

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION
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COMMONWEALTH OF VIRGINIA, *ex rel.*

STATE CORPORATION COMMISSION

v.

CASE NO. SEC-2016-00046

NEW YORK BAGEL ENTERPRISES, INC.,

JOSEPH V. SMITH,

and

DENNIS KENNETH MASON a/k/a KEITH SAMUELS,

Defendants

RULE TO SHOW CAUSE

The Division of Securities and Retail Franchising ("Division") of the Virginia State Corporation Commission ("Commission"), conducted an investigation of New York Bagel Enterprises, Inc. ("New York Bagel"), Joseph V. Smith ("Smith") and Dennis Kenneth Mason a/k/a Keith Samuels ("Mason") (collectively, "Defendants"), pursuant to § 13.1-567 of the Virginia Retail Franchising Act ("Act"), § 13.1-557 *et seq.* of the Code of Virginia ("Code"), and alleges as follows:

I. Summary of Allegations

1. The Defendants offered and sold three bagel franchises to be operated in the Commonwealth of Virginia ("Virginia") when the franchise was not registered with the Division. In connection with these sales, the Defendants accepted over \$61,000 in franchising fees.

2. When selling these unregistered franchises, the Defendants failed to provide required disclosures to franchisees concerning store closings and material litigation involving the franchise. The Defendants also made misrepresentations to franchisees regarding support that

New York Bagel would provide regarding financing for franchise locations, logistical support and training.

3. Accordingly, the Defendants violated: (i) § 13.1-560 of the Act by offering and/or selling unregistered franchises in Virginia; (ii) § 13.1-563 (4) of the Act by failing to provide franchisees a disclosure document that had been cleared by the Division; and (iii) § 13.1-563 (2) of the Act by making false statements or material omissions to franchisees in connection with an offer or sale of a franchise.

4. The Division requests restitution, civil penalties, and costs of investigation, and an injunction barring the Defendants from further violations of the Act and from future franchise sales in Virginia.

II. The Defendants

5. New York Bagel is a company organized under the laws of New Jersey with its principal offices located in Rutherford, New Jersey. New York Bagel has never received a certificate of registration as a foreign corporation to transact business in Virginia. As part of its business, however, New York Bagel has offered and sold franchises in numerous states, including Virginia, as well as offered and sold franchises to be located in Virginia.

6. Smith is a resident of New York and the President of New York Bagel.

7. Mason purportedly is a resident of New Jersey and is a franchise sales agent or broker for New York Bagel. Mason is alleged to use at times the alias "Keith Samuels" in connection with his work for New York Bagel.

III. Background

8. New York Bagel offers bagel franchises that purport to sell a distinctive brand of bagels and other deli items at New York Bagel store locations. New York Bagel purportedly has locations in numerous states, including Virginia.

9. New York Bagel operates as a registered franchise in some states, but it never has been registered as a franchise in Virginia. New York Bagel submitted a franchise registration application in Virginia, but the Division denied that application in August 2012.

10. Despite denial of its registration application, New York Bagel in 2013 began offering stores for sale and operation in specific territories in Virginia, including Fairfax County. New York Bagel made these offers through the Internet on its own website (www.nybagelcafe.com) as well as through advertisements on other websites, such as Craigslislist.org, BizBuySell.com, and BizQuest.com.

11. The Division alleges that New York Bagel, through Smith and Mason, offered and sold at least three unregistered franchises in Virginia from 2013 to 2015. The Division further alleges that the Defendants failed to provide material disclosures as part of these sales, including information showing that a significant number of New York Bagel stores had closed as well as numerous lawsuits against the franchise.

A. The Defendants Offered and Sold Unregistered Franchises in Virginia

12. Following the Division's denial of New York Bagel's franchise registration application in 2012, the Defendants offered and sold at least three franchises to Virginia residents ("Franchisees").

13. The Franchisees each responded to online advertisements by New York Bagel offering stores for sale in Northern Virginia.

14. In each instance, the Defendants offered and sold the Franchisees a franchise that was to be located and operated in Fairfax County, Virginia.

15. As part of the offer, Smith or Mason conducted negotiations on behalf of New York Bagel with each Franchisee and provided them with a purported "license agreement" ("Agreements"). The Division does not regulate license agreements – unless such agreements actually are franchise agreements that only purport to be licensing relationships.

16. Here, the Agreements provided to the Franchisees were not narrow in scope or typical of licensing agreements. License agreements generally are limited to granting a licensee certain rights to use the licensor's brand or trademarks.

17. Instead, the Agreements provided to the Franchisees were substantially identical to franchise agreements that New York Bagel used in other states where its franchise was registered. Many of the provisions were the same and, in places, the Agreements included terms such as "franchise," "franchisor" and "franchisee" instead of licensing terms.

18. The provisions of the Agreements also were substantially similar to those typical of franchise agreements rather than licensing agreements. Among other things, the Agreements required the Franchisees to: (a) operate their stores according to a marketing plan or system prescribed by New York Bagel; (b) operate their stores in a manner substantially associated with New York Bagel branding; and (c) pay an initial franchise fee of \$15,000 or more.

19. In conjunction with the Agreements, the Defendants also provided the Franchisees with a Franchise Disclosure Document ("FDD") – which is required to register a franchise and provides relevant information that must be disclosed to prospective franchisees by law.

20. Each of the Franchisees signed an Agreement, which also were signed by Smith as the President and Chief Executive Officer of New York Bagel.

21. Each of the Franchisees paid an initial franchising fee to the Defendants as required by the Agreements. Although each Franchisee paid a different amount for their initial franchising fee, the Franchisees paid the Defendants a total of \$61,500 in such fees.

22. At the time of the sale to each Franchisee, New York Bagel's franchise was neither registered to be sold nor exempt from registration by rule or order of the Commission.

B. The Defendants Failed to Provide Required Disclosures and Made Misrepresentations to the Franchisees in the Offer and Sale of the Franchises

23. The Defendants' offer and sale of at least three unregistered franchises in Virginia involved failures to make required disclosures as well as misrepresentations to the Franchisees.

24. As part of an offer and sale of a franchise, franchisors such as New York Bagel must provide potential franchisees with an FDD, which includes information about the financial condition of the franchisor and litigation affecting the franchise. The FDD is designed to protect potential franchisees and allow them to make an informed decision regarding the purchase of the franchise.

25. A franchisor must submit an FDD as part of the registration process with the Division. Additionally, the Division must clear the FDD as part of the franchise registration. Before offering or selling a franchise, a franchisor must provide the franchisee with a copy of the FDD that has been cleared by the Division.

26. Here, the Defendants provided the Franchisees with an FDD. The FDD that the Defendants used, however, had *not* been cleared by the Division as required.

27. The Defendants also failed to provide information to the Franchisees necessary to avoid misleading them about the franchise.

28. For example, the Defendants informed two of the Franchisees that New York Bagel had 14 stores open as of November 2011 and that no stores had closed from 2008 to 2011. The Defendants, however, failed to inform the Franchisees about new stores opening after 2011 and – more importantly – that at least 17 New York Bagel stores had closed from 2012 to 2014.

29. Additionally, the Defendants made misrepresentations to the Franchisees about litigation involving New York Bagel. The Defendants informed the Franchisees that the franchise had no history of litigation. New York Bagel, however, was a defendant in at least four civil lawsuits concerning the franchise from 2010 to 2014.

30. The Defendants also represented to the Franchisees during the offer and sale of the franchises that New York Bagel would provide them with assistance in setting up and operating a store – including assistance with obtaining financing, identifying a location and signing a lease, and providing training for staff.

31. The Franchisees, however, received little or no assistance from the Defendants after signing the Agreements and paying their initial franchise fees.

32. Only two of the three Franchisees have opened for business as a New York Bagel store, and one of those Franchisees already has closed his store. Each of the Franchisees, however, has incurred substantial costs and expenses in attempting to open and operate a New York Bagel franchise – including expenses for rent, renovations and equipment.

IV. Violations

33. The Defendants violated § 13.1-560 of the Act by selling or offering to sell a franchise in Virginia when they offered and sold franchises that neither were registered under the Act nor exempt from registration by rule or order of the Commission.

34. The Defendants violated § 13.1-563 (4) of the Act, in connection with the sale or offer to sell a franchise in Virginia, by failing to provide each Franchisee a copy of a disclosure document as required by rule or order of the Commission.

35. The Defendants violated § 13.1-563 (2) of the Act, in connection with the sale or offer to sell a franchise in Virginia, by making untrue statements of a material fact or omitting to state a material fact necessary in order to avoid misleading the offeree. Among other things, the Defendants violated § 13.1-563 (2) of the Act by:

- (a) failing to inform the Franchisees about the number of New York Bagel store closings from 2012 to 2014;
- (b) misrepresenting that New York Bagel had no history of litigation while failing to disclose at least four civil lawsuits concerning the franchise; and
- (c) misrepresenting that New York Bagel would provide assistance with obtaining financing, identifying a location and signing a lease, and providing staff training.

NOW THE COMMISSION, upon consideration of this matter and having been advised by the Division, is of the opinion and finds that the Defendants should be provided an opportunity to respond to the Division's allegations, which appear to describe activities that constitute violations of Title 13.1 of the Code, and a Hearing Examiner shall be appointed to conduct further proceedings in this case on behalf of the Commission.

Accordingly, IT IS ORDERED THAT:

- (1) This matter is docketed as Case No. SEC-2016-00046.
- (2) In accordance with 5 VAC 5-20-120 of the Commission's Rules of Practice and Procedure, 5 VAC 5-20-10 *et seq.*, this matter is assigned to a Hearing Examiner who shall conduct all further proceedings in this case on behalf of the Commission and file a final report.
- (3) On January 11, 2017, at 10 a.m., the Commission's Hearing Examiner shall convene a hearing in this case in the Commission's Courtroom, Second Floor, Tyler Building, 1300 East

Main Street, Richmond, Virginia 23219, at which time and place the Defendants may appear and show cause why: (i) the Defendants should not be requested to make restitution to the Franchisees pursuant to § 13.1-570 of the Act; (ii) the Defendants should not be penalized pursuant to § 13.1-570 of the Act; (iii) the Defendants should not be permanently enjoined from violating the Act pursuant to § 13.1-568 of the Act; (iv) the Defendants should not be assessed the costs of investigation pursuant to § 13.1-567 of the Act; and (v) the Defendants should not be subject to any other sanctions authorized by the Act. The Defendants should understand that the Commission may enter a default judgment against the Defendants should the Defendants elect not to appear at the hearing scheduled herein.

(4) On or before November 4, 2016, the Defendants shall file with the Clerk of the Commission a responsive pleading in which the Defendants expressly admit or deny the allegations contained in the Rule and present any affirmative defenses to the allegations that the Defendants intend to assert. If the Defendants present any affirmative defenses, they shall set forth in their responsive pleading a full and clear statement of all the facts upon which the Defendants are prepared to prove such affirmative defenses. The Defendants shall expressly indicate in such responsive pleading whether or not they desire and intend to appear and be heard before the Commission on the scheduled hearing date. If not filed electronically, an original and eight (8) copies of the responsive pleading shall be delivered to Joel H. Peck, Clerk, State Corporation Commission, c/o Document Control Center, P.O. Box 2118, Richmond, Virginia 23218, and shall contain the caption setting forth the style of this case and its number.

(5) The Defendants may be found in default if they fail to either timely file a responsive pleading as set forth above or other appropriate pleading or if the Defendants file such a pleading and fail to make an appearance at the hearing. If found in default, the Defendants shall be

deemed to have waived all objections to the admissibility of evidence and may have entered against them a judgment by default imposing some or all of the aforesaid sanctions permissible by law.

(6) The Defendants may offer to negotiate a settlement of this matter by telephoning the Office of General Counsel at (804) 371-9671. Any negotiated settlement is subject to approval by the Commission.

(7) This case is continued.

AN ATTESTED COPY of this Rule shall be sent by the Clerk of the Commission, as statutory agent, pursuant to § 13.1-566 of the Act and in accordance with § 12.1-19.1 of the Code, by CERTIFIED MAIL, RETURN RECEIPT REQUESTED, to: New York Bagel, Inc., 301 Route 17 North, #800, Rutherford, New Jersey 07070; Joseph V. Smith, 30 N. Plank Road, Newburgh, New York 12550; Dennis Kenneth Mason, 1285 County Road 519, Frenchtown, New Jersey, 08825; and a copy shall be delivered to the Commission's Office of General Counsel and the Division of Securities and Retail Franchising.