



## **Avoiding Franchise Investment Fraud in Wisconsin**

Franchises can be very attractive to people looking to own their own business for a variety of reasons – the goodwill established by a brand, having an established business model instead of starting from scratch, shared costs for some aspects like marketing or advertising, in addition to other forms of support from the franchisor. Franchises have become a popular and successful method for starting businesses for over a century, beginning with sewing machines and motors, and expanding rapidly to hundreds of different markets. Franchises in Wisconsin are governed by the Federal Trade Commission’s Franchise Rule<sup>1</sup>, as well as the Wisconsin Franchise Investment Law<sup>2</sup>, which requires anyone selling what is defined as a “franchise” to register with the state, and meet certain legal requirements.

Under Wisconsin law, a franchise generally involves a contract between two or more people where the franchisee gets the right to offer, sell, or distribute goods or services under a marketing plan or system prescribed by the franchisor, the franchisee’s business under that plan is substantially associated with the franchisor’s business, and the franchisee is required to pay a franchise fee.<sup>3</sup>

Since franchises have become so widespread, there is concern for the potential of scam artists and criminals to take advantage of investors under the guise of a legitimate franchise business. Typical areas for franchise investment fraud have been vending machine, display rack, pay phone, medical billing, and some Internet-related businesses. If you are interested in investing in a franchise, consider the following areas when evaluating whether the franchise is legitimate and appropriate for you.

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<sup>1</sup> 16 C.F.R. Part 436.

<sup>2</sup> Wis. Stat. Ch. 553.

<sup>3</sup> Wis. Stat. 553.03(4).

## 1. Is the franchise registered in Wisconsin?

The Wisconsin Franchise Investment Law governs franchise registration and disclosure, while the Wisconsin Fair Dealership Law<sup>4</sup> governs the franchise relationship. Franchises in Wisconsin are required to register annually, and the filing must take place prior to the first sale during any annual period, which is measured from the date of first filing.<sup>5</sup> Some franchises are excluded or exempt from registration.<sup>6</sup>

Since a franchise must be registered prior to the first sale in Wisconsin, if you are considering buying a franchise, contact the [Division of Securities](#) to determine if the franchise is legally registered within the state. If a franchise has not registered, the sale is illegal, and should send up a red flag that the business may not be legitimate. The Division of Securities considers the following grounds for denying, suspending, or revoking a franchise's registration<sup>7</sup>, and should be a red flag for potential buyers:

- Failing to offer a circular (offering prospectus) at least 14 (fourteen) days prior to the execution of a franchise agreement.
- The franchisor or seller sells a franchise by means of a written or oral communication that contained an untrue statement of material fact, or omitted a material fact necessary to make the other statements not misleading. In other words, the franchisor or seller commits fraud in order to sell the franchise.
- Any person noted in the circular as being involved with the franchise has been convicted of a criminal or civil offense requiring disclosure, and the offense has not been disclosed.

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<sup>4</sup> Wis. Stat. Ch. 135.

<sup>5</sup> Wis. Stat. 553.21

<sup>6</sup> Wis. Stat. 553.22, 553.23 and 553.235

<sup>7</sup> Wis. Stat. 553.28

## **2. Does the franchise advertise with “No risk!” “Guaranteed!” “Quick and Easy” “Prime Locations Available Today” “Earn \$2000 a month!” “Work from home!” or “100% Return on Your Investment!”?**

### **Returns on Investment**

Ads which promise a huge payout with little investment or risk should send up red flags for being fraudulent. The amount of returns for legitimate business ventures are usually correlated with the amount of risk involved. The bigger the return, the bigger the risk, and vice versa.

### **Location, location, location**

Ads promising to provide locations may not provide profitable ones. A location may be in a low traffic area, an area which is difficult to service or manage because it is located too far away, or the merchandise being vended may be of poor quality or out of date. Many will provide the services of professional locators but insist that the buyer pay for the services. When asked to find better locations, many will refuse, or ask the buyer to pay the locator again, or will find locations no better than before.

### **Hard Work IS Required**

Ads promising an idealized work situation of working from home and setting your own hours often ignores the reality of being a small business owner, especially in the first year of starting the business. Claims about “proven” techniques or technologies are often unproven and untested. Many times, they will not work, or not work as advertised.

### **Money Does NOT Grow on Trees**

If an ad claims that you will make a certain amount of money consistently, it must provide statistical and financial information to substantiate this claim – usually the percentage and number of franchisees who actually achieved this sort of income within a specific period of time. If an ad is using this sort of claim but does not have the required information, make a request – if the promoter will not divulge it, they are violating the law. Don’t trust an ad just because it appears in a reputable or legitimate magazine or newspaper. It could still be inaccurate or contain misleading statements.

### **3. Does the franchisor engage in high pressure sales tactics?**

If the franchisor insists that the franchise is “limited time offer” or “won’t be here tomorrow,” you may want to wait and conduct more research. Do not be pressured into signing any documents without investigating and evaluating the franchise offer first. Legitimate businesses will expect you to do this, and if you feel you are being rushed, this is a red flag.

Franchises usually involve a substantial sum of money to start up. Take the time to consult with experts such as a lawyer, accountant, or business advisor to make sure that the franchise is the right business plan and decision for you. It is better to spend money at the beginning to prevent becoming involved in larger problems later.

### **4. Have you been provided with an Offering Prospectus or Franchise Disclosure Document?**

Under the Federal Trade Commission’s Franchise Rule, a franchisor or seller must offer a detailed disclosure document that includes:

- the total number of franchises and the number of franchises terminated or not renewed during the previous year
- the bases and assumptions for any claims about potential earnings or the earnings of existing franchisees
- the cost of starting and maintaining the business
- the names, addresses and telephone numbers of at least 10 franchisees who live closest to you
- the background and experience of the franchisor’s key executives
- a fully audited financial statement of the franchisor; any lawsuits against the franchisor or its directors by franchisees
- and the responsibilities you and the franchisor have to each other once you’ve purchased the franchise.<sup>8</sup>

Make sure that the disclosure document that you receive is the same one that has been submitted to the Federal Trade Commission for approval. Some scams provided two brochures – one to the Federal Trade Commission and the other to franchisees with vastly different terms and information.

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<sup>8</sup> 16 C.F.R. 436.2-5

Claims about earnings, sales, gross sales, or income projections have to be based on actual operating history of the franchise and included in the disclosure statement, which the franchisor or seller is required to provide the potential buyer with.<sup>9</sup> If the information about earnings or profits is given as separate from the franchise disclosure document or offering prospectus, treat it as suspect.

## **5. Are the initial start-up fees reasonable for the franchise business involved?**

Some scams have involved high start up fees with contracts that allow the franchisor or seller to keep the fee if the business has not started within a certain period of time, or certain requirements are not met. Consider having the start up fees held in an escrow account until an agreed upon time.<sup>10</sup> For example, if the franchise involves merchandise, make sure you have received and are happy with the merchandise before releasing the funds.

For example, one scam promised six-figure earnings for the display rack sale of discount computer software. Buyers were told that the software would feature brand names like IBM, Corel, and Microsoft. What was delivered was "junk software", cheap shareware, and samples marked "not for resale." Sometimes, sellers will vanish with the buyer's money, and no merchandise has been delivered at all.

## **6. Have you considered these additional precautions?**

Contact the [Wisconsin Attorney General's Office](#) and [Better Business Bureau](#) about the company you are considering investing in and see if they have had any complaints lodged against them. Even if there are no complaints, it does not mean that a business is legitimate or a good investment choice. You should consult with an attorney, accountant, or business advisor before making any major decisions which may financially obligate you.

Check out other franchise locations in your area, and contact them about their satisfaction with the franchise and their earnings. The franchisor is required to give you at least 10 names of the franchisees closest to you, so if they try to avoid doing this, beware.<sup>11</sup> When you talk to other franchisees, make sure they aren't "singers" or "shillers" – people compensated to give a favorable review of the franchise.

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<sup>9</sup> 16 C.F.R. 436.9(c)-(d)

<sup>10</sup> DFI Sec. 32.08

<sup>11</sup> 16 C.F.R. 436.2

## **Additional Concerns About “Franchise Brokers”**

Franchise brokers are also known as “business coaches,” “advisors,” “referral sources,” or “sales consultants.” They advertise in newspapers and on the internet to help people who want to buy a franchise choose from among the various options available based on the potential buyer’s investment resources and goals. They may also help with applications and other documents required by a franchisor.

Potential buyers should be aware that these brokers often work for franchisors and also may be paid on a commission basis where they only receive compensation for completed sales. Some brokers may only work for a few franchisors, so their ability to match a buyer to the “best” opportunity may be of limited scope. This can also impact the selection standards of the broker – if they accept any franchisor willing to pay a commission, they could be steering buyers towards a franchise which is failing or does not have a proven track record of success. Some brokers may engage in “upselling” when the size of their commission is based on the price of the franchise. Brokers on this kind of commission schedule will have an incentive to recommend and steer potential buyers to more expensive franchises, even if it may not be in the buyers’ best interests.

Before using a franchise broker’s services, ask the following:

1. Can you get enough information researching online or reading trade magazines?
2. Is the broker is paid by the franchisor? Is the broker’s commission tied to the franchise price? If it does, be sure to ask about less costly alternatives.
3. How many franchisors does the broker represent, and how might that limit the match ups they can offer you?
4. How does the broker select the franchisors? How many franchisors has the broker turned down recently? If the selection criteria are in writing, ask to see them.
5. Verify if the franchisor has authorized potential earning claims. Ask for written documentation laying out the basis for the claim. Consider consulting an accountant about the claims’ reasonableness and if the results are reproducible for you.

## **What if you think you have been defrauded?**

First, contact the franchisor or seller and ask for your money back. Second, carefully document every phone call, e-mail, or face-to-face conversation you have with the franchisor or seller by taking notes of the time, date, and topic on which you spoke to them, saving emails, and keep a log of the timeline over which your communications are occurring. Even if you get a representative or answering machine, add it to your log for documentation.

Next, inform the franchisor or seller about your plans to notify the [Division of Securities](#) about your experience. Then, contact the Division and ask for the forms to make a complaint, which can also be found [here](#). Fill out the complaint forms completely and send them to the Division of Securities with attention to Enforcement.

Do not send back any originals of the paperwork back to the company, even if requested. Only send copies. When sending copies or other documents via mail, always send it certified with a return receipt requested.

You have the right to file a civil complaint against the franchisor under Wis. Stat. 553.51 if the franchise has been sold in violation of Wisconsin's Franchise Investment Law.