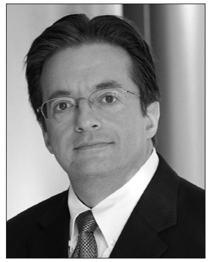
# Personal Liability for Franchise Sellers

*Robert M. Einhorn & Benjamin W. Clements**

## I. Introduction



**Mr. Einhorn**

**Mr. Clements**

Franchising is regulated by the Federal Trade Commission (FTC), which aims to protect prospective franchisees from deceptive practices. The FTC Act[1] explicitly prohibits material misrepresentations about any business investment, and the FTC's Franchise Rule (Franchise Rule) requires franchisors offering or selling a franchise in the United States to provide all prospective franchisees with a disclosure document containing twenty-three items of information about the offered franchise, its officers, and other franchisees.[2] The FTC Act also prohibits a franchisor from making financial representations about the potential performance or profitability of the franchise unit outside the disclosure document.[3]

Despite these regulations, franchisors sometimes engage in unlawful conduct or fraudulent activities in the sale of franchises. This conduct may lead to significant financial losses for franchisees. Because no private cause of action exists under the Franchise Rule, franchisees must rely on state statutes that

1. 15 U.S.C. §§ 41–58. The FTC Act empowers the FTC, inter alia, to (a) prevent unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce; (b) seek monetary redress and other relief for conduct injurious to consumers; (c) prescribe rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices; (d) gather and compile information and conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and (e) make reports and legislative recommendations to Congress and the public. *Id.* §§ 45(1)(2), 46(a), 46(f), 57a, 57b.

2. 16 C.F.R. § 436.1–436.10; *see also* Samuel Levine, *Holding Franchisors Accountable for Illegal Practices*, Fed. Trade Comm'n (Aug. 3, 2022), https://www.ftc.gov/business-guidance/blog/2022/08/holding-franchisors-accountable-illegal-practices.

3. 16 C.F.R § 436.9(c) (prohibiting franchisors from disseminating "any financial performance representations to prospective franchisees unless . . . the representation is included in Item 19 of the franchisor's disclosure document").

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prohibit unfair or deceptive practices to bring claims against franchisors. When franchise disclosure documents contain false or misleading information or when franchisors make material misrepresentations during the sale of a franchise, franchisees can also assert state common law fraud claims.

However, franchisees in these situations may have little practical recourse to obtain compensation for their losses against a franchisor lacking cash flow or assets. Indeed, franchisors engaged in illegal franchise sales and related fraud are often not long for this world. Such franchisor entities may end up financially defunct or bankrupt under the weight of regulatory action, franchisee closures, and litigation.

This paper examines potential solutions to these circumstances by looking a step beyond a franchisor's potential liability and exploring the potential personal liability of the franchisor's principals or agents involved in illegal franchise sales. It examines the extent to which these individuals can be held personally accountable for their involvement in fraudulent activities. As this paper will illustrate, the personal liability of a principal involved in conducting a franchise sale will vary based on applicable state law, but in any event will likely turn on the nature and egregiousness of the fraud or statutory violation and the degree of participation by the individual.

## II. The FTC's Pursuit of Civil Penalties Against Principals

The FTC has occasionally pursued individuals involved in illegal franchise sales as part of its regulatory oversight of franchising. In 2016, the FTC sued LearningRx Franchise Corp. and its CEO and sole director, Ken Gibson, for "making a range of false and unsubstantiated claims" to franchisees and consumers.[4] The FTC alleged Gibson disseminated advertising and marketing materials containing false or unsubstantiated claims that LearningRx's "brain training" programs were "clinically proven to permanently improve serious health conditions," such as attention deficit hyperactivity disorder and dementia,[5] and to significantly increase IQ scores.[6] The FTC detailed the extent of Gibson's control over nearly every aspect of Learning Rx's operations as follows:

> Defendant Ken Gibson is the CEO, secretary, and sole director of LFC. He is the department manager of LFC's "executive department," which is responsible for overseeing all aspects of LFC. Mr. Gibson signs LearningRx franchise agreements, conducts training for franchisees as part of LFC's Training Program, which includes training on marketing and sales, reviews and approves advertising,

4. Press Release, Fed. Trade Comm'n, Marketers of One-on-One 'Brain Training' Programs Settle FTC Charges That Claims About Ability to Treat Severe Cognitive Impairments Are Unsupported (May 18, 2016), https://www.ftc.gov/news-events/news/press-releases/2016/05/marketers-one-one-brain-training-programs-settle-ftc-charges-claims-about-ability-treat-severe.

5. *Id.*

6. Complaint for Permanent Injunction and Other Equitable Relief at 5, Fed. Trade Comm'n v. LearningRx Franchise Corp., No. 1:16-cv-1159 (D. Colo. May 18, 2016).

> and is responsible for LearningRx advertising claim substantiation issues. He has the authority to review and approve all advertising and marketing materials for LearningRx programs, including the materials disseminated to franchisees. At all times material to this Complaint, acting alone or in concert with others, he has formulated, directed, controlled, had the authority to control, or participated in the acts and practices of LFC, including the acts and practices set forth in this Complaint.[7]

The FTC alleged that LearningRX's deceptive acts were squarely in violation of Sections 5(a) and 12 of the FTC Act.[8] The FTC sought "such relief as the Court finds necessary to redress injury to consumers resulting from Defendants' violation of the FTC Act, including but not limited to, recission or reformation of contracts, restitution, the refund of monies paid, and the disgorgement of ill-gotten monies."[9] Despite the FTC's decision to name Gibson as a defendant in his individual capacity, the FTC's proposed settlement did not hold him jointly and severally liable for the stipulated $4 million judgment against LearningRx,[10] which ultimately settled for $200,000.[11]

In *LearningRX*, the FTC sought relief under Section 13 of the FTC Act, which provides for injunctive relief.[12] However, the FTC could have also sought relief under Section 5 of the Act, which imposes civil liabilities of up to $10,000 per violation on a "person, partnership or corporation" who violates an FTC rule "with actual knowledge or knowledge fairly implied on the basis of objective circumstances that such act is unfair or deceptive and is prohibited by such rule."[13] The FTC in that particular instance chose to limit its focus to equitable relief under Section 13 of FTC Act.[14]

More recently, the FTC has taken a firmer approach in holding individual principals liable for violations of the FTC Act. In 2022, the FTC sued fast food burger restaurant franchisor, BurgerIM Group USA, Inc., along with its affiliate company tasked with managing the franchisees, BurgerIM Group, Inc., and its CEO Oren Loni. There, the FTC specifically sought "monetary civil penalties from *each* Defendant for every violation of the Franchise Rule."[15] In contrast to the *LearningRX* complaint, the *BurgerIM*

7. *Id.* ¶ 7.
8. *Id.* ¶¶ 12–16.
9. *Id.* ¶ 21.
10. Stipulated Order for Permanent Injunction and Other Equitable Relief Against Defendants LearningRX Franchise Corp. and Ken Gibson at 9, Fed. Trade Comm'n v. LearningRx Franchise Corp., No. 1:16-cv-1159-RM (D. Colo. May 24, 2016).
11. Press Release, *supra* note 4.
12. 15 U.S.C. § 53.
13. 15 U.S.C § 45(m)(1)(A).
14. *See also In re* Carrot Neurotechnology, Inc., 2016 WL 807980, at *37 (F.T.C. Feb. 22, 2016) (ordering Carrot Neurotechnology and its owners to pay $150,000); Stipulated Final Judgment and Order for Permanent Injunction and Other Equitable Relief at 9, Fed. Trade Comm'n v. Lumos Labs, Inc., 3:16-cv-00001-sk (N.D. Cal. Jan. 8, 2016) (ordering Lumos Labs, but not any individuals, to pay $2,000,000.00 in consumer redress).
15. Complaint for Permanent Injunction and Monetary Judgments for Civil Penalties and Consumer Redress, and Other Relief at 16, United States v. BurgerIM Group USA, No. 2:22-CV-825 (C.D. Cal. Feb. 7, 2022) (emphasis added).

complaint expressly sought to hold Loni jointly and severally liable for damages resulting from the violations that he and the entities under his control committed.[16] The FTC alleged that the fast-food chain "lure[d] would-be entrepreneurs into paying tens of thousands of dollars" by "making representations in their disclosure document that contradicted other statements they made to the prospective franchises."[17] The FTC alleged BurgerIM and Loni not only induced potential franchisees through false promises, but also withheld material information as required by the Franchise Rule.[18] According to the *BurgerIM* complaint,

> Defendant Oren Loni ("Loni") was at all relevant times the chief executive officer of BIMGUSA and BIMG (collectively, "Corporate Defendants"). Acting alone or in concert with others, he has formulated, directed, controlled, had the authority to control, or participated in the acts and practices of Corporate Defendants, including the acts and practices set forth in this Complaint. Loni has advertised, marketed, distributed or sold BurgerIM franchises to consumers throughout the United States. At all times material to this Complaint, Loni formulated, directed, controlled, had the authority to control, or participated in the acts and practices of Corporate Defendants. Loni has been a signatory on BIMGUSA and BIMG bank accounts, communicated with prospective and existing franchisees about the BurgerIM franchise opportunity, entered into agreements, and negotiated contracts with franchisees.[19]

On January 19, 2024, the U.S. District Court for the Central District of California entered a default judgment against BurgerIM and Loni, in his individual capacity, awarding the FTC $7,750,000 in civil penalties and $48,476,689 in consumer redress.[20] The *BurgerIM* case therefore appears to represent a more aggressive approach by the FTC in its use of its enforcement action powers and its willingness to pursue individual liability against franchise sellers under Section 5 of the FTC Act. While the FTC's more aggressive actions may give wronged franchisees another opportunity at redress, the FTC does not have unlimited resources and must prioritize individual actions like these with larger regulatory and enforcement authority. Further, the FTC is subject to the oftentimes shifting policy priorities of each Presidential administration.

## III. Personal Liability Under State Law

Because no private cause of action exists under the Franchise Rule, a franchisee seeking redress for a violation of the Rule must look to applicable

16. *Id.*
17. *Id.* ¶¶ 2, 4.
18. *Id.* ¶ 36.
19. *Id.* ¶ 18.
20. Default Judgment and Final Order for Permanent Injunction and Monetary Judgments for Civil Penalty and Consumer Redress at 4, United States v. BurgerIM Grp. USA, No. 2:22-CV-825-DMG (C.D. Cal. Jan. 19, 2024).

state law.[21] Before its 2007 amendments, the Franchise Rule had remained unchanged since its promulgation in 1979. As a result, states enacted their own franchise statutes to accord greater protection to franchisees. Significantly, these state laws vary. Some states regulate franchising under franchise-specific statutes, business opportunity statutes, or both. Twenty-three states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico have enacted franchisor-franchisee relationship laws, but only fourteen of these states expressly recognize the potential personal liability of franchisor principals who make misrepresentations in connection with the offer, sale, or purchase of a franchise.[22] Notably, despite the existence of these statutory provisions, a franchisee's success in holding a principal personally liable still largely depends upon the language of the applicable statute and the court's interpretation of that statutory language, as well as the nature and extent of the principal's participation in the unlawful conduct.

### A. *State Franchise Laws*

As others have commented, state franchise laws imposing joint and several liability on principals share a few common features.[23] First, they require a predicate statutory violation by the franchisor. Second, they typically categorize individuals who are subject to joint and several liability either as persons who directly or indirectly control the franchisor (control persons); executive officers, directors, or persons occupying a similar status or performing similar functions; or employees. Third, for some or all of these categories, they require proof that the individual "materially aids" the act or transaction constituting the statutory violation.

To the extent that courts have addressed these statutory provisions, most of the analysis has concerned the "materially aids" limitation. There is some variability in how state legislatures have structured their statutes to apply this limitation. On one end of the spectrum, Indiana requires the individual defendant to "materially aid[] or abet[]" the underlying violation, regardless

21. *See* Arruda v. Curves Int'l, Inc., 861 F. App'x 831, 835 (5th Cir. 2021) ("Even if the Franchise Rule would cover such omissions, Plaintiffs concede the Federal Trade Commission Act ('FTCA') provides no private right of action.") (collecting cases).

22. Megan B. Center, *Is It Possible To Fully Insulate Yourself from Personal Liability?*, 37 Franchise L.J. 379, 380 & n.8 (2018). These states are the following: California (Cal. Corp. Code § 31302); Hawaii (Haw. Rev. Stat. § 482E-9(b)); Illinois (815 Ill. Comp. Stat. 705/26); Indiana (Ind. Code § 23-2-2.5-29); Maryland (Md. Code Ann., Bus. Reg. § 14-227(d)); Michigan (Mich. Comp. Laws § 445.1532); Minnesota (Minn. Stat. § 80C.17(2)); New York (N.Y. Gen. Bus. Law § 691); North Dakota (N.D. Cent. Code § 51-19-12(2)); Oregon (Or. Rev. Stat. § 650.020); Rhode Island (19 R.I. Gen. Laws § 19-28.1-21(b)); South Dakota (S.D. Codified Laws § 37-5B-49); Washington (Wash. Rev. Code § 19.100.190); and Wisconsin (Wis. Stat. § 553.51). In addition, Iowa's statute includes similar language that expressly recognizes the potential personal liability of principals under its business opportunity law. Iowa Code § 551A.8.

23. Cynthia M. Klaus, *Personal Liability of Franchisor Executives & Employees Under State Franchise Laws*, 29 Franchise L.J. 99, 100 (2009); Center, *supra* note 22, at 380–81.

of whether he or she is a control person, an executive officer, or a mere employee.[24] Indiana's statute reads:

> Every person who materially aids or abets in an act or transaction constituting a violation of this chapter is also liable jointly and severally to the same extent as the person whom he aided and abetted, unless the person who aided and abetted had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.[25]

That is, there is only one category of defendant: "person[s] who materially aid[] or abet[] in an act or transaction constituting a violation."[26]

On the other end of the spectrum, Maryland expressly applies the "materially aids" limitation solely to "employee[s]."[27] Under the Maryland Franchise Registration and Disclosure Law, joint and several liability extends to:

> (i) each person who directly or indirectly controls a person liable under this section;
> (ii) each partner in a partnership liable under this section;
> (iii) each principal officer or director of a corporation liable under this section;
> (iv) each other person that has a similar status or performs similar functions as a person liable under this section; and
> (v) each employee of a person liable under this section, if the employee materially aids in the act or transaction that is a violation under this subtitle.[28]

Using a clear structure that other states might learn from, Maryland lists each separate category of defendant and employs the "materially aids" limitation only in the final category for employees, imposing joint and several liability on "each employee of a person liable under this section, if the employee materially aids in the act or transaction that is a violation."[29]

For most other states, whether an individual defendant must "materially aid" the underlying violation to be jointly and severally liable remains somewhat murky. At least to an extent, the ambiguity in applying these state statutes derives from their structure.

As other commentators have noted, the placement of a single comma may be responsible for different outcomes in the case law.[30] Four states—Illinois, New York, Rhode Island, and South Dakota—employ a comma before the phrase "who materially aids in the act or transaction constituting the violation."[31] For example, Illinois's statute reads:

> Every person who directly or indirectly controls a person liable under this Section 26, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every manager of a limited liability company

24. Ind. Code § 23-2-2.5-29. Indiana is also unique in employing the "materially *aids or abets*" formulation. *Id.* (emphasis added).
25. *Id.*
26. *See id.*
27. Md. Code Ann., Bus. Reg. § 14-227(d)(1).
28. *Id.*
29. *Id.*
30. Klaus, *supra* note 23, at 100–01.
31. 815 Ill. Comp. Stat. 705/26; N.Y. Gen. Bus. Law § 691; 19 R.I. Gen. Laws § 19-28.1-21(b); S.D. Codified Laws § 37-5B-49.

> so liable, every person occupying a similar status or performing similar functions, and every employee of a person so liable, *who materially aids in the act or transaction constituting the violation*, is also liable jointly and severally[.][32]

By contrast, five states—California, Michigan, Minnesota, North Dakota, and Wisconsin—do not employ a comma before that same phrase.[33] For example, California's statute reads:

> Every person who directly or indirectly controls a person liable under Section 31300 or 31301, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable *who materially aids in the act or transaction constituting the violation*, are also liable jointly and severally . . . .[34]

Four states—Minnesota, North Dakota, Oregon, and Wisconsin—go a step further. These states do not just remove the comma; they also add the conjunction "and" before the final category concerning "employees."[35] For example, Oregon's statute reads:

> Every person who directly or indirectly controls a franchisor liable under subsection (1) of this section, every partner, officer or director of the franchisor, every person occupying a similar status or performing similar functions, *and every person who participates or materially aids in the sale of a franchise is also liable jointly and severally to the same extent as the franchisor*, unless the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of the facts on which the liability is based.[36]

Principles of statutory interpretation suggest that the varying structures of these statutes should dictate differing meanings. Grammatically, the placement of the comma immediately before the "materially aids" limitation, as in the laws of Illinois, New York, Rhode Island and South Dakota, suggests that the limitation should apply to all preceding categories.[37] By contrast, the absence of the comma, not to mention the addition of "and," in the laws of Minnesota, North Dakota, Oregon,[38] and Wisconsin, strengthens the grammatical argument that "materially aids" applies to only the immediately preceding category concerning "employees." Under the last-antecedent rule, "a limiting clause or phrase . . . should ordinarily be read as modifying only the noun or phrase that it immediately follows."[39]

32. 815 Ill. Comp. Stat. 705/26 (emphasis added).

33. Cal. Corp. Code § 31302; Mich. Comp. Laws § 445.1532; Minn. Stat. § 80C.17(2); N.D. Cent. Code § 51-19-12(2); Wis. Stat. § 553.51(3).

34. Cal. Corp. Code § 31302 (emphasis added).

35. Minn. Stat. § 80C.17(2); N.D. Cent. Code § 51-19-12 (2); Or. Rev. Stat. § 650.020; Wis. Stat. § 553.51(3).

36. Or. Rev. Stat. § 650.020 (emphasis added).

37. *See* Jama v. Immigr. & Customs Enf't, 543 U.S. 335, 344 n.4 (2005) (noting that the last-antecedent rule may not apply where "[t]he modifying clause appear[s] not in a structurally discrete statutory provision, but at the end of a single, integrated list").

38. Oregon extends liability to those who *participate* or materially aid in the sale of a franchise. Or. Rev. Stat. § 650.020.

39. Lockhart v. United States, 577 U.S. 347, 351 (2016).

To date, however, courts have mostly declined to address these statutory nuances. To the extent that courts have addressed them at all, they have done so in a manner that is not easily reconcilable. For example, a federal district court in Michigan purported to apply the last-antecedent rule in construing the Michigan Franchise Investment Law.[40] Noting the absence of the comma in Michigan's law, the court held that "[t]he proper grammatical reading is that the clause 'materially aids in the act or transaction constituting the violation' modifies only the last antecedent, 'an employee of a person so liable.'"[41] The upshot was that the plaintiffs did not need to prove that the franchisor's control persons "materially aided" the violation.[42] But in reaching this conclusion, the Michigan court cited the opinion of an Illinois federal district court that construed the Illinois Franchise Disclosure Act.[43] As discussed earlier, Illinois's law does contain the comma.[44] The Michigan court was apparently unconcerned by that distinction, but the court's failure to address the distinction could limit its persuasive value in the future.

Similarly, a few recent New York cases eschewed a nuanced statutory analysis in favor of a pragmatic distinction between "control persons" on the one hand and executive officers and employees on the other. In one case, a New York state court held that the two owners of the corporate franchisor were "control persons" who were jointly and severally liable without any discussion of whether they "materially aided" the statutory violation.[45] Likewise, the U.S. District Court for the Eastern District of New York suggested that control persons may be held liable "merely by virtue of their position."[46] By contrast, another decision from the U.S. District Court for the Eastern District of New York recently applied the "materially aids" limitation to the general counsel and an officer of the corporate franchisor, suggesting that these high-ranking employees were different from control persons.[47] The

40. Tankersley v. Lynch, No. 11-12847, 2012 WL 683384, at *10 (E.D. Mich. Mar. 2, 2012).

41. *Id.*

42. *Id.*

43. *Id.* (citing Shipman v. Case Handyman Servs., L.L.C., 446 F. Supp. 2d 812, 814 (N.D. Ill. 2006)).

44. In *Shipman*, the federal district court held that, notwithstanding the comma, Illinois's law distinguished between control persons on the one hand, who do not need to "materially aid" the violation to be liable, and employees on the other hand, who do need to "materially aid" the violation to be liable. *Shipman*, 446 F. Supp. 2d at 814.

45. S. Shore D'Lites LLC v. First Class Prods. Grp., LLC, 187 N.Y.S.3d 185 (App. Div. 2023) ("Furthermore, plaintiffs are entitled to a summary judgment ruling that defendants Todd Coven and Magda Abt, the individual owners of defendant First Class, are control persons jointly and severally liable for any Franchise Act violations pursuant to General Business Law § 691 (1) and (3).").

46. Schwartzco Enters. LLC v. TMH Mgmt., LLC, 60 F. Supp. 3d 331, 358 (E.D.N.Y. 2014) (considering whether "group pleading" was permissible "given the statute's provision for 'control person' liability under § 691(3) for an individual merely by virtue of their position").

47. Sea Tow Servs. Int'l, Inc. v. Tampa Bay Marine Recovery, Inc., 632 F. Supp. 3d 91, 113 (E.D.N.Y. 2022) ("Stein, as Sea Tow's General Counsel, and Frohnhoefer, an Officer of Sea Tow, are each 'persons' within the meaning of the NYFSA, and the allegations in the Third-Party Complaint extensively detail their direct participation in facilitating the Management Agreement with the Jaeger Defendants.") (citing A. J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc., 663 N.E.2d 890, 895 (N.Y. 1996)).

U.S. District Court for the Eastern District of Wisconsin has also rejected the argument that chief executive officers are automatically liable because they "should know everything about their companies."[48]

Although there is still plenty of room for practitioners to maneuver when litigating these issues, there appears to be a growing consensus that, regardless of statutory structure or interpretive rules, control persons need not "materially aid" the underlying violation to be jointly and severally liable. Given this apparent consensus, franchisees likely will have an easier time establishing joint and several liability against a control person—that is, someone like Ken Gibson in the *LearningRx* case or Oren Loni in the *BurgerIM* case—than other officers or other employees of the corporate franchisor.[49]

The significance of control person liability was illustrated by a United States Bankruptcy Court that refused to discharge a franchisee's claims against control persons under New York's franchise law. In *In re Butler*,[50] a franchisee filed an action against the franchisor's principals, the Butlers, to recover franchise payments from the unlawful sale of twelve franchises.[51] The franchisee initially sought to recover $714,000 in franchise payments from

48. Cousin Subs Sys. Inc. v. Better Subs Dev. Inc., No. 09-C-0336, 2011 WL 4585541, at *14 (E.D. Wis. Sept. 30, 2011) (granting summary judgment on claim against president and CEO under Indiana Franchise Disclosure Act where "there is no evidence to show that Specht violated 23–2–2.5–29 other than, in his role as president, he should know everything," thereby rejecting "the inference that CEOs should know everything about their companies").

49. Although the focus of this paper is personal liability of principals, franchise brokers have become common in the industry and may act as an intermediary between a franchisor and prospective franchisee. Recently, courts have imposed liability on brokers as "sellers" of a franchise under state franchise laws. *See, e.g.*, Xiaolin Li v. FranChoice, Inc., No. 19-cv-1267, 2019 WL 7598656, at *4–5, *8 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264273 (D. Minn. Jan. 17, 2020) (holding that a franchise broker and its individual agent could be liable under the Illinois Franchise Disclosure Act and the New York Franchise Sales Act for alleged misrepresentations relied on by a prospective franchisee because they were engaged in "solicitation" and thus an "offer to sell"); Hanley v. Doctors Express Franchising, LLC, No. CIV.A. ELH-12-795, 2013 WL 690521, at *35 (D. Md. Feb. 25, 2013) ("The word 'sells' expands the scope of liability beyond the franchisor; any other interpretation would not make sense of the legislature's inclusion of both 'sell[ing]' and 'grant[ing]' a franchise as predicates for liability. The legislature's intent to establish a broad scope of liability under the statute is further confirmed by the provisions for joint and several liability under B.R. § 14–227(d)(1), which make liable, *inter alia*, 'each other person that has a similar status *or performs similar junctions* as a person liable under [B.R. § 14–227],' and 'each employee of a person liable under [B.R. § 14–227], if the employee *materially aids in the act or transaction* that is a violation under [the Maryland Franchise Law].' This language is sufficiently broad to include an agent who participates in making the sale of a franchise. [The contrary] interpretation is further undercut by the interpretive regulations promulgated by the Commissioner, which delineate and proscribe particular fraudulent and misleading activities when performed by any 'person authorizing, aiding in, or causing to be made an offer or sale of a franchise.'" (citations omitted)); Johnson v. FranChoice, Inc., No. 19-cv-1417, 2019 WL 7598623 (D. Minn. Dec. 19, 2019) (finding franchise broker liability under Michigan's Franchise Investment law).

50. *In re* Butler, No. 10-32030, 2012 WL 6106586, at *1 (Bankr. W.D.N.C. Dec. 10, 2012).

51. *Id.* The circumstances of the illegal sales are as follows. The franchisor's permit to sell franchises in New York was still pending. The law requires that a franchisor with a pending permit must escrow the franchise fees paid in a separate trust pending approval of its application. Once approved, the franchisor must provide the franchisee the most recent franchise disclosure document and give the franchisee an opportunity to rescind the franchise agreement and have the fees returned. In this case, the franchisor failed to escrow the initial fees, provide

the franchisor entity in New York State court; however, the Butlers filed for personal bankruptcy.[52] Applying a New York appellate court's "directly participates" requirement, the Bankruptcy Court held that the franchisor's owners were personally liable to the franchisee because they "were personally involved in [his] solicitation," having sold him the franchises "by promoting [themselves] as the key members of the franchisor in the advertising materials."[53] The owners also "active[ly] control[led]" the franchisor, were "the primary decision-makers" in how the franchisee's fees were used, and allocated those fees "to fund their [own] salaries."[54] In addition to finding the owners personally liable, the Bankruptcy Court held that the franchisee's claims were not dischargeable because the claims arose from the owners' fraud and defalcation.[55] As this case demonstrates, control persons may be unable to discharge personal liability in bankruptcy proceedings.

In contrast to the states discussed above, three states—Arkansas, Florida, and Virginia—do not expressly refer to joint and several liability for principals. Instead, the Arkansas Franchise Practices Act and the Florida Franchise Act more broadly declare it unlawful for "any person," which includes an "individual" in Florida, or "natural person" in Arkansas, to make certain misrepresentations in connection with the offer or sale of a franchise.[56] Similarly, Virginia's Retail Franchise Act makes it unlawful for "any person" to engage in fraud in the sale of a franchise.[57] Although none of these three statutes requires that a person "materially aids" in the act or transaction constituting the statutory violation, the Florida statute requires that a person "intentionally . . . misrepresent";[58] Arkansas finds liability whether a person "directly or indirectly" commits fraudulent acts, provided these acts were performed "knowingly";[59] and Virginia mirrors Arkansas except that it omits the "knowingly" requirement.[60] In these states, personal liability likely depends on the court's interpretation of the statutes and the extent of an individual's participation in the alleged fraud. Florida courts, for example, have held that individual defendants *may* be personally liable for violating the Florida Franchise Act where they themselves participated in the prohibited misrepresentations in the sale of a franchise.[61]

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the franchisee with a registered disclosure document, or offer recission. Instead, the franchisor distributed the franchise fee payments to its principals. *Id.* at *7–12.

52. *Id.* at *1.

53. *Id.* at *7 (noting that under *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 663 N.E.2d 890 (N.Y.1996) "[i]f one of the individuals or entities defined as a person directly participates in an unlawful offer or sale, there is civil liability for the purchaser's resulting damages").

54. *Id.* at *8.

55. *Id.* at *9–12.

56. Ark. Code Ann. § 4-72-202, -207; Fla. Stat. § 817.416.

57. Va. Code Ann. § 13.1-563.

58. Fla. Stat. § 817.416.

59. Ark. Code Ann. § 4-72-207.

60. Va. Code Ann. § 13.1-563.

61. *E.g.*, KC Leisure, Inc. v. Haber, 972 So. 2d 1069, 1075 (Fla. Dist. Ct. App. 2008); *see also* SIG, Inc. v. AT & T Digit. Life, Inc., 971 F. Supp. 2d 1178, 1193 (S.D. Fla. 2013) (granting

### B. *Imposing Liability Using State Business Opportunity Statutes, Consumer Protection Statutes, and Common Law*

In addition to franchise-specific laws, franchisees may seek redress under state business opportunity or consumer protection laws as well as state common law. Many state franchise laws expressly note that "[t]he rights and remedies provided . . . shall be in addition to any and all other rights and remedies that may exist at law or in equity."[62] It is therefore common for injured franchisees to seek additional remedies through other state statutes and common law claims.

For example, in Florida, injured franchisees may seek additional damages through Florida's Deceptive and Unfair Trade Practices Act (FDUTPA)[63] and Florida's Sale of Business Opportunities Act.[64] In *KC Leisure, Inc. v. Haber*,[65] a Florida appellate court explained that the "actively participated" standard that governs an individual's personal liability under the FTC Act is similar to the "direct participant" standard that governs individual liability under FDUTPA.[66] Applying Florida law and citing *KC Leisure*, a Michigan federal district court recently found a franchisor's president and area developer jointly and severally liable for false statements and fraudulent omissions in connection with the sale of a spa franchise.[67] The franchisee was awarded

individual defendants' motion to dismiss claim for alleged violations of Florida's Franchise Act where "Plaintiffs' Complaint is completely devoid of any facts with respect to James and Robert Diamond's personal participation in anything").

62. Va. Code Ann. § 13.1-563(d); *see also* Cal. Corp. Code § 31306 ("Nothing in this chapter shall limit any liability which may exist by virtue of any other statute or under common law if this law were not in effect."); 815 Ill. Comp. Stat. 705/28 ("Nothing in this Act shall limit any liability which may exist by virtue of any other statute or under common law if this Act were not in effect."); Md. Code Ann., Bus. Reg. § 14-204 ("The powers, remedies, procedures, and penalties of this subtitle are in addition to and not in limitation of any other powers, remedies, procedures, and penalties provided by law."); Mich. Comp. Laws § 445.1534 ("Nothing in this act shall limit a liability which may exist by virtue of any other statute or under common law if this act were not in effect."); Minn. Stat. § 80C.17(2) ("Nothing herein shall limit any liability which may exist by virtue of any other statute or under common law if sections 80C.01 to 80C.22 were not in effect."); N.Y. Gen. Bus. Law § 691(5) ("Nothing in this article shall limit a liability which may exist by virtue of any other statute or under common law if this article were not in effect."); N.D. Cent. Code § 51-19-12(6) ("Nothing herein limits any liability which may exist by virtue of any other statute or under common law if this chapter were not in effect."); Or. Rev. Stat. § 650.085 ("Nothing in ORS 650.005 to 650.100 limits any statutory or common-law rights of a person to bring an action in any court for an act involved in the sale of franchises . . . ."); 19 R.I. Gen. Laws § 19-28.1-23 ("Nothing in the act limits liability that may exist under another statute or at common law."); S.D. Codified Laws § 37-5B-49 ("Nothing in this section limits any liability which would exist by virtue of any other statute or under common law if this chapter were not in effect."); Wash. Rev. Code § 19.100.910 ("The provisions of this chapter shall be cumulative and nonexclusive and shall not affect any other remedy available at law."); Wis. Stat. § 553.51(5) ("The rights and remedies under this chapter are in addition to any other rights or remedies that may exist at law or in equity.").

63. Fla. Stat. § 501.203.

64. *Id.* § 559.80 *et seq.*

65. *KC Leisure, Inc.*, 972 So. 2d 1069.

66. *Id.* at 1074–75.

67. MTR Cap., LLC v. Lavida Massage Franchise Dev., Inc., No. 2:17-CV-13552-TGB-EAS, 2021 WL 1626353, at *1, *4–5 (E.D. Mich. Apr. 27, 2021).

damages for its FDUTPA claim in the amount of the initial franchise fee.[68] Thus, an individual who is liable for violating the FTC Act and Florida's Franchise Act may also be held liable for violating FDUTPA. Other states' unfair trade practices laws similarly align with liability under the FTC Act.[69]

As *KC Leisure* illustrates,[70] the existence of an applicable franchise-specific statute does not necessarily preclude a franchisee from seeking relief under a state's business opportunity laws. Twenty-six states have laws that regulate the sale of opportunities to engage in new business ventures.[71] Therefore, businesses opportunity laws may provide an additional or alternative avenue for franchisees to hold principals individually liable for their fraudulent acts.[72] However, franchisees will need to assess whether such a law applies to their particular situation. Although a franchise may often be a new business venture, whether a franchise opportunity is covered by a particular state's business opportunity law will vary by state.

For example, Florida's Sale of Business Opportunities Act applies to transactions that enable the purchaser "to *start* a business" under certain defined circumstances.[73] It does not apply to the sale of "an ongoing business."[74] For that reason, the court in *Batlemento v. Dove Fountain, Inc.*[75] reversed a judgment based on an alleged violation of the law in connection with the sale of an existing restaurant business.[76] The court also noted that "[t]he prohibitions of the act apply to the *seller* of the opportunity, not the shareholders of the seller or individuals who act for the seller."[77]

Similarly, courts have held that the Oklahoma Business Opportunity Sales Act does not apply to certain franchises. In *Tallyho Enterprises, LLC v. PremierGarage Systems, LLC*,[78] the court held that the plaintiff's franchise fell outside the definition of "business opportunity" because Oklahoma's statute expressly excludes certain business opportunities that involve sellers with a minimum net worth of $1 million.[79] Some states go even further and expressly exclude any franchise from their business opportunity laws. Alaska's Sale of Business Opportunities law, for example, "does not apply to a sale of or an offer to sell . . . a franchise under [the Franchise Rule]."[80]

68. *Id.*

69. *See, e.g.*, Conn. Gen. Stat. § 42-110b.

70. *KC Leisure*, 972 So. 2d at 1074.

71. David J. Kaufmann, *An Overview of Federal and State Franchise Laws, Rules, and Regulations*, N.Y. L.J. (Oct. 17, 2023, 12:00 PM), https://www.law.com/newyorklawjournal/2023/10/17/an-overview-of-federal-and-state-franchise-laws-rules-and-regulations.

72. As discussed earlier, Iowa's business opportunity law expressly recognizes the potential personal liability of corporate principals. Iowa Code § 551A.8.

73. Fla. Stat. § 559.801(1)(a) (emphasis added).

74. Batlemento v. Dove Fountain, Inc., 593 So. 2d 234, 239 (Fla. Dist. Ct. App. 1991).

75. *Id.*

76. *Id.*

77. *Id.*

78. Tallyho Enters., LLC v. PremierGarage Sys., LLC, No. CV-07-01791-PHX-SRB, 2008 WL 11338891, at *7 (D. Ariz. Apr. 29, 2008).

79. *Id.*

80. Alaska Stat. § 45.66.220(2).

In the absence of an applicable franchise-specific or business opportunity law, franchisees may consider state consumer protection laws. Here, a recurring question is whether a franchisee is a "consumer" within the meaning of the statute. Again, the answer will likely vary by state.

For instance, in *Carlock v. Pillsbury Co.*,[81] which involved a dispute about an ice cream franchise, a Minnesota court found that Idaho-based franchisees could proceed under the Idaho Consumer Protection Act.[82] The franchisees sought to hold the franchisor's president liable for claims of fraudulent inducement to enter the franchise agreement, and for claims of fraud in the distribution of the ice cream and the operation of the franchise system.[83] In interpreting Idaho's consumer protection statute, the Minnesota court declined to narrow the definition of "consumer" within the act to preclude franchisees.[84] The court held that the plaintiffs stated a claim against *all* named defendants to proceed under the Idaho Consumer Protection Act.[85]

By contrast, in *Tallyho Enterprises*, the court narrowly interpreted "consumer transaction" under Kansas's Consumer Protection Act to exclude transactions involving franchisees who purchased branded goods from a franchisor for resale.[86] The court there held that the Kansas Consumer Protection Act covered the purchase of goods "to be used or consumed in the course of one's business" but not "for the purpose of resale to customers for profit."[87]

Common law fraud claims can also be a source of personal liability against a franchise seller, either exclusively or in conjunction with alleged statutory violations. For example, in *Bans Pasta, LLC v. Mirko Franchising, LLC*, a franchisee sued a franchise and its principals for written misrepresentations regarding the financial viability of an Italian restaurant franchise.[88] Although the franchisee's claim under the Virginia Retail Franchising Act was dismissed on procedural grounds, the franchisees were able to proceed with their common law claims against the franchisor and its principals.[89]

In some cases, common law claims may provide franchisees the only viable path to relief. For example, in *Upshaw v. Lacado*,[90] the president of a franchise was found personally liable for breach of contract and common law fraud claims relating to omissions and misrepresentations in the franchisor's franchise disclosure document and franchise agreements.[91] The franchisee

81. Carlock v. Pillsbury Co., 719 F. Supp. 791, 798 (D. Minn. 1989).
82. *Id.* at 850–52.
83. *Id.* at 827.
84. *Id.* at 851.
85. *Id.*
86. Tallyho Enters., LLC v. PremierGarage Sys., LLC, No. CV-07-01791-PHX-SRB, 2008 WL 11338891, at *4 (D. Ariz. Apr. 29, 2008).
87. *Id.* at *6 (citing Wayman v. Amoco Oil Co., 923 F. Supp. 1322, 1364–65 (D. Kan. 1996)).
88. Bans Pasta, LLC v. Mirko Fran., LLC, No. 7:13-CV-00360-JCT, 2014 WL 637762, at *1 (W.D. Va. Feb. 12, 2014).
89. *Id.* at *14.
90. Upshaw v. Lacado, 650 S.W.3d 61 (Tex. App. 2021).
91. *Id.* at 71.

prevailed in Texas state court on its common law claims, and a jury found the franchisor's president jointly and severally liable for damages exceeding $1 million.[92]

In federal court, and in most jurisdictions around the country, allegations of fraud or mistake are subject to a heightened pleading standard.[93] One important consideration for common law claims sounding in fraud is that they require franchisees to clearly detail and assert that the principal actively engaged in the misconduct or fraud.

## Conclusion

Principals of franchisors who actively participate in fraudulent or illegal franchises are not immune from personal liability. However, such personal liability is usually challenging to establish by franchisees. Ultimately, establishing liability for a fraudulent franchise offer or sale through business opportunity statutes, consumer protection laws, or common law claims requires more than just asserting that someone holds a principal role in a franchise. Franchisees who are induced to purchase franchises due to fraudulent or illegal actions on the part of the franchise sellers will likely need to specifically allege and prove the principal's direct involvement in the wrongful conduct.

92. *Id.*
93. *See generally* Fed. R. Civ. P. 9(b).