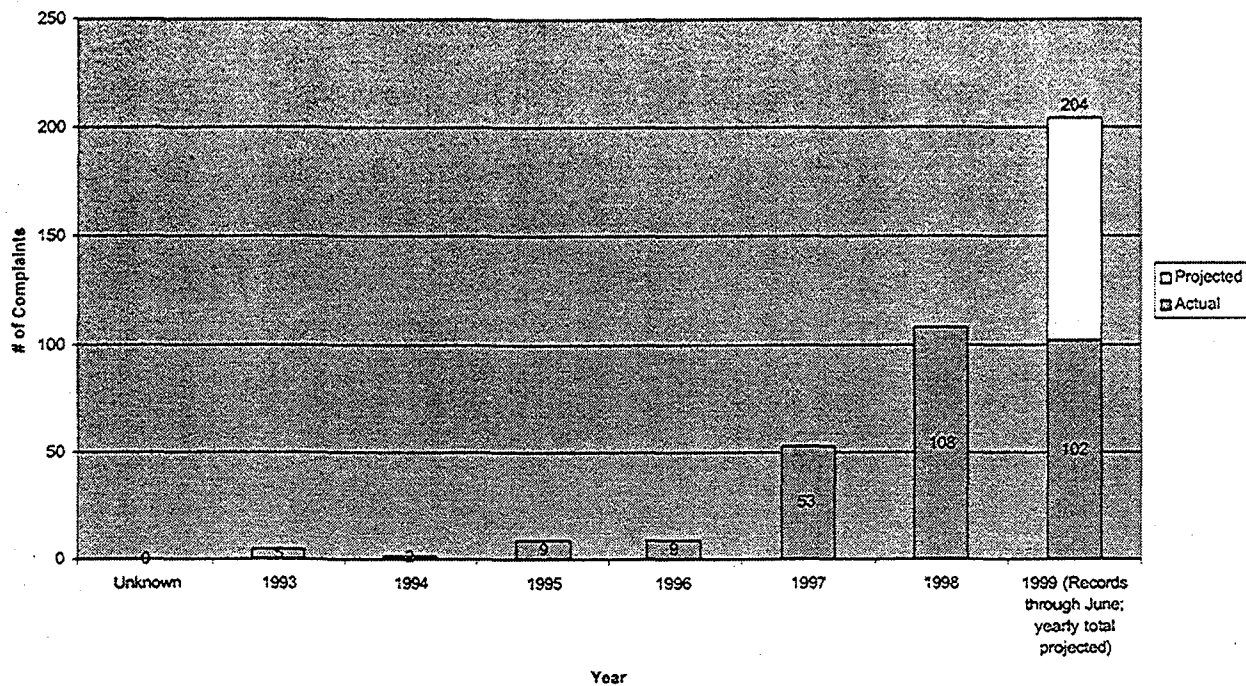


Chart A.4  
**Business Opportunity Complaints by Year**

As with Charts A.2 and A.3, business opportunity complaints follow the trend of generally increasing numbers each year.

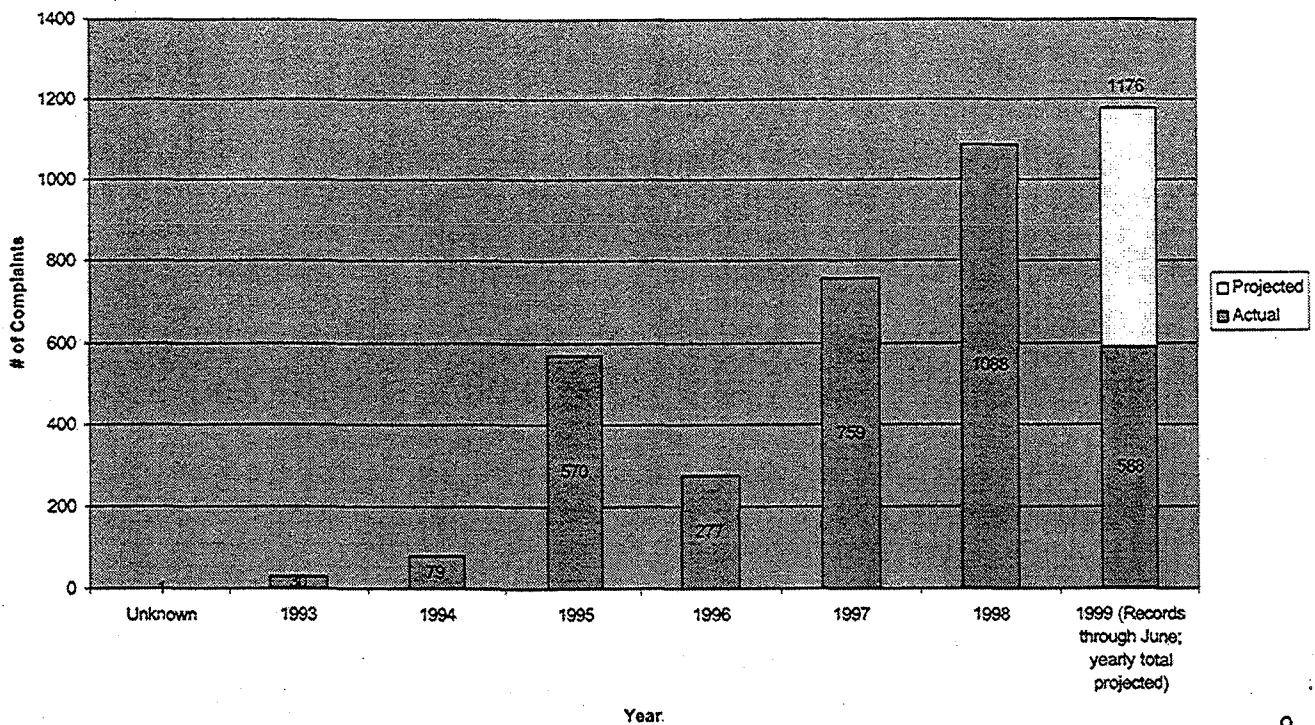




Chart A.5

# **Complaints by Source**

This chart analyzes the source of complaint data. The "All FTC" category incorporates entries from several different offices within the FTC, but FTC Regional Office records are kept separate. The State Law Enforcement category groups records originating with both State Attorneys General and State Departments of Justice. Public Users refers to email complaints sent to the FTC by consumers. FTC sources – home office, regions, direct mail to the agency, and the FTC hotline – make up the bulk of the complaint records.

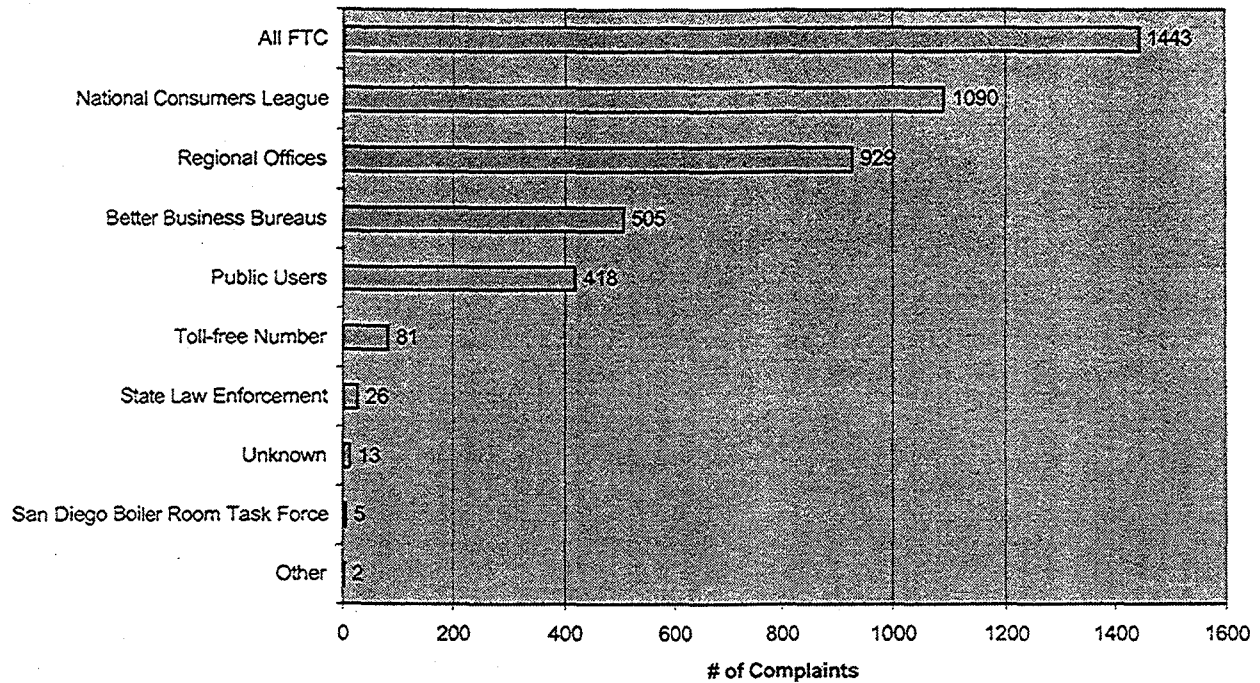
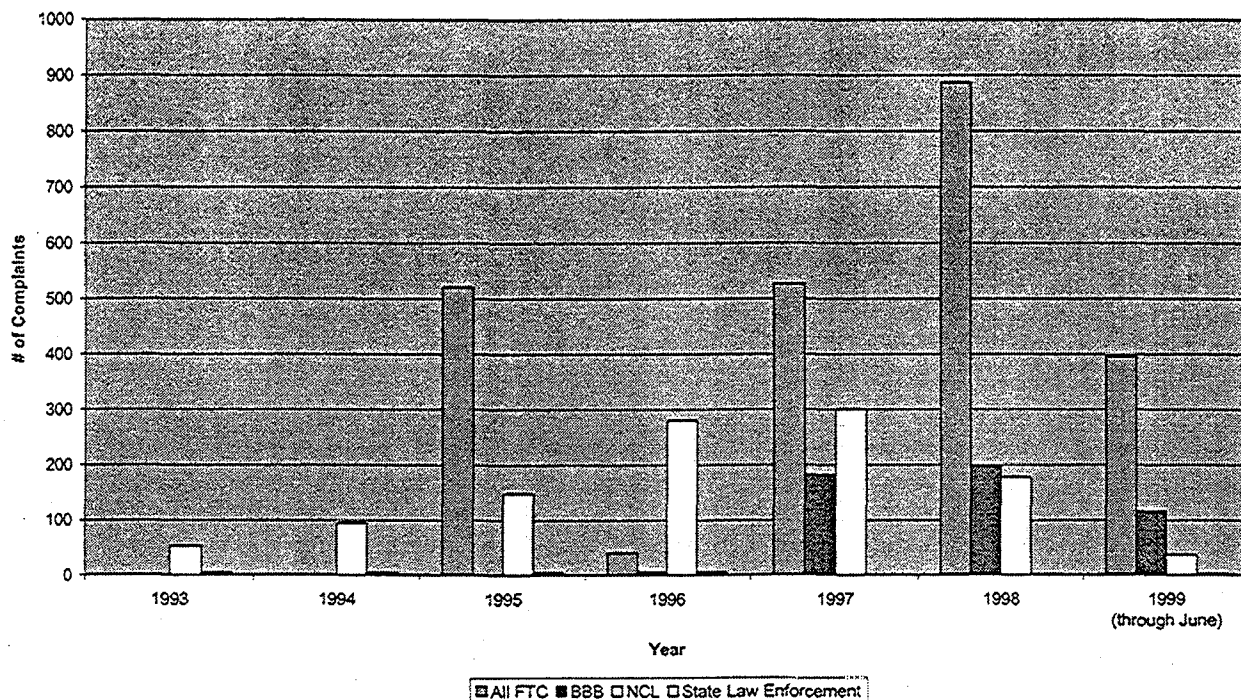


Chart A.6

# **Top Information Sources by Year**

Chart A.6 combines data from the Year field and the Source of Information field, tracking over time the number of complaints from the database's top information sources. The result suggests the emerging importance of Public User and FTC hotline complaints. Note: FTC internal sources are combined with the Regional Office numbers for this chart's FTC category.



## Companies

The Companies section breaks down information on the companies identified in each complaint, including company location and complaints per company.

### Findings

1. The most populous states tended to exhibit higher complaint counts; Florida, California, Texas, and New York were the most common company locations. One notable exception was Utah, which made the top five states.
2. The majority of complaints – almost 75% – were isolated occurrences. Very few companies generated more than one complaint, and only about 5% of companies had more than 6 complaints.

### Supporting Data and Analysis

Chart B.1

#### Top 10 States, by Number of Companies Complained About

Chart B.1 indicates the states with the most complaints against in-state companies. Complaints generally seemed to follow state population. However, given the sample size involved in the database, the relative ranking of those states with fewer complaints should not be interpreted as definitive. This chart excludes the sizeable category of “unknown” locations – where the complaint did not provide the state of the subject company. This category represented the second highest complaint count.

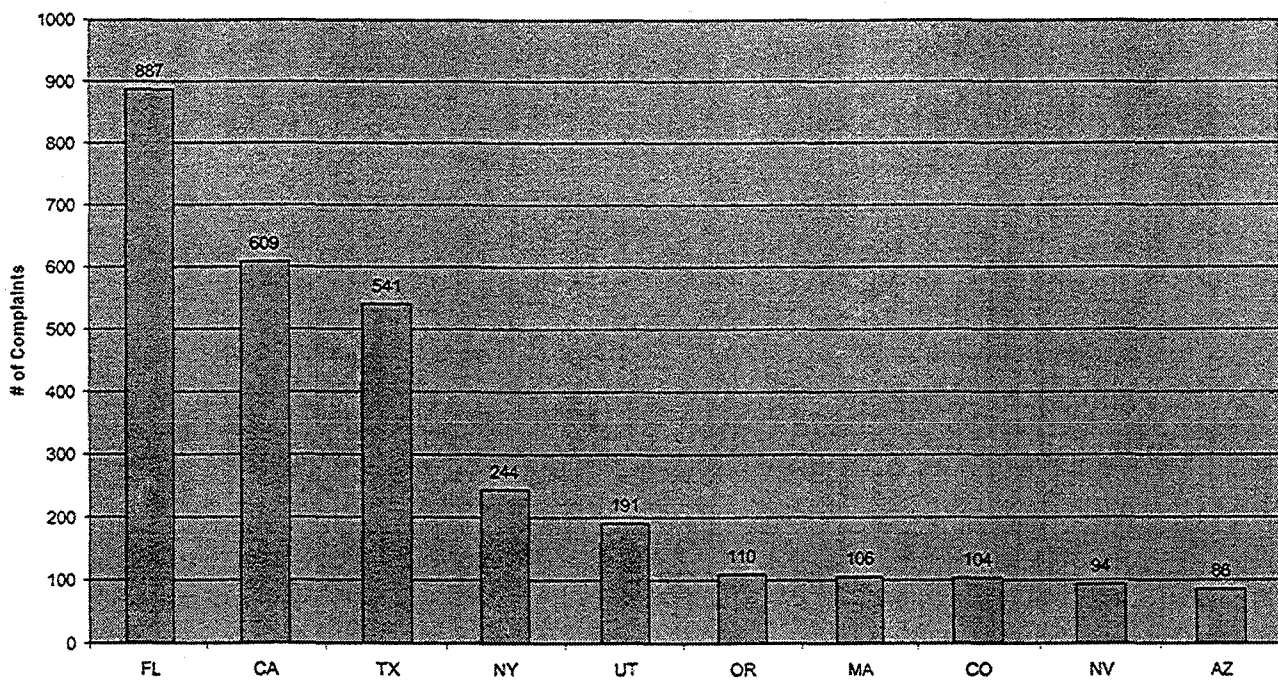
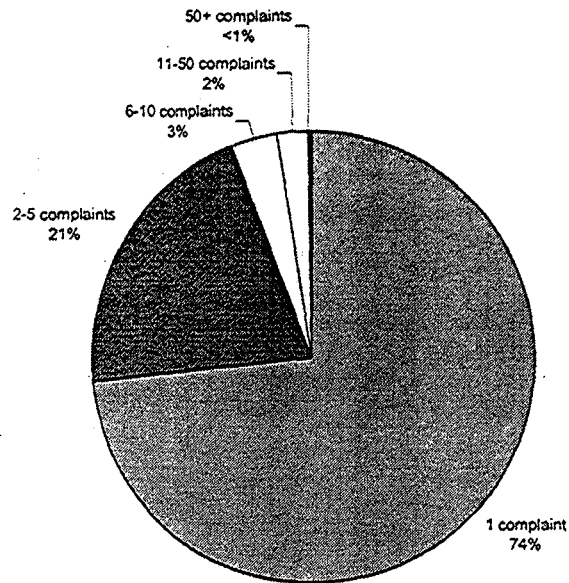


Chart B.2

**Complaints per Company**

Chart B.2 shows that the overwhelming majority of complaints were isolated; less than 6% of the companies in the FBOD generated six or more complaints.



## Consumers

The "Consumers" section highlights information about complainants, including geographic distribution and amount of injury per complainant.

### Findings

1. Of the consumers who complained, nearly 75% reported that they had experienced some financial injury.
2. More than 90% of identifiable consumer injury amounted to less than \$20,000 per consumer. Instances of injury over \$100,000 were extremely rare. However, when comparing business opportunities and franchises separately, complaints about franchises tended to report higher injury amounts. About 17% of franchise complaints indicated injury over \$20,000.
3. The more populous states tended to exhibit higher complaint counts: California, Texas, Florida, and New York were the most common consumer locations.

### Supporting Data and Analysis

Chart C.1

#### Top 10 States, by Number of Consumer Complaints

Chart C.1 indicates the states with the most consumer complaints. Complaint volume generally seemed to follow state population. However, given the sample size involved in the database, the relative ranking of those states with fewer complaints should not be interpreted as definitive. This chart excludes the sizeable category of "unknown" locations — where the complaint did not provide the complainant's state. This category represented the fifth greatest complaint count.

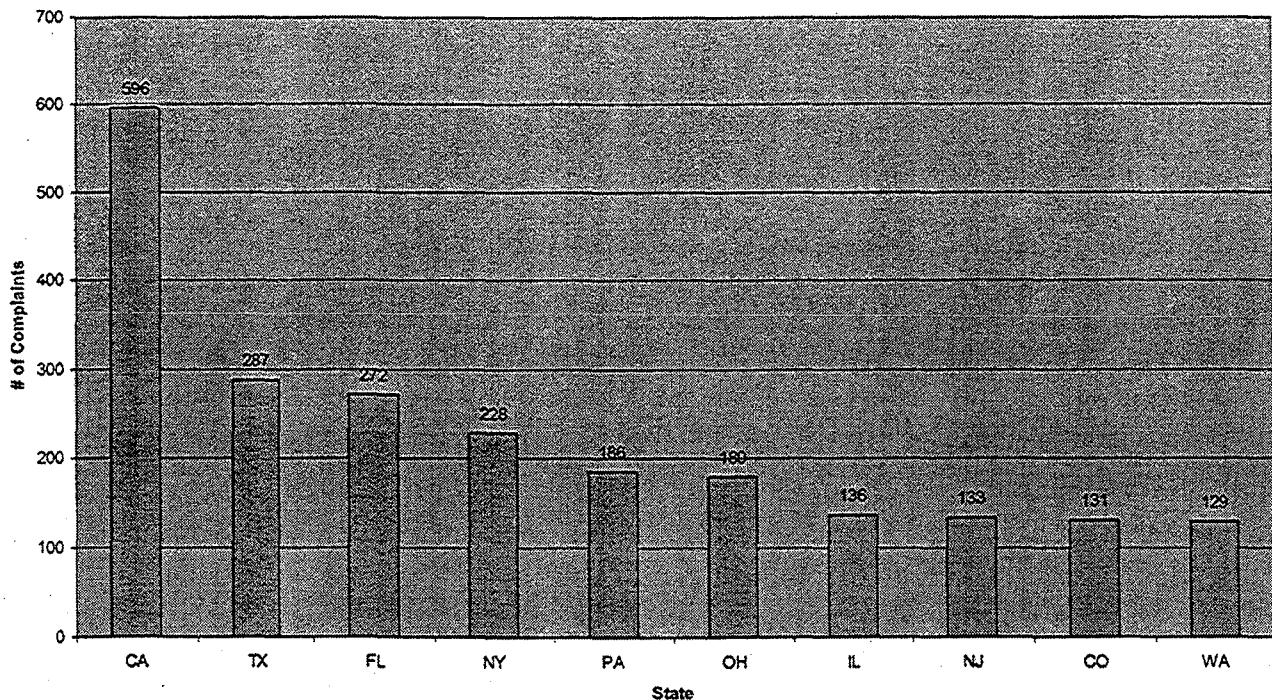


Chart C.2  
**Amount of Injury**

Chart C.2 shows there was a wide range of injury to individual consumers, but most of the identifiable injury fell under \$20,000 per consumer. Injury amount, however, was not stated in a substantial number of the complaints.

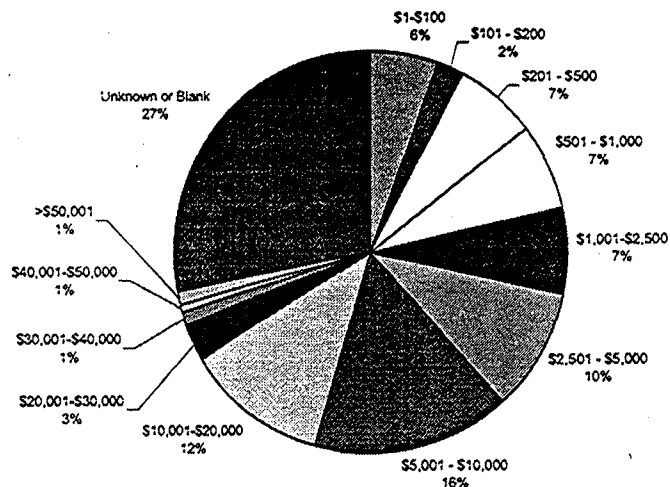


Chart C.3  
**Amount of Injury (unknowns or blanks omitted)**

Chart C.3 indicates that where the amount of injury was specified, the most frequent amounts fell between \$2,500 and \$20,000; these made up more than 50% of the known total.

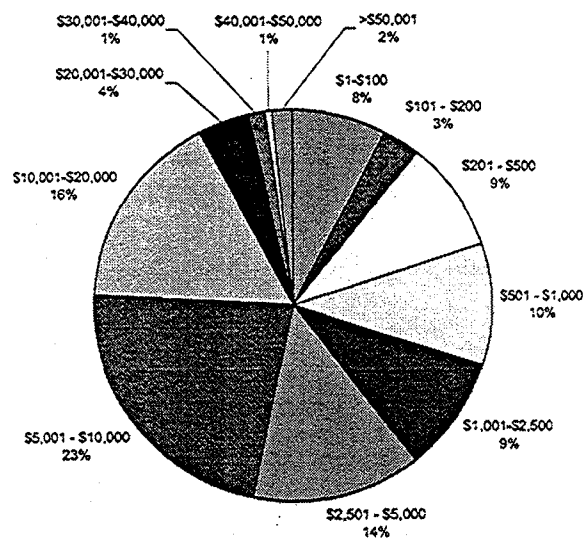




Chart C.4  
**Franchise Consumer Injury**

Chart C.4 shows consumer injury figures for franchise records, where injury amount was available. While the \$2,500 to \$20,000 range is predominant, franchise complaints report relatively more injury in the \$20,000+ brackets.

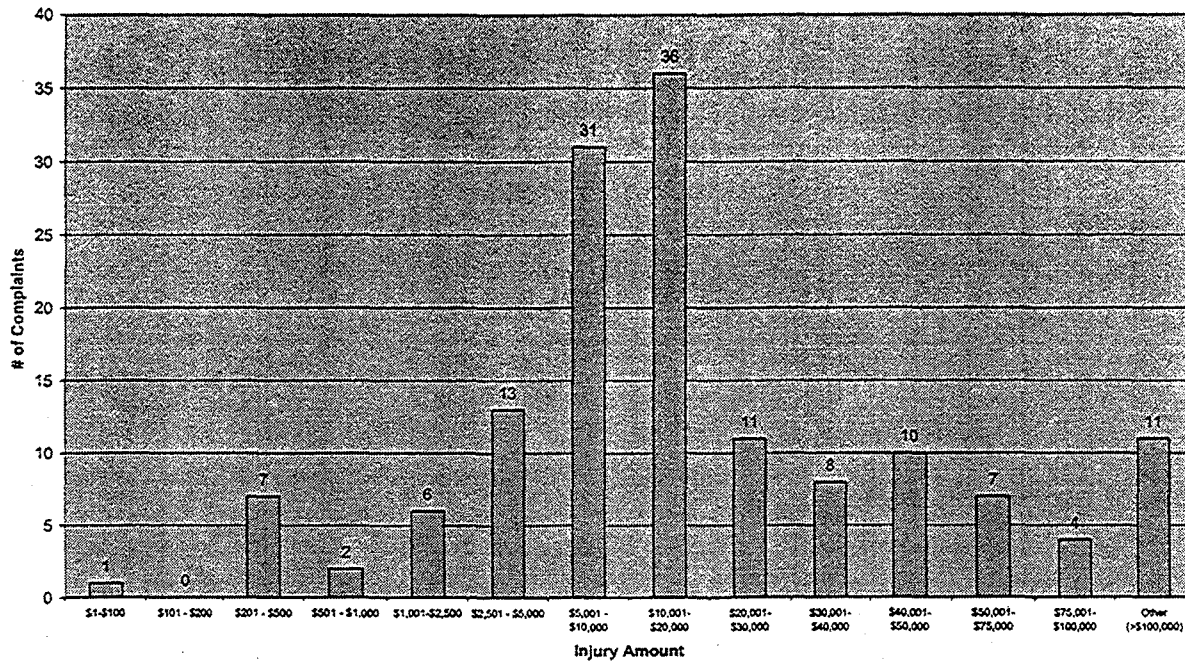


Chart C.5  
**Business Opportunity Consumer Injury**

This graph shows consumer injury figures for business opportunity records where injury amount was available. It reinforces the frequency of injury in the \$2,500 to \$20,000 range and indicates the rarity of very high injury amounts for business opportunities.

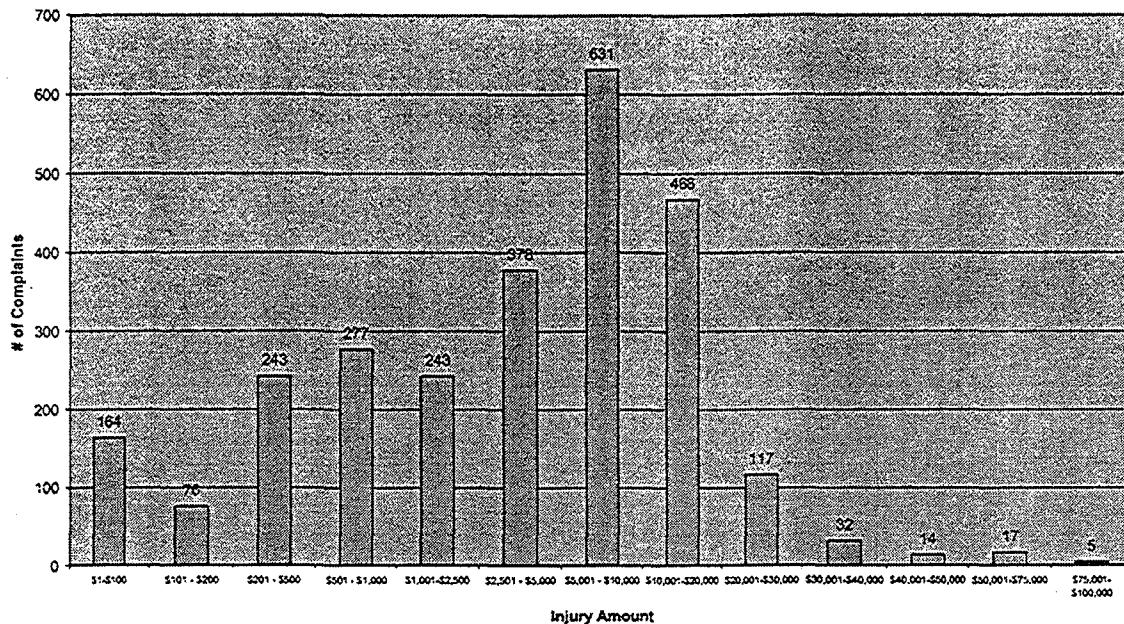
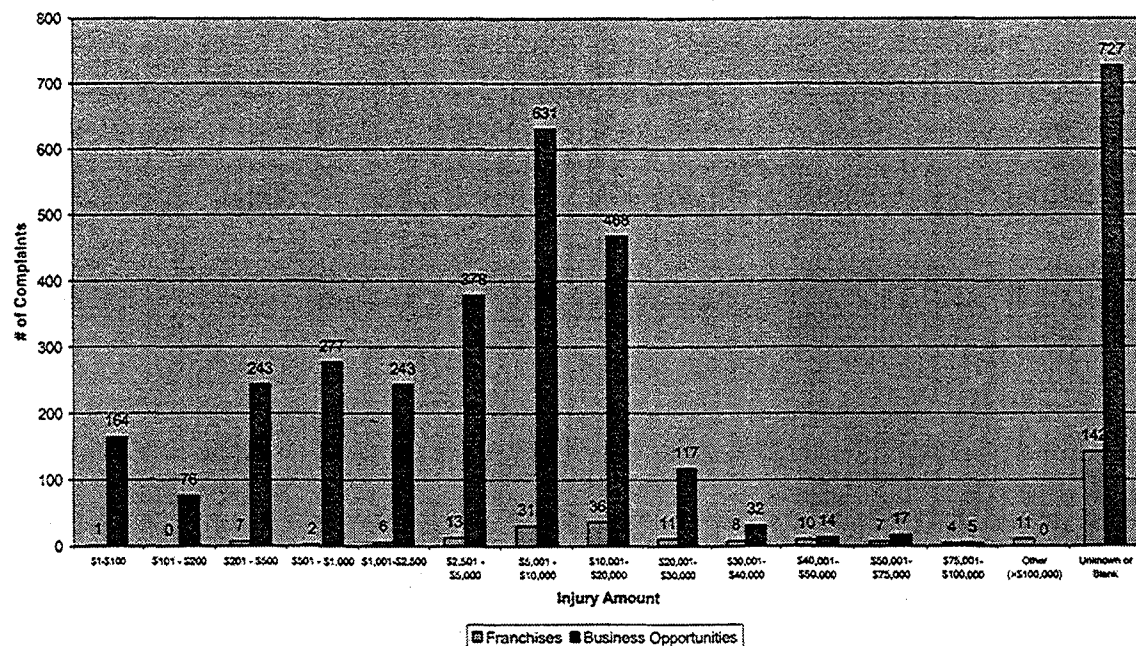


Chart C.6  
**Franchise and Business Opportunity Consumer Injury**

This graph contrasts the injury amounts reported for franchises and business opportunities, highlighting the somewhat divergent injury ranges as well as the prevalence of business opportunities in the database.





## Delivery and Goods

The "Delivery and Goods" section details the offerings and the sales process, including how offerings were advertised, what products or services appeared most frequently as an integral part of the offering, and specific complaints about the goods offered in connection with the offering.

### Findings

1. Traditional advertising media – print, direct mail, and phone – remain the most important methods for publicizing both franchises and business opportunities. Advertising via email and the Internet made up less than 10% of the complaints where the medium was stated.
2. The complaints relate to a very wide range of products and services, although medical billing and pay phone sales were among the most frequently occurring.
3. The most common complaint about goods was non-delivery, cited in more than 10% of cases.

### Supporting Data and Analysis

Chart D.1  
**How Advertised**

Chart D.1 identifies how consumers originally became aware of the franchise or business opportunity. Although this information was only available for about half of the complaints, traditional media appear to remain the most frequent means of contact.

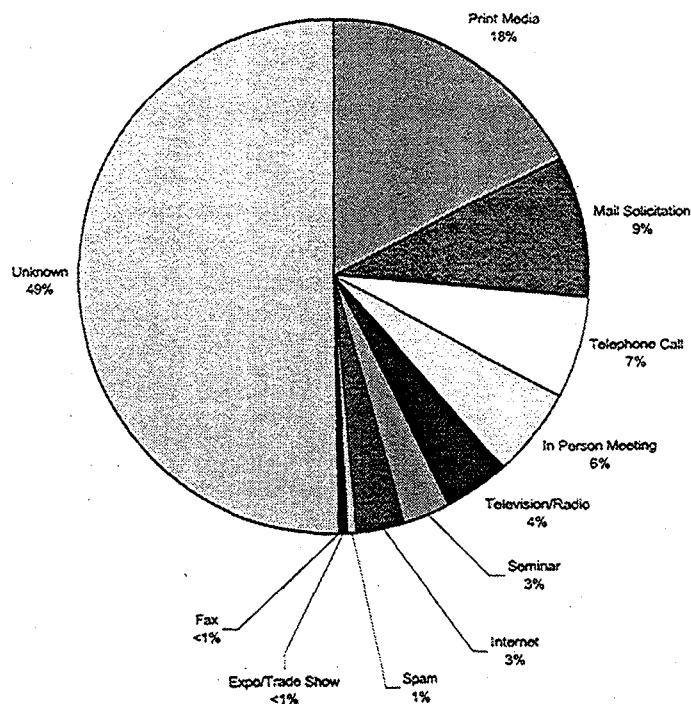


Chart D.2

### How Advertised (non-values omitted)

Chart D.2 indicates the breakdown of the records for which the advertising medium was stated in the complaint. Print and mail together make up more than half of these complaints.

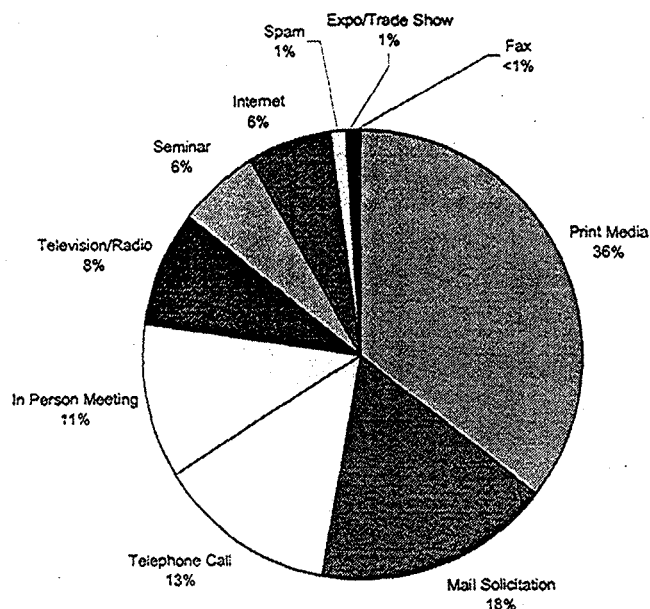


Chart D.3

### Top 15 Products

Chart D.3 shows the product categories that received the most complaints in the database. Product type information was available for 659 of the records. The complaints identified a wide range of products, falling into 124 different categories.

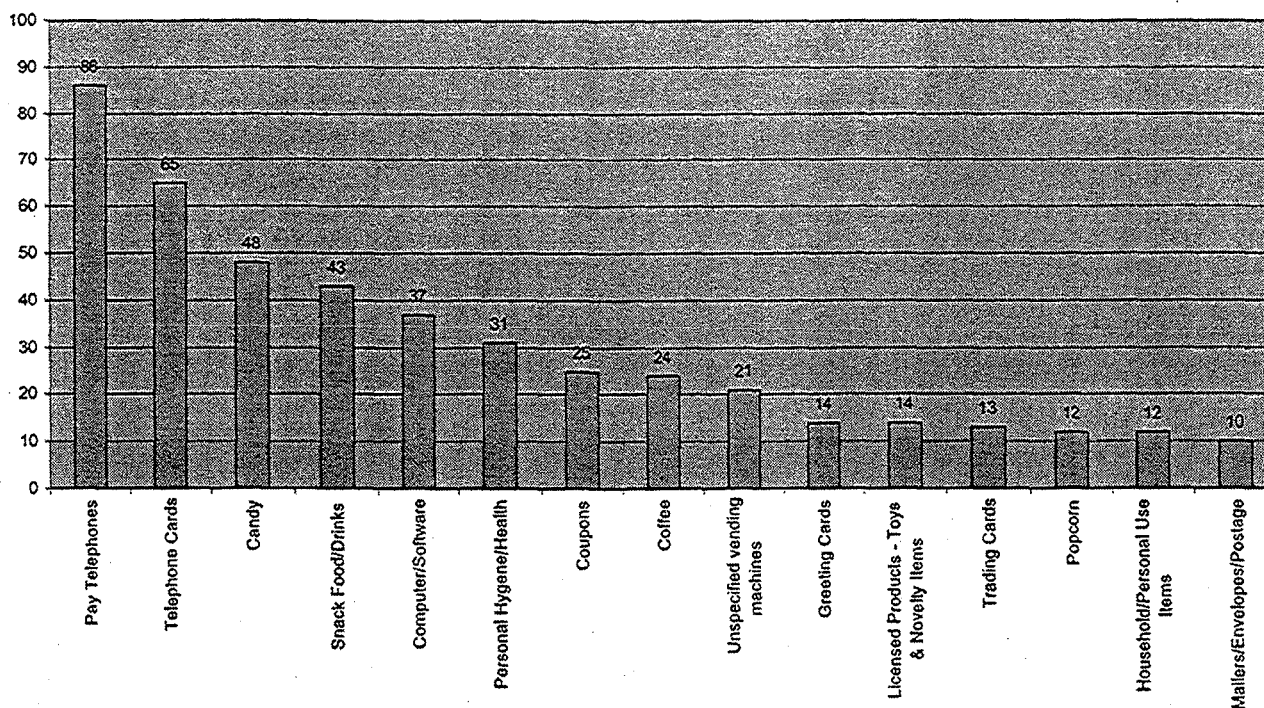


Chart D.4  
**Top 15 Services**

Chart D.4 shows the service categories that received the most complaints in the database. Service type information was specified in 628 of the records. Medical billing was the dominant source of complaints, although as with product types, there was a wide range of services identified in 83 categories.

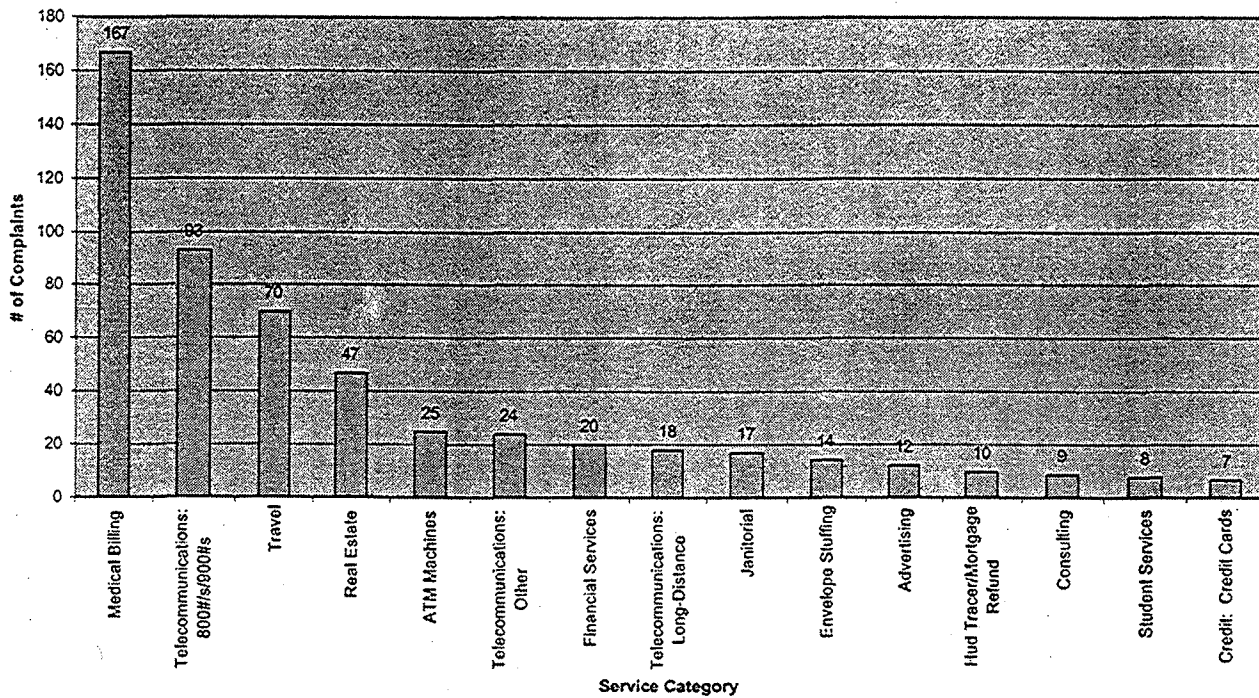


Chart D.5

### Top Internet Offerings

Internet offerings represented a relatively small proportion of the database complaints. They comprised 22 different categories within the 179 records where information was available. Chart D.5 identifies Internet shopping malls as the leading cause of Internet opportunity complaints.

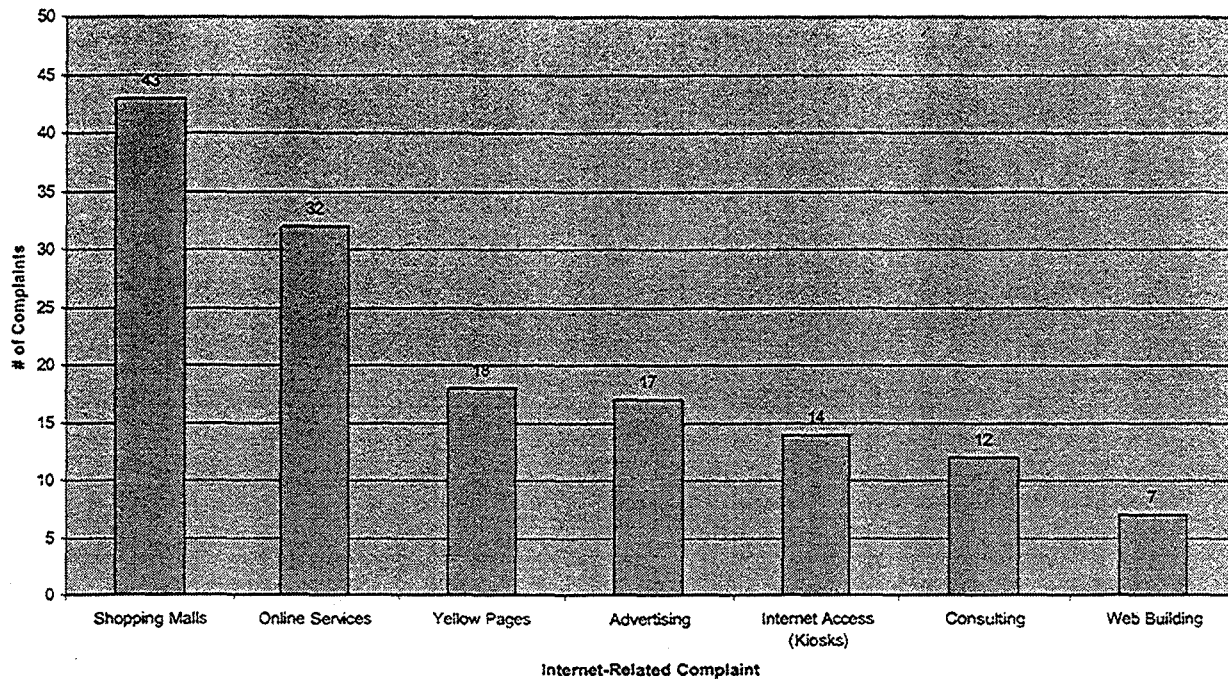


Chart D.6

### Complaints About Goods

Chart D.6 displays goods-related complaints. Non-delivery was the most common complaint from franchise and business opportunity purchasers, occurring in more than 10% of all records.

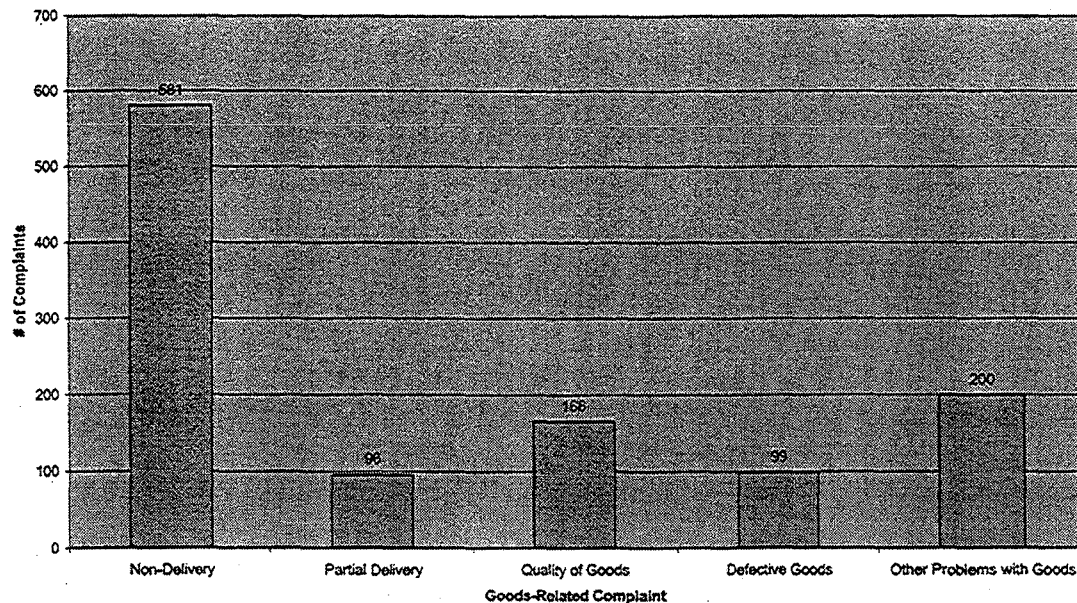


Chart D.7  
**Complaints About Franchise Goods**

Chart D.7 confirms that for the subset of franchises, non-delivery was still the dominant complaint.

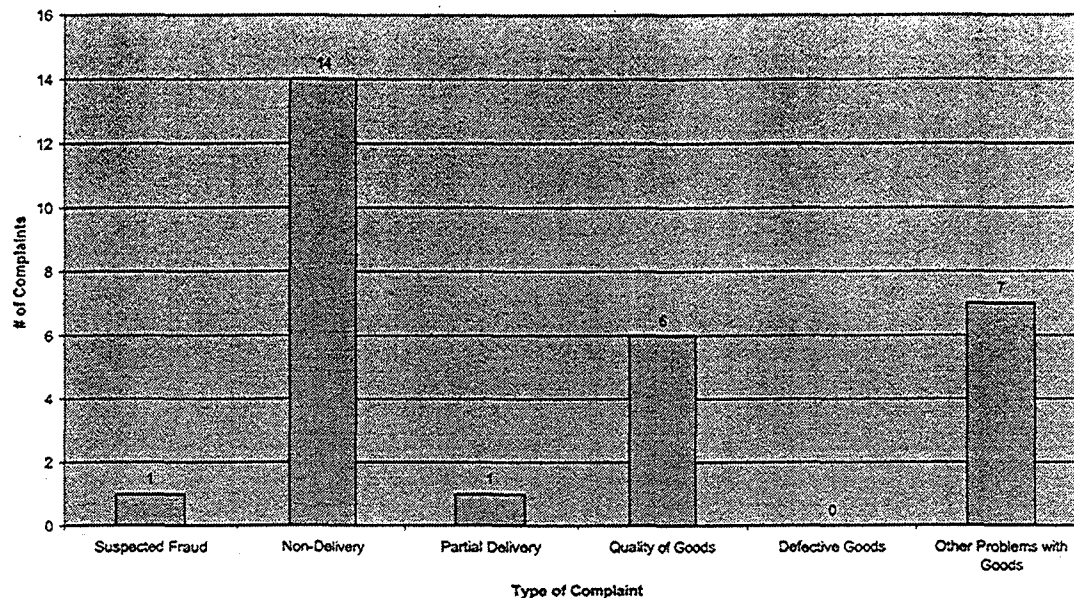


Chart D.8  
**Complaints About Business Opportunity Goods**

The subset of business opportunity complaints reflected a similar distribution of goods-related issues, with non-delivery again the most common. Chart D.8 indicates that defective goods were a more frequently identified problem for business opportunities than for franchises.

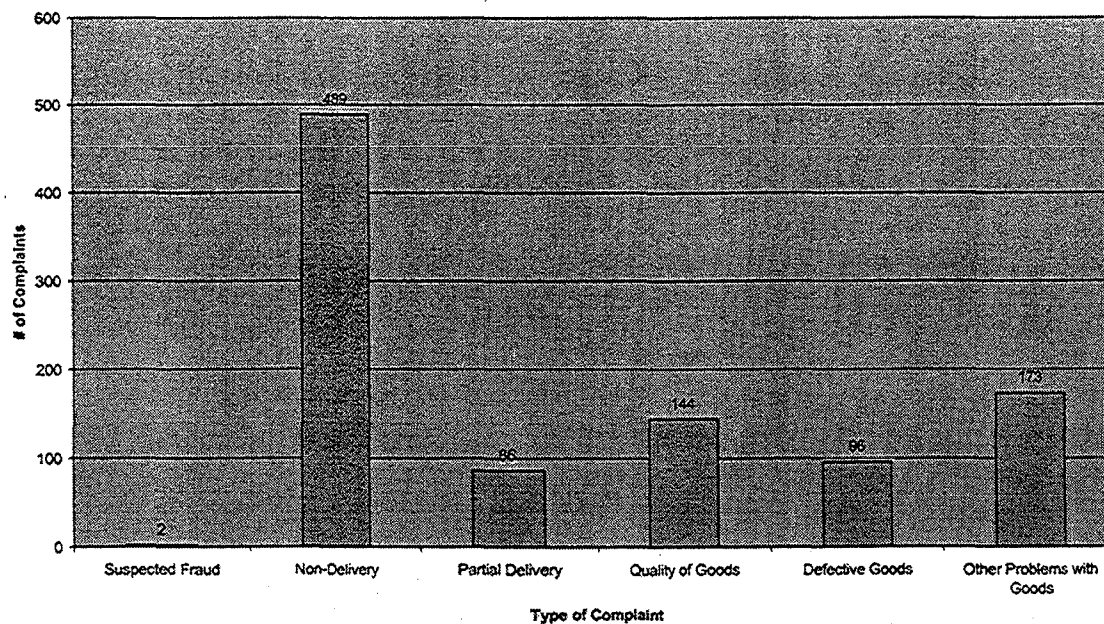
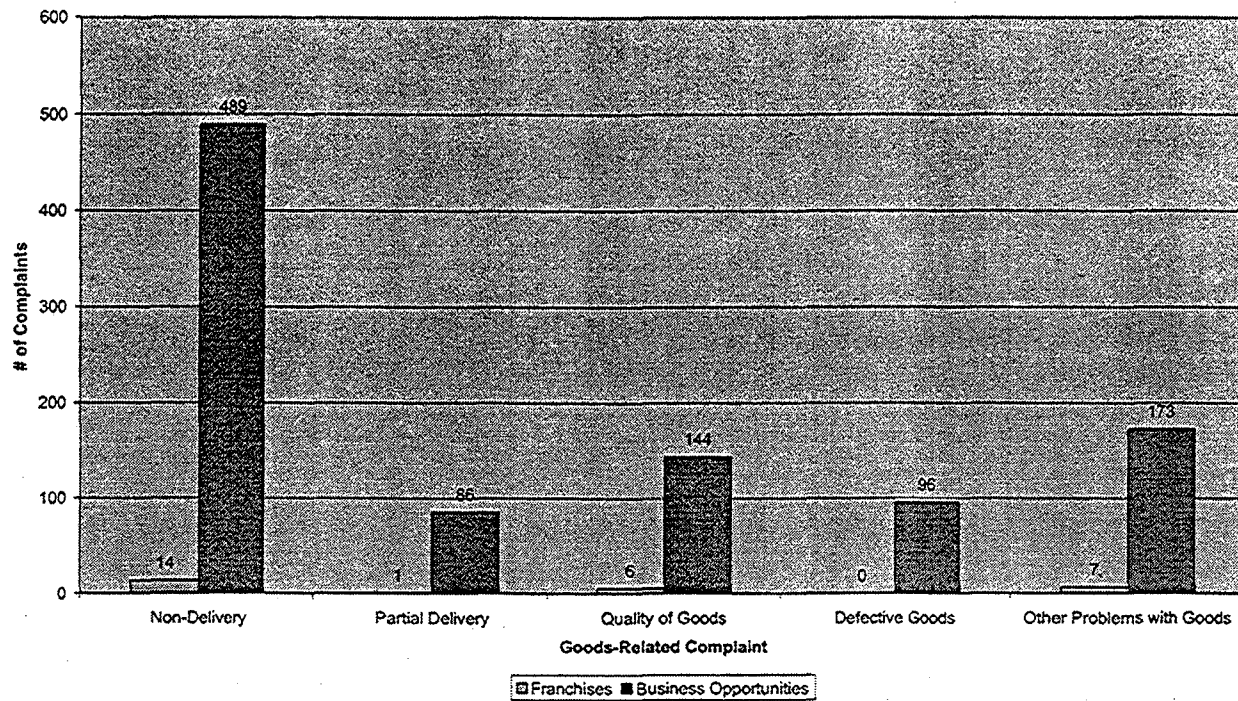




Chart D.9

**Franchise and Business Opportunity Complaints About Goods**

Chart D.9 compares the relative frequency of franchise and business opportunity complaints in various goods-related complaint categories.



## Expectations, Disclosures, and Post-Sale Issues

The “Expectations, Disclosures, and Post-Sale” section identifies various other problems encountered in the course of the business interaction, including earnings claims, misrepresentations about support or training, disclosure issues, and refund disputes.

### Findings

1. More than 10% of records included complaints about earnings claims. Lack of support or of promised locations each appeared in almost 5% of records.
2. Problematic disclosure issues (such as the absence of a disclosure document) were proportionally more frequent for franchises than for business opportunities.
3. Many complainants raised post-sale issues. Nearly 25% of records indicated that the complainant wanted to cancel, and more than 20% of records identified a refund policy issue or the inability to obtain a requested refund.

### Supporting Data and Analysis

Chart E.1

#### Expectations Not Met

A large number of records reported that the description of the franchise or business opportunity included specific earnings claims. Chart E.1 also indicates that various support problems were among the most common complaints raised by franchise and business opportunity purchasers.

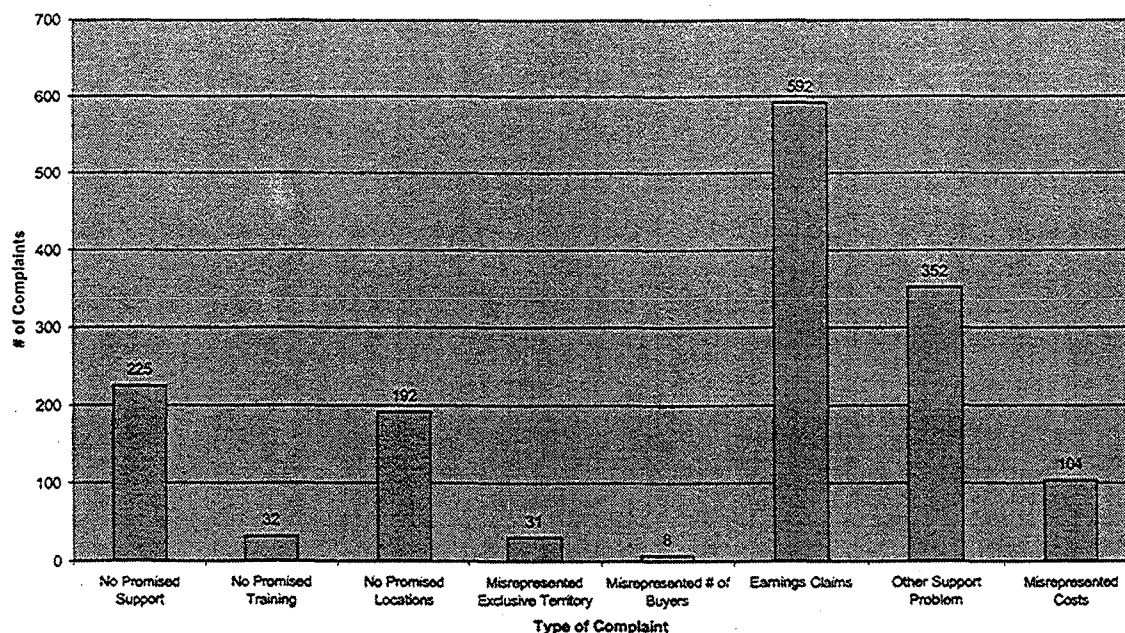


Chart E.2

**Franchise Consumer Expectations Not Met**

Chart E.2 indicates that territory and cost misrepresentations and lack of promised support were, proportionally, slightly more significant in the subset of franchise complaints than in the database as a whole.

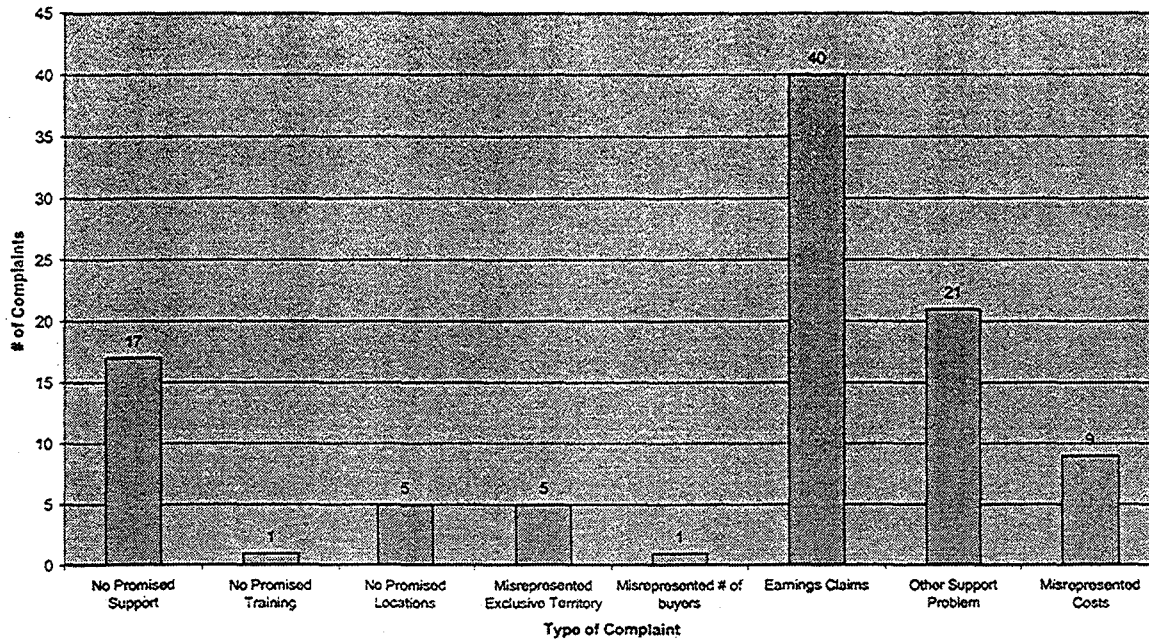


Chart E.3

**Business Opportunity Consumer Expectations Not Met**

Chart E.3 reinforces the frequency of earnings claims, support problems, and location complaints for the subset of business opportunities.

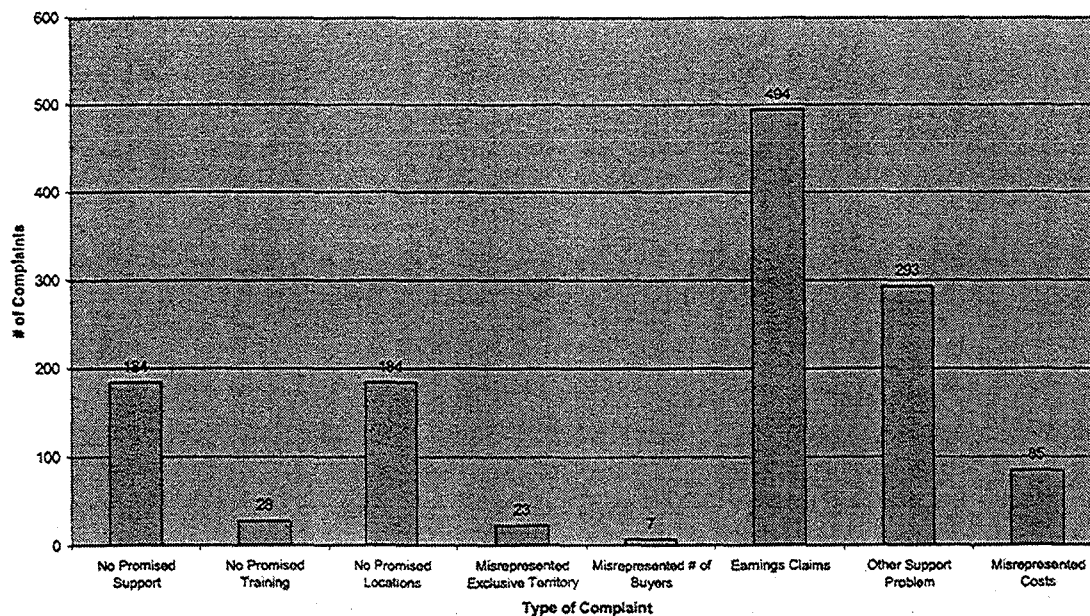




Chart E.4

### Franchise and Business Opportunity Consumer Expectations Not Met

Chart E.4 compares the relative frequency of franchise and business opportunity complaints in several expectations-related complaint categories.

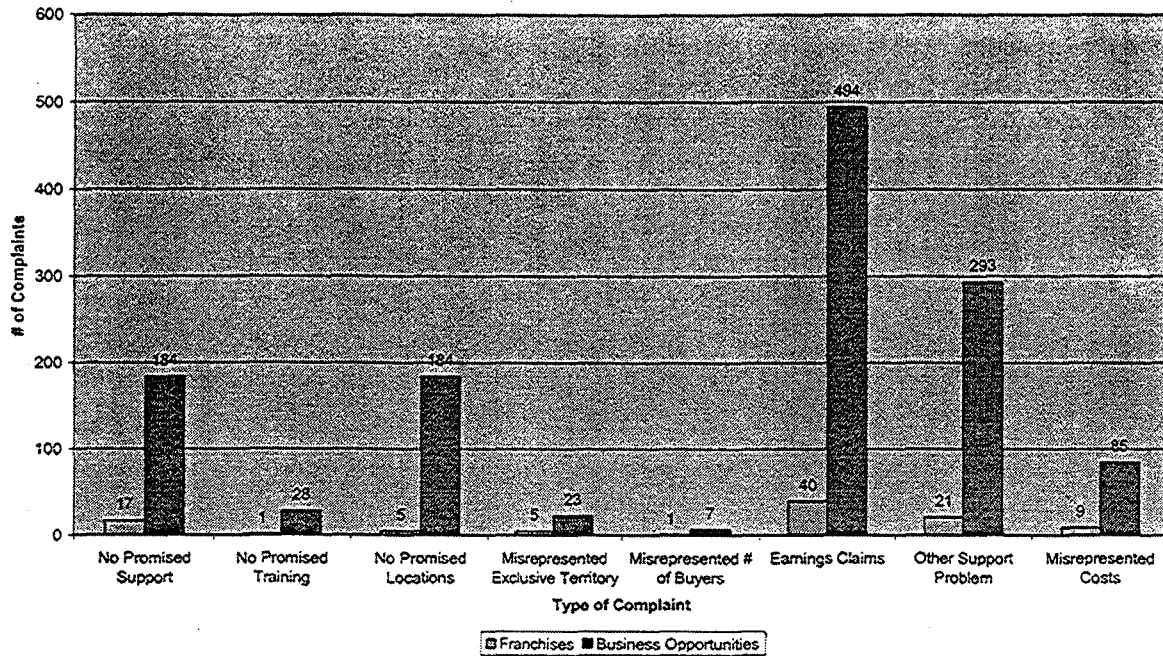


Chart E.5

### Disclosure Questions

A relatively small number of consumers specifically indicated either that they had received no disclosure document or that some other substantive disclosure had not been made prior to the sale of the franchise or business opportunity.

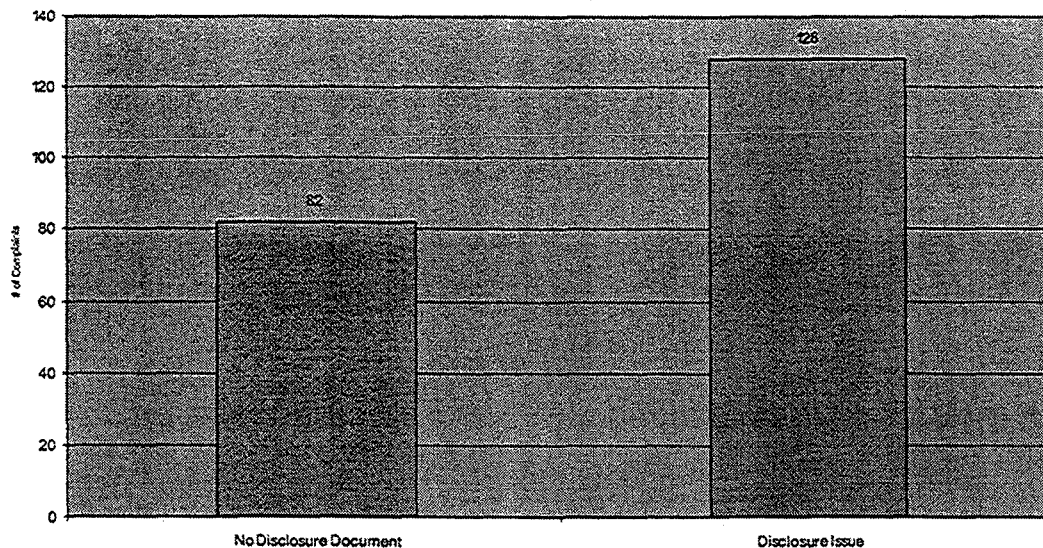


Chart E.6

**Franchise and Business Opportunity Disclosure Questions**

As Chart E.6 indicates, disclosure issues were proportionally far more frequent for franchises than for business opportunities. More than 15% of franchise records indicated a disclosure issue, and nearly 10% received no disclosure document. Disclosure complaints were proportionally sparse in the subset of business opportunity complaints, although the raw numbers were comparable to the franchise subset for those issues.

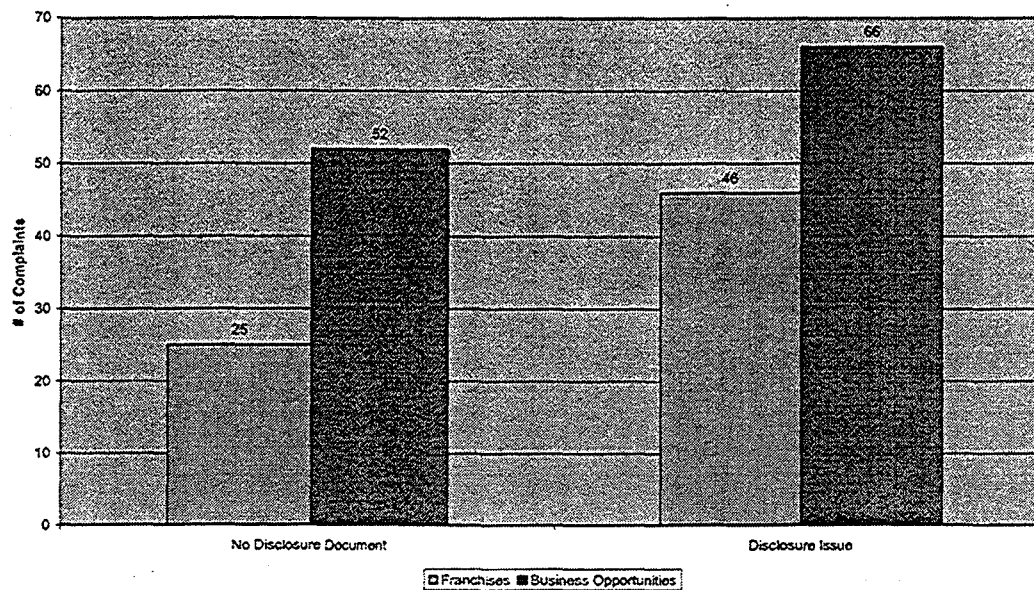


Chart E.7

**Cancellation, Refund, and Billing Issues**

Chart E.7 reveals that many records indicated consumer intentions to cancel after the sale; a significant number also cited the company's failure to refund or complained about the company's refund policy.

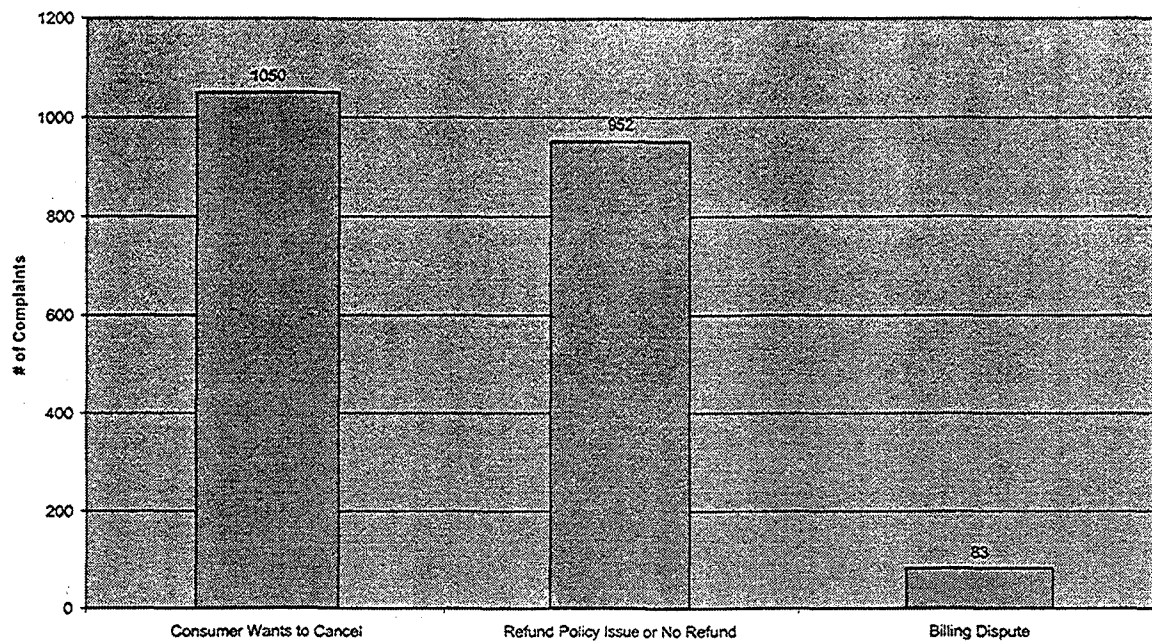
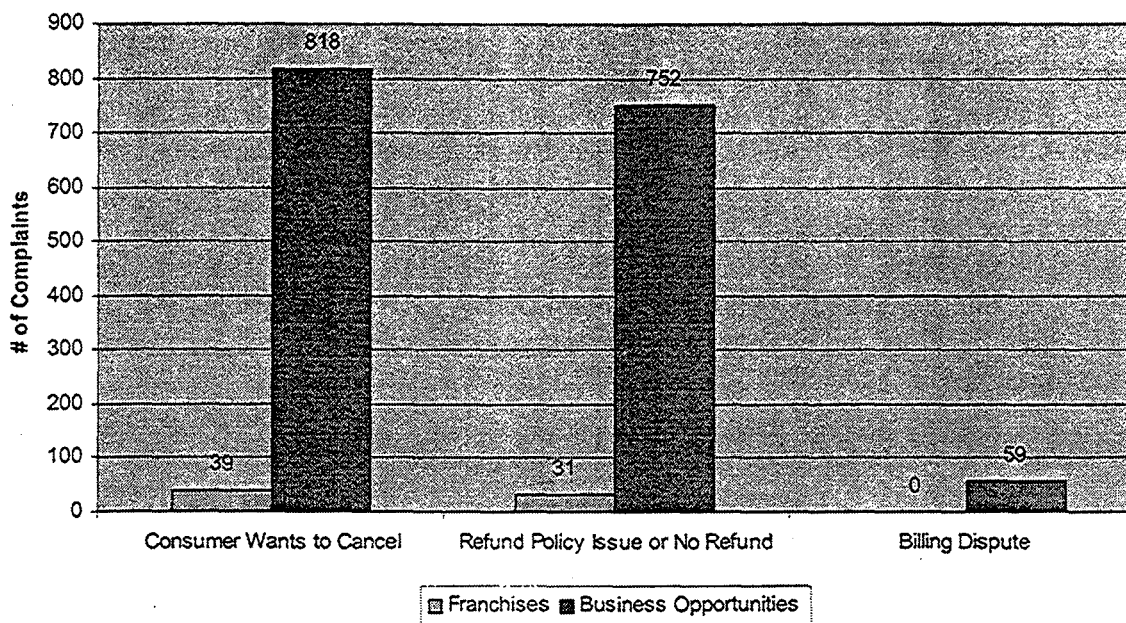


Chart E.8

**Franchise and Business Opportunity Cancellation, Refund, and Billing Issues**

Post-sale issues were proportionally less frequent in franchise complaints than in the database as a whole. Nearly a quarter of business opportunity complaints indicated the consumer's desire to cancel, and more than 20% failed to receive a refund or were dissatisfied with company refund policies.



# Law Enforcement

This section presents an analysis of franchise and business opportunity-related law enforcement activities from 1993 through 1999. It includes cases that were filed in 2000, if an investigation was opened in 1999 or earlier.

## Law Enforcement Analysis Structure

The statistical analysis of franchise and business opportunity complaint data is divided into the five sections described below. Each section includes a summary, applicable charts, and analysis.

**Investigations:** This section analyzes the number of investigations opened during the relevant time period. Statistics are provided for both franchises and business opportunities covered by the Franchise Rule and only by Section 5 of the FTC Act.

**Cases:** This section analyzes the number of cases opened during the relevant time period. Statistics are provided for both franchise and business opportunities covered by either the Rule, Section 5 of the FTC Act, or both.

**Victims:** This section analyzes the number of victims in cases, to the extent known.

**Allegations:** This section analyses the Rule and Section 5 allegations charged in law enforcement matters.

**Correlations:** This section analyses the correlation between consumer complaints and investigations.

## General Observations

We can draw several conclusions from our analysis of Commission law enforcement activities. First, during the relevant time period, the Commission pursued significantly more potential Rule and Section 5 business opportunity law enforcement matters (273 investigations, of which 148 resulted in cases) than franchise matters (59 investigations, of which 22 resulted in cases). This law enforcement approach was consistent with the number of business opportunity complaints submitted to the Commission, as analyzed in the previous section.

Second, since 1994, the Commission, in many instances, has leveraged its resources by bringing coordinated law enforcement projects with other federal, state, and local law enforcement authorities.

Third, the number of victims in Commission cases was consistent with the FBOD complaint statistical analysis: in many instances, the Commission brought law enforcement actions against companies with over 100 victims. In some instances, the number of victims was 50,000 or higher.

Fourth, making false or unsubstantiated earnings claims was the most frequent Rule and Section 5 allegation charged in Commission actions (127 Rule allegations and 123 Section 5 allegations).

Fifth, there was a direct correlation between the number of investigations opened by Commission staff and complaint data in the FBOD. In all instances where a business opportunity company remaining in business generated 18 or more complaints, an investigation was opened. Where business opportunities generated five to 17 complaints, Commission staff opened investigations against approximately a half to a third of the companies, provided they were still in business. Staff also opened 68 business opportunity investigations where only a single complaint was filed.

Similarly, staff opened investigations of each franchisor generating five or more complaints, and an additional 11 investigations where franchisors generated 4 or fewer complaints, including 8 investigations based upon only one complaint.

# Investigations

## Findings

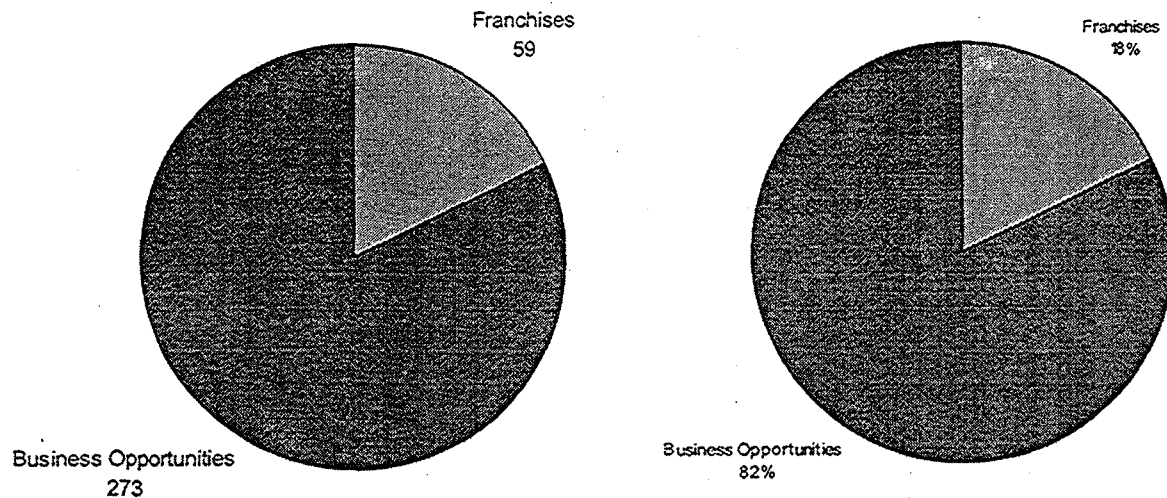
1. The Commission staff pursued 332 franchise and business opportunity investigations during the relevant time period. This included 273 business opportunity investigations and 59 franchise investigations.
2. Business opportunity investigations comprised 82% of the total investigations opened in this field.

## Supporting Data and Analysis

Chart F.1

### **Franchise and Business Opportunity Investigations Opened, by Number and by Percent**

These charts present the distribution of 332 Commission franchise and business opportunity (Rule and Section 5) investigations opened by staff between 1993 and 1999. Although franchise complaints represented only about 6% of the database, they represented 18% of investigations.



## Cases

### Findings

1. Since 1994, the Commission has coordinated its law enforcement activities with the states, bringing actions through law enforcement sweeps.
2. Since 1993, the Commission has brought 170 franchise or business opportunity cases. In the 170 cases, the Commission named as defendants 330 corporations and other entities (e.g. d/b/a's) and 305 individuals.
3. Of the 170 franchise or business opportunity cases, 148 were against business opportunity schemes during the relevant time period. This was consistent with our statistical analysis showing that the overwhelming number of complaints submitted to the Commission pertained to the sale of business opportunity ventures.
4. Of the 170 franchise or business opportunity cases, 22 were against franchisors during the relevant time period.
5. Starting in 1998, the Commission staff has referred franchise matters that raise technical or minor violations of the Rule to an Alternative Law Enforcement Program administered by the National Franchise Council (NFC), in lieu of a formal Commission action.

### Supporting Data and Analysis

Table G.1

#### **Joint Law Enforcement Projects**

This table lists the joint law enforcement projects with states and other federal agencies from 1994 to 1999.

1994: Trade Show Sweeps
1995: Project Telesweep
1996: Operation Missed Fortune
1997: Project Trade Name Games
1998: Project Vend Up Broke
1999: Project Bizillion\$



Chart G.2

### Case Breakdown by Type

This chart presents a breakdown of 170 cases filed by the Commission during the relevant time period. The chart divides Commission cases into three categories: 1) franchise cases; 2) franchise referrals, since 1998, to the National Franchise Council's Alternative Law Enforcement Program; and 3) non-franchise cases, which includes business opportunity matters pursued under the Franchise Rule, as well as under Section 5 of the FTC Act.

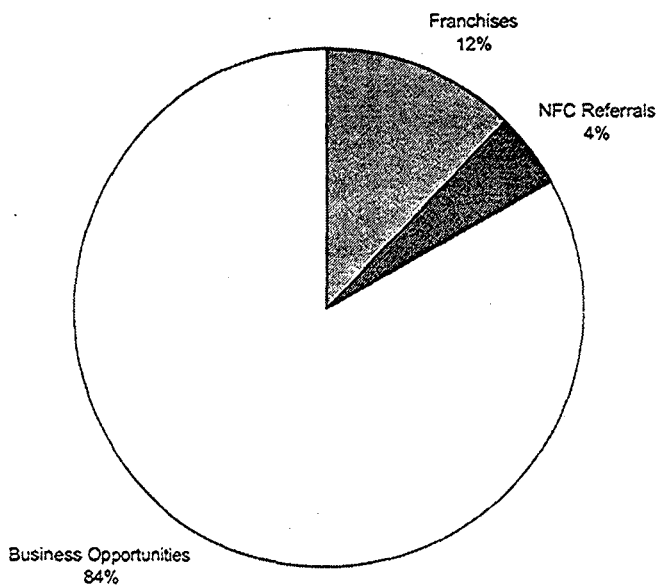


Table G.3

### FTC Franchise Cases

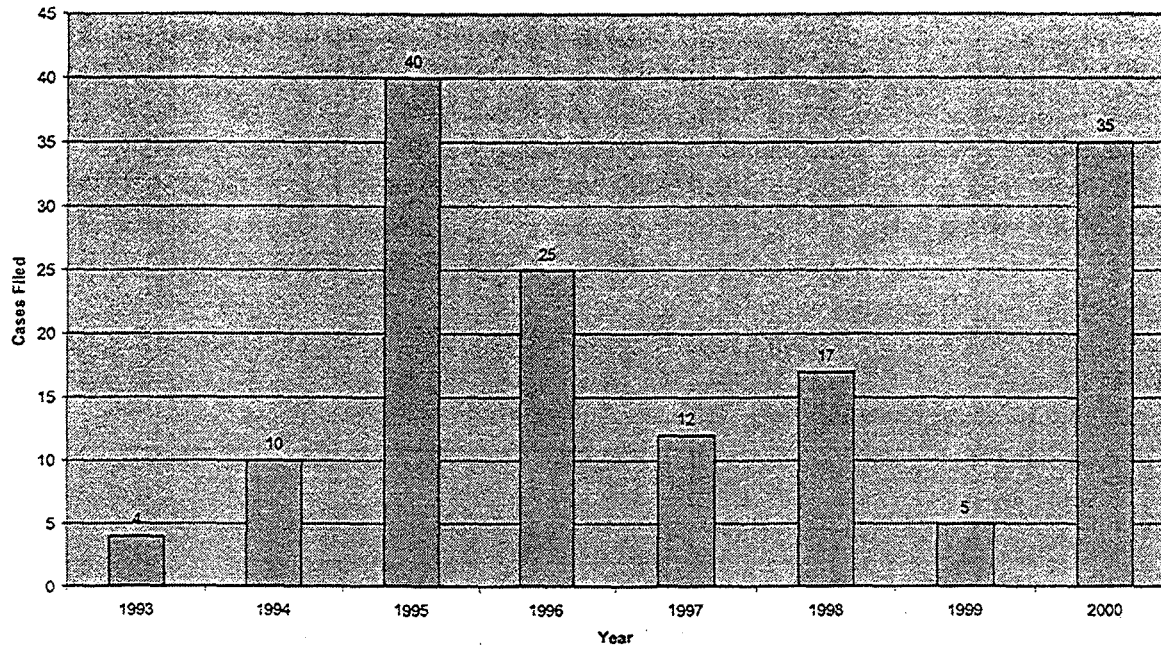
This table shows the distribution of 22 franchise cases and 8 NFC referrals from 1993 to 1999.

1993:	7 court cases
1994:	7 court cases
1995:	5 court cases
1996:	3 court cases
1997:	0
1998:	1 NFC referral
1999:	6 NFC referrals
2000:	1 NFC referral

Chart G.4

**FTC Business Opportunity Cases Filed**

This chart shows the distribution, by year, of 148 business opportunity cases filed from 1993 to 2000.



## Victims

### Findings

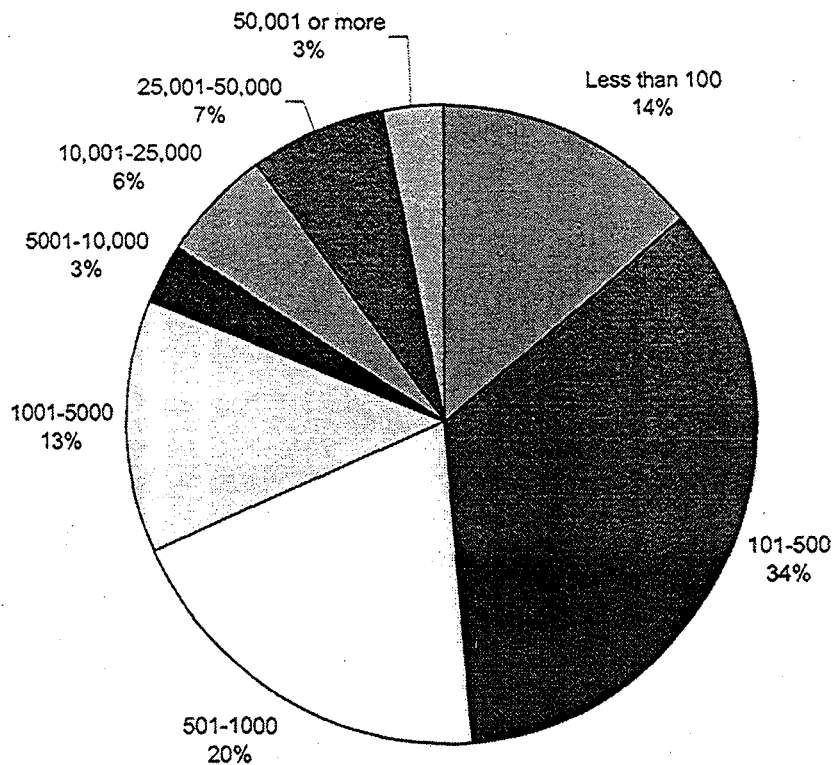
1. In many instances the number of victims of the defendants in Commission law enforcement actions is unknown. Based upon the information available, we found the Commission used its resources to bring actions in the public interest to combat widespread law violations that affected a large number of consumers.
2. Most Commission law enforcement actions targeted schemes with over 100 victims; 10% of the Commissions actions targeted schemes with 25,000 or more victims and 14% targeted schemes with fewer than 100 known victims.

### Supporting Data and Analysis

Chart H.1

#### Case Distribution by Number of Victims

This chart presents the approximate distribution of victims in franchise and business opportunity cases. In most instances, even the approximate number of victims is unknown. For those cases where an approximate number of victims could be calculated, the most frequent number of victims ranged from 100 to 500.



## Complaint Allegations

### Findings

1. The most frequent allegation raised in Commission Franchise Rule cases was that the defendants made earnings claims in violation of the Rule (127 allegations). This included earnings claims made without providing an earnings claims document (or the equivalent Uniform Franchise Offering Circular [UFOC] Item 19 information required under state law); unsubstantiated earnings claims; or earnings claims made in the general media without the Rule's required disclosures.
2. The second most frequent allegation was the failure to furnish a disclosure document. This allegation has been particularly frequent with respect to business opportunity ventures. Commission cases alleged the failure to provide disclosure documents in 123 instances.
3. The most frequent allegation regarding the completeness and accuracy of disclosure documents applied to franchisee information (11 allegations). This included instances where the disclosure documents lacked franchisee names and addresses, as well as franchisee statistics (e.g., number of outlets and closures). Failure to disclose all litigation (6 allegations) had the second highest number of allegations.
4. Where the Commission alleged deceptive or unfair conduct under Section 5 of the FTC Act, the largest number of allegations (94) pertained to false earnings claims. This was followed by the use of skills or other false references (28).

## Supporting Data and Analysis

Table I.1

### Rule Complaint Allegations

This table presents a breakdown of the Rule allegations raised in all franchise and business opportunity enforcement matters. The most common allegation was the making of earnings claims without substantiation or without providing the required earnings claims document (127). The most common failure to disclose information in a disclosure document pertained to franchisee statistical information, as well as franchisee names, addresses, and telephone numbers (11).

Earnings claims	127
No disclosure document	113
Failure to disclose:	
Franchisee information	11
Litigation	6
Background information	4
Terminations, renewals, etc.	2
Bankruptcy	1
Costs/fees	1
Financial information	1
Refund policy	1
Inconsistent statements	4
Failure to make refunds	2
Contempt/order violations	2

Table 1.2

**Section 5 Complaint Allegations**

This table presents a breakdown of Section 5 allegations raised in all franchise and business opportunity enforcement matters. The most common allegation was false earnings claims (94). Other common false or deceptive representations pertained to testimonials and references (28); profitability and availability of locations for vending machines or other devices (24); and support and assistance (17).

Earnings	94
Testimonials/references	28
Profitable locations/ availability of locations	24
Support/assistance	17
Nature of products/services/opportunity	11
Exclusive territories	10
Prior success of seller or locator	10
Investment/Costs/Expenses	9
Refunds	9
Availability of work	5
Delivery date	5
Location replacement policy	5
Availability of clients	3
Benefits	3
Government affiliation/approval	3
Investment recovery	3
Training	3
Commissions	2
Compliance with FTC/state requirements	2
Legal requirements	2
Previous buyers' success/failure rates	2
Product demand	2
Access to suppliers	1
Cancellation policy	1
Complaint resolution history	1
Litigation	1
Necessary effort	1
Prior experience required	1
Profit sharing	1
Selling requirements	1
Sources of income	1

## **Correlation Between Law Enforcement and Complaints**

### **Findings**

1. The opening of franchises and business opportunity investigations strongly correlated with the number of complaints received in the FBOD. This does not mean that every investigation was prompted by one or more complaints, although most were. In some instances, investigations were prompted by advertisements, or referrals from third parties, not reflected in the CIS database.
2. In all instances where the FBOD indicated that a business opportunity generated 18 or more complaints, Commission staff opened an investigation, provided that the company involved remained in business.
3. Where business opportunities generated fewer than 18 complaints, but more than seven complaints, Commission staff opened investigations in approximately half of the instances, provided the company involved remained in business.
4. Staff opened investigations in every instance where the FBOD showed that a franchise generated five or more complaints, provided that the complainant named the franchisor involved and stated a specific allegation (154 complaints). Staff also opened eight investigations where only a single complaint was filed.
5. In many instances, franchise complaints raise concerns that do not lend themselves to a law enforcement solution. For example, a complaint may 1) provide insufficient information for staff to take action (e.g., fails to name the franchiser or to state a specific allegation); 2) fall outside the Commission's jurisdiction (e.g., raises state law issues only); or 3) raise purely contractual matters (e.g., requires interpretation of contract provisions).

## Supporting Data and Analysis

Table J.1

### Correlation of Complaints to Business Opportunity Investigations

This table presents the correlation between the number of business opportunity complaints and the opening of an FTC investigation. Except in four instances (where the company complained about was already out of business) the Commission opened an investigation of each company generating 18 or more consumer complaints. For 17 or fewer complaints, the number of investigations decreased in proportion to a decline in the number of complaints filed. Nonetheless, Commission staff pursued 68 investigations of companies generating only one complaint.

Number of Complaints	Investigation Rate <sup>1</sup>
More than 101	1/1
91-100	1/1
81-90	1/1
71-80	2/2
61-70	1/1
51-60	1/1
41-50	2/2
31-40	3/5 (remaining 2/5 were out of business)
21-30	4/6 (remaining 2/6 were out of business)
20	1/1
18	3/3
17	1/3 (1 of remaining 2/3 was out of business)
16	3/4 (remaining 1/4 was out of business)
15	3/7 (2 of remaining 4/7 were out of business)
14	4/7 (1 of remaining 3/7 was out of business)
13	3/6 (1 of remaining 3/6 was out of business)
12	1/1
11	3/5 (1 of remaining 2/5 was out of business)
10	5/7
9	6/11
8	4/7
7	6/13
6	7/18 (8 of remaining 9/18 were out of business)
5	13/30 (6 of remaining 17/30 were out of business)
4	8/45 (7 of remaining 37/45 were out of business)
3	22/68 (8 of remaining 46/68 were out of business)
2	30/154 (26 of remaining 124/154 were out of business)
1	68/539 (42 of remaining 471/539 were out of business)

<sup>1</sup>Number of investigations opened/number of companies generating the number of complaints indicated in first column.



Table J.2

**Correlation of Franchise Complaints to Investigations**

This table presents the correlation of franchise complaints to the franchise investigations noted above. The Commission staff opened an investigation of each franchise matter generating at least five complaints. No company received more than eight complaints. At the same time, staff opened an additional 11 investigations\* where companies received four or fewer complaints, including eight investigations of companies with only one complaint.

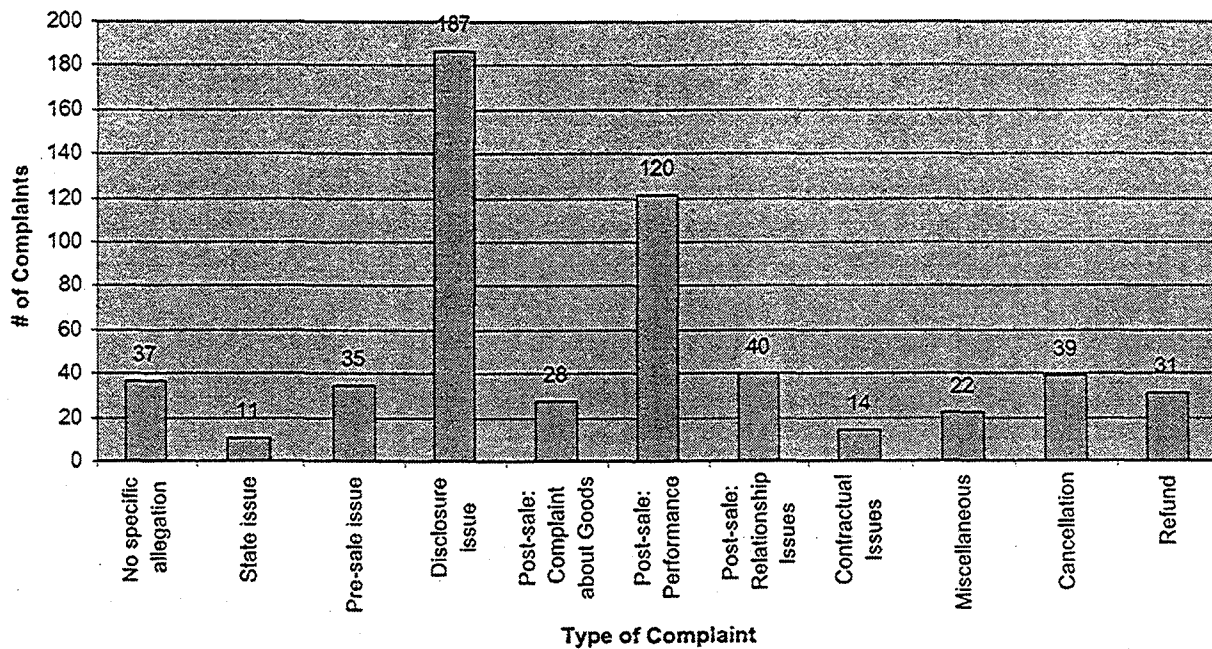
\*This does not include the first company that was referred to the NFC program.

<b>Number of Complaints</b>	<b>Investigation Rate<sup>1</sup></b>
8	1/1
5	1/1
4	1/2
3	2/6
2	0/12
1	8/91

<sup>1</sup>Number of investigations opened/number of companies generating the number of complaints indicated in first column.

Table J.3  
**Franchise Complaint Viability**

When considering the correlation between franchise complaints and investigations opened, we must consider not only whether the company remains in business, but whether the complaint is viable, that is, names a specific company, states a specific allegation, and falls within the Commission's jurisdiction. In many instances, franchise complaints made no specific allegation (37 complaints); raised state law issues only (11 complaints); raised contractual interpretation issues only (14 complaints); or voiced concerns that do not lend themselves to a law enforcement solution, such as expressing remorse or a wish to cancel the franchise agreement (39 complaints).



# Consumer Education

## Overview

The FTC Office of Consumer and Business Education (OCBE) produces print, broadcast and online materials that offer practical, plain English advice for consumers about buying a wide variety of products and services and explain how various federal regulations help protect consumers' rights. It also produces print materials for business explaining how to comply with various rules and regulations.

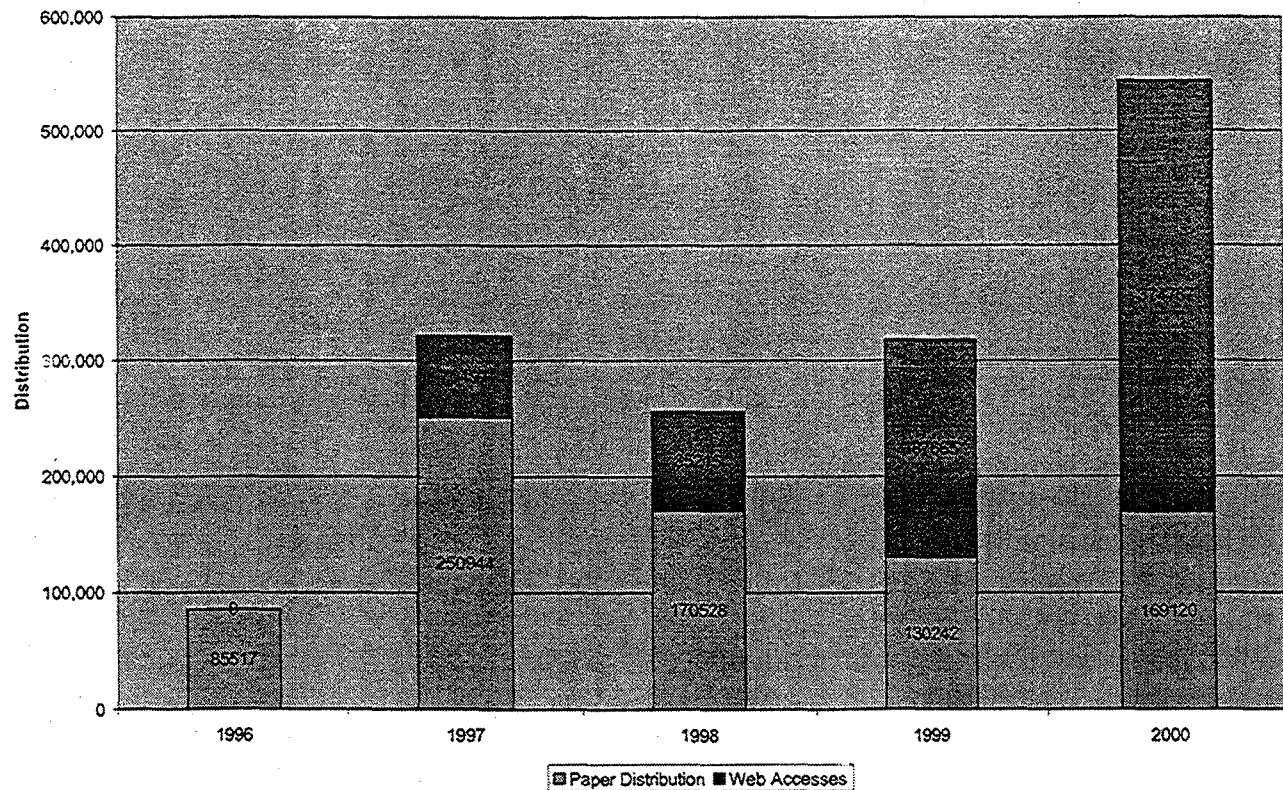
OCBE has taken an ambitious approach to educating consumers about their rights in the franchise and business opportunities marketplace. In the last several years, the Office has produced more than a dozen relevant publications and launched several major education initiatives.

## Print Products

OCBE's inventory includes 14 different publications for consumers who are interested in pursuing franchises and business opportunities. These publications seem to address a need: Since October 1995, over 806,000 of these publications have been distributed; an additional 718,000 publications have been accessed via the FTC's website since October 1996.

Chart K.1

**Distribution of Franchise/Business Opportunity Consumer Education Information by Fiscal Year, 1996 to 2000**



## Websites ([www.ftc.gov](http://www.ftc.gov), [www.consumer.gov](http://www.consumer.gov))

In 1997, OCBE put all its consumer publications online, enhancing outreach considerably. Consumers can access the publications not only at the FTC's website, but also at [www.consumer.gov](http://www.consumer.gov), the federal government's "one-stop" outlet for federal consumer information (hosted and managed by the FTC). We cannot keep track of all the sites that link to the information on [www.ftc.gov](http://www.ftc.gov) or [www.consumer.gov](http://www.consumer.gov), but a look at the numbers indicates that consumers are accessing the publications from a wide variety of sites.

## Teaser Sites

Too often, consumers don't find consumer protection information until it's too late. Using "teaser" websites, OCBE tries to reach consumers before they make a purchase or invest their money. These web pages are accessible from major search engines and indexing services and mimic fraudulent sites. Internet shoppers looking for a business opportunity, for example, may find a site that offers a fantastic, money-making opportunity in display racks. (See [www.wemarket4u.net/eztoys](http://www.wemarket4u.net/eztoys)). Clicking through the "come on," the FTC seal appears, alerting consumers that they could have been scammed. The site offers tips on how to distinguish fraudulent pitches from legitimate ones and links to the FTC's website for additional information. Uniformly, visitors to these sites have praised the FTC for the novel and attention-getting way it is imparting information. (See also [www.wemarket4u.net/netops](http://www.wemarket4u.net/netops)).

In addition, OCBE also has devised Internet tutorials in the form of interactive puzzles and games to reinforce what consumers have read on the FTC's website or in their local newspapers. For example, the education component of enforcement actions dealing with investment fraud features an online quiz called "Test Your Investment IQ." A series of typical telemarketing misrepresentations asks consumers to define the investment offering as "solid" or "risky."

## Audio Public Service Announcements

In 1995, OCBE distributed four audio public service announcements (PSAs) and corresponding announcer scripts about buying a franchise to 2,000 English language radio stations and three Spanish language PSAs to 200 Spanish language radio stations. Nearly 700 radio stations broadcast at least one of the PSAs, resulting in a total of more than 35,354 broadcasts of at least one PSA. The total audience reached through these broadcasts was approximately 96 million. The equivalent value of the air time received if purchased would be approximately \$884,000.

In 1996, OCBE distributed an additional four Spanish language audio "franchise" PSAs and two announcer scripts to 228 Spanish language radio stations. A total of 124 radio stations broadcast at least one of the PSAs, resulting in a total of 9,453 broadcasts of at least one PSA. The total audience reached through these broadcasts was more than 30 million. The equivalent value of the air time received if purchased would be approximately \$236,325.

In 1997, OCBE distributed four additional "franchise" public service announcements and announcer scripts to 1,000 radio stations. A total of 242 radio stations broadcast at least one of the PSAs, resulting in a total of 13,364 broadcasts of at least one PSA. The total audience reached through these broadcasts was more than 18 million. The equivalent value of the air time received if purchased would be approximately \$334,100.

## Campaigns

In December 2000, OCBE launched "Top 10 Internet Scams," a campaign designed to educate consumers about the most prevalent scams on the Internet and how to recognize and avoid them. Business opportunity scams advertised online ranked eighth in the Top 10. This OCBE effort supported the Bureau of Consumer Protection's large law enforcement sweep. OCBE produced two new publications for print and the web: a Facts for Consumers (FFC) brochure, *Dot Cons* and a "news you can use" type feature, *Consumers Find Internet Offers That Just Don't Click*. OCBE sent the brochure to a mailing list of 6,200 intermediaries, in addition to Internet service providers, Internet advertising groups, business groups, military news services, Fortune 100 copies and 25 top-circulation magazines. The consumer feature was distributed to media via BusinessWire, an online news distributor. OCBE developed a special website, [www.ftc.gov/dotcons](http://www.ftc.gov/dotcons), that drew a record number of accesses for the FTC.

As part of "Project Biz-illion\$," a multi-pronged attack on traditional fraudulent business opportunities, OCBE issued six consumer publications: *Franchise and Business Opportunities*, *Medical Billing Business Opportunity Schemes: A Bitter Pill*, *Work-At-Home Schemes*, *'Net-Based Business Opportunities: Are Some Flop-portunities?*, *Could 'Biz Opp' Offers Be Out for Your Coffers?*, and *Answering the Knock of a Business Opp*. OCBE sent the publications to its mailing list of 6,200 and to more than 13,000 media. OCBE also encouraged select websites to post information on their sites or link to a dedicated web page on [www.ftc.gov](http://www.ftc.gov). As part of its marketing efforts, the Office contacted four search engines offering public service announcements in the form of classified ads, to five classified ad sites; 10 women's sites; seven sites geared to people with disabilities; and 21 employment services sites.