ISSUE SPOTLIGHT: Risks to Small Business Success in Franchising

I. Introduction

Use of the franchise business model is growing rapidly. A 2017 Census report found 498,328 franchise establishments nationwide, with over $1.7 trillion in revenue.[1] The International Franchise Association projected a 60% increase by 2024, estimating more than 820,000 franchised establishments nationwide.[2] For some, owning a franchise can be a ladder of opportunity to owning a business. In recent years, however, concern has increased about unfair or deceptive practices by franchisors, along with concerns about ways in which the business model may suppress wages and job quality.[3]

On March 10, 2023, Commission staff issued a Request for Information ("RFI") to seek comments from a broad range of stakeholders about how franchising is working well, and how it is not.[4] The RFI focused on six main issues: (1) the franchise relationship; (2) provisions of the franchise agreement; (3) franchisor business practices; (4) payments to franchisors from third parties; (5) indirect effects on franchisee labor costs; and (6) language barriers. The comment period closed on June 8, 2023, and the Commission received over 2,200 posted public comments. This Issue Spotlight summarizes areas of concern raised in academic literature, the RFI responses, as well as ongoing FTC work in this area. Commission staff also analyzed data from the Small Business Administration ("SBA") regarding franchise loan default rates.

II. Background

In 1978, the FTC issued the Franchise Rule, which is a pre-sale disclosure rule intended to prevent unfair and deceptive practices by ensuring that potential franchise purchasers have access to the information they need to make an informed investment decision about a franchise opportunity. The Rule was issued in response to widespread evidence of deceptive and unfair practices in connection with the sale of franchises and business opportunities, and accordingly regulated the sale of both franchises and other business opportunities. In 2007, the FTC bifurcated the original Franchise Rule into two rules: The Franchise Rule, 16 C.F.R. pt. 436, now covers only the sale of franchises, and the Business Opportunity Rule, 16 C.F.R. pt. 437, covers the sale of business opportunities.

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[1] *Franchising in America: An Overview of Key Data from the 2017 Economic Census Franchise Statistics Report*, CENSUS BUREAU (Sept. 1, 2021), https://www2.census.gov/about/training-workshops/2021/2021-09-01-franchising-presentation.pdf.

[2] Ashley Rogers, Jin Qi & Khadija Cochinwala, *2024 Franchising Economic Outlook*, INTERNATIONAL FRANCHISE ASSOCIATION (Feb. 13, 2024), https://www.franchise.org/sites/default/files/2024-02/2024%20Franchising%20Economic%20Report.pdf.

[3] *See, e.g.*, The Office of Senator Cortez Masto, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices* (April 2021), https://www.cortezmasto.senate.gov/wp-content/uploads/media/doc/Franchise%20Report%20from%20the%20Office%20of%20Senator%20Cortez%20Masto.pdf and Brian Callaci, *What Do Franchisees Do? Vertical Restraints as Workplace Fissuring and Labor Discipline Devices*, OPEN MARKETS INSTITUTE (2021), https://escholarship.org/uc/item/9x17w2kv.

[4] *FTC Seeks Public Comment on Franchisors Exerting Control Over Franchisees and Workers* (Mar. 10, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/03/ftc-seeks-public-comment-franchisors-exerting-control-over-franchisees-workers.

As franchising has gained prevalence in the economy, it has also expanded to many new industries. The first wave of explosive growth in franchising occurred in the 1950s and was dominated by chains requiring investment in physical locations and equipment. These chains ranged from fast food chains to Midas mufflers to Holiday Inn hotels.[5] However, more recently franchising has expanded to less capital-intensive industries—to areas with investment costs starting at just a few thousand dollars—such as cleaning services and event planning.[6] These are some of the fastest growing franchises in the nation.[7]

As this business model has proliferated, concerns about franchisor abuses have also grown. Analysis of recent FTC franchise-related complaint data shows that the number of franchise-related complaints has increased significantly over the past three years.[8]

A growing body of work by economists, scholars, and journalists has also raised concerns that the current structure of the franchising model may be contributing to labor law violations, the suppression of wages, and the degradation of working conditions. The Washington Post reported earlier this year that child labor law violations have tripled in the past 10 years, and that chain fast food restaurants are the most frequent offenders. The analysis specifically found that "major chains that depend on the franchise business model have much higher rates of violations than those that don't."[9] Academic research has also shown that "[f]ranchisee-owned fast food restaurants experience systematically higher levels of noncompliance with minimum wage and overtime [laws] than do comparable establishments owned and managed by the franchisor."[10] Some have offered that this dynamic may be the result of the fact that franchisors presently determine many aspects of franchisees' costs, such that the primary lever by which franchisees can protect or increase their profits is to reduce labor costs. One scholar argues "that at the root of low workplace standards in franchise stores is the franchisor's deep involvement in franchise

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[5] International Franchise Association, *The History of Modern Franchising*, https://www.franchise.org/blog/the-history-of-modern-franchising; and Brian Callaci, *Control Without Responsibility: the Legal Creation of Franchising 1960-1980*, 22 ENTER. & SOC'Y 156 (2020).

[6] Barbara Booth and Susan Caminiti, *10 low-cost franchises you can start with $15,000 or less and reap a six-figure salary*, CNBC (Sept. 21, 2019), https://www.cnbc.com/2019/09/21/10-low-cost-franchises-you-can-start-with-15000-or-less.html and *2024 Top Franchises for Less Than $50,000 Ranking*, ENTREPRENEUR https://www.entrepreneur.com/franchises/directory/top-low-under50k-ranking.

[7] 2024 Fastest-Growing Franchises Ranking, ENTREPRENEUR https://www.entrepreneur.com/franchises/directory/fastest-growing-ranking; and International Franchise Association, *The Fastest Growing Franchises in 2024,* https://www.franchise.org/blog/the-fastest-growing-franchises-in-2024.

[8] U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-105338, FEDERAL TRADE COMMISSION: ACTIONS NEEDED TO IMPROVE EDUCATION EFFORTS AND AWARENESS OF COMPLAINT PROCESS FOR FRANCHISE OWNERS 22 (2023) ("Between 2018 through 2022, FTC received a total of approximately 20 million complaints on a wide variety of topics. Our analysis of franchise-related complaints found that during that period, FTC received approximately 5,900 complaints—representing less than 1 percent of all complaints the agency received during this period.").

[9] Lauren Kaori Gurley & Emmanuel Martinez, *Fast-food giants overwork teenagers, driving America's child labor crisis*, WASH. POST (Jan. 14, 2024), https://www.washingtonpost.com/business/2024/01/14/child-labor-fast-food-franchises/.

[10] Minwoong Ji & David Weil, The Impact of Franchising on Labor Standards Compliance, 68 ILR REV. J. WORK & POL'Y 977, 1003 (2015).

store operations, which can mask and even encourage violations."[11] As one academic study found, for an overwhelming percentage of franchisees, the franchisor restricts operations through terms like mandatory operating hours and required price ranges.[12] Franchisees are also often restricted in their ability to exit the franchise through noncompete clauses and franchisor rights of first refusal to purchase.[13]

III. Top Dozen Concerns Raised by Franchisees

In response to the FTC staff's 2023 RFI, the Commission received 5,291 comments. Of those, 2,216 were publicly posted on the docket; the remainder were unresponsive.[14] The Commission heard from a wide range of participants in the franchise model. A little over half of commenters said they were franchisees, and a very small percentage of commenters, accounting for less than 10% of all comments, identified themselves as franchisors, organizations, trade groups, attorneys, and suppliers. Nearly 40% did not identify any role in the model. A wide range of industries were represented. About one third of commenters indicated they were involved in general services franchise models (e.g., hair salons or healthcare), followed by restaurants, and then relatively few from hotels and janitorial franchises. Comments were submitted by franchisors and franchisees associated with 154 different franchises.

Overall, about one third of commenters called for some further substantive regulation of the relationship between franchisors and franchisees beyond the Franchise Rule.[15] Roughly 15% of all commenters called for changes to the Franchise Rule, while about 10% called for greater enforcement of existing law. About one quarter of commenters generally supported the status quo. Unsurprisingly, franchisees favored regulatory changes more frequently than franchisors. Almost 75% of franchisors supported the status quo, compared with roughly 40% of franchisees. About 5% of identified franchisors supported regulating the post-sale franchisor-franchisee relationship, compared to about 30% of franchisees.

The chart below lists the top 12 issues of concern identified by franchisees. For each of these issues, the chart identifies specific franchise chains that were most frequently referenced in connection with the issue. If a particular issue area disproportionately referenced certain franchises, they are identified here.[16] Some issues were relatively uniform across franchises, where no particular franchise received a disproportionate number of comments. These are designated "N/A."

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[11] Andrew Elmore, *Franchise Regulation for the Fissured Economy*, 86 GEO. WASH. L REV. 907, 911 (2018).

[12] Callaci, *supra* note 3.

[13] *Id*.

[14] *See* https://www.regulations.gov/faq. ("Agencies may choose to redact or withhold certain submissions (or portions thereof) such as those containing private or proprietary information, inappropriate language, or duplicate/near duplicate examples of a mass-mail campaign. Therefore, the number of comments posted may be lower than the comments received.").

[15] Some commenters had multiple requests and goals. For example, some supported both post-sale regulation and changes to the Franchise Rule.

[16] Comments are not necessarily representative of all franchisee's experiences with a particular franchise. Additionally, comments and the narratives therein have not been verified.

Top Dozen Concerns for Franchisees	Frequently Referenced Franchises
1. Unilateral changes to franchise operating manuals	Home Instead
2. Franchisor misrepresentations and deception	Premier Martial Arts (owned by Unleashed Brands) Dickey's Barbecue Pit
3. Fees and royalties	Home Instead Dickey's Barbecue Pit
4. Franchise supply restrictions and vendor kickbacks	Dickey's Barbecue Pit Edible Arrangements
5. Actual and feared retaliation	Premier Martial Arts (Unleashed) Subway
6. Non-competes and no-poach clauses	N/A
7. Franchise renewal problems	Home Instead Subway
8. Franchisor refusal to negotiate contract terms	N/A
9. Franchise Disclosure Document issues	Unleashed Brands Dickey's Barbecue Pit
10. Private equity takeovers	Home Instead Unleashed Brands
11. Marketing fund transparency	Subway Dickey's Barbecue Pit Edible Arrangements
12. Liquidated damages clauses and early termination fees	N/A

#1 Franchisee Concern: Unilateral changes to franchise operating manuals

The top concern raised by franchisees was frustration over franchisors unilaterally changing the terms of operating manuals that set requirements for franchisees. For one franchisee, the result was "a massive overhaul, which . . . effectively turned the operations manual into a de facto franchise agreement."[17] Significant changes flagged by commenters during the agreement included "add-on service[s]," changes to operating hours, and restrictions on use of vendors.[18] One franchisee decried a "a recent ops manual change [that]. . . add[ed] a $100,000 liquidated damages provision" that had not been disclosed in the Franchise Disclosure Document ("FDD")

[17] FTC-2023-0026-1660, Comment from Anonymous.

[18] *See, e.g.*, FTC-2023-0026-0003, Comment from Anonymous ("One example was that the franchisor changed the service provider for an add-on service, which doubled my cost for that add-on service. Another change was to add a new service, which is included in around 40% of my jobs, leading to a higher cost per job for me."); FTC-2023-0026-0126, Comment from Anonymous ("For example, when I signed my contract, I agree to keep my store open until 9 pm every night. They have used the 'operation manual' to increase that time to 930 pm for online orders.") and FTC-2023-0026-0251, Comment from Aggen, butch ("For example, we are now required to purchase a curriculum package priced at twice the open market value and a recurring monthly subscription of $700/month.").

or Franchise Agreement. The franchisee didn't "believe that could be legal, but [said] the threat is sufficient to scare us."[19] Franchisees risk termination if they attempt to reject these changes.[20]

Supporters of franchisors' ability to make unilateral changes said they are necessary to keep up with changing "consumer expectations, competitive pressures, and the regulatory environment."[21] In the words of one franchisee, "I am reliant on the franchisor to not only develop a high[-]quality swim lesson curriculum that is systemized and standard, but also to continuously invest in research and development to better implement best practices for the brand."[22]

One commenter's proposed solution "would be to allow franchise owners the ability to negotiate the terms of operation manual changes and/or postpone them until the time of renewal."[23] In addition, one franchisor noted that changes "made in consultation with . . . franchise owners' association, advisory boards, or committees" were less likely to be concerning to franchisees.[24]

Washington state has a 7-day waiting period for "alter[ing] unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document."[25]

[19] FTC-2023-0026-0044, Comment from Anonymous.

[20] FTC-2023-0026-1655, Comment from Lagarias, Peter ("Almost every franchise agreement provides that the franchisor can change the operations manual, and the franchisee must strictly comply with all provisions or face default and termination.").

[21] FTC-2023-0026-1645, Comment from International Dairy Queen, Inc.

[22] FTC-2023-0026-0831, Comment from Anonymous.

[23] FTC-2023-0026-2171, Comment from Small Business Majority ("Failure to comply with new operating regulations could result in termination. One solution to offset the power imbalance would be to allow franchise owners the ability to negotiate the terms of operation manual changes and/or postpone them until the time of renewal.").

[24] FTC-2023-0026-1935, Comment from Certa ProPainters, Ltd.

[25] Wash. Rev. Code § 19.100.080. In addition, Franchise Rule item 11 requires disclosure of "the table of contents of the franchisor's operating manual provided to franchisees." 16 C.F.R. § 436.5(k)(6). On a related note, some states regulate changes to the franchise agreement itself. *See* Ind. Code Ann. § 23-2-2.7-1(3) (prohibiting "[a]llowing substantial modification of the franchise agreement by the franchisor without the consent in writing of the franchisee.") and Wis. Stat. Ann. § 135.03 ("No grantor, directly or through any officer, agent or employee, may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause.").

#2 Franchisee Concern: Franchisor misrepresentations and deception

Several franchisees discussed misrepresentations franchisors made during the sales process.[26] Start-up costs and sales, revenue, and profit data were some of the critical areas where commenters reported receiving information they believed was false or misleading. One commenter described "sales data that does not add up," and a "completely false" estimated profit margin.[27] Another commenter said that:

> "Dickey[']s barbecue business model involves selling stores at substantially more than quoted with dickeys getting a big portion of the cut. Dickey[']s will tell franchisees the costs will be 400k and it will cost sometimes double that but you don't know until you are already heavily invested. Then the owner will default on their SBA loan and the next buyer comes in and pays half but then they will default until the restaurant is sold for about 10% of the original costs to build."[28]

Commenters also reported franchisors had deceived franchisees about the extent of marketing assistance and training the franchisor would provide.[29] And in many instances, franchisee comments addressed multiple, and overlapping, types of deception. For example, one Solar Grids franchisee described being told there would be earnings beyond those disclosed in the FDD and that representations about other aspects of the businesses—such as how much control the franchisee would have over solar installs—did not turn out to be true.[30]

Commenters described dire consequences from these reported misstatements. For example, one stated that "[M]y experiences have been nothing short of a nightmare, marked by deception, mistreatment, and severe financial hardship. As of today, my family is saddled with over $900,000 of commercial lease liability and a $250,000 SBA loan, as well as the accumulation of losses from opening and operating the franchise."[31]

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[26] FTC-2023-0026-1557, Comment from Anonymous ("In short, I was lured into business they knew was not profitable with promises of sales they knew were not sustainable and costs they knew were much higher than they claimed.") and FTC-2023-0026-1971, Comment from Brave Optical, Inc. ("We learned that Luxottica knew of the insurance fraud and other issues and turned a blind eye as they long as they received their 15% for franchise fees. When the Gutmans sold the Pearle Vision locations to us, Luxottica supported the false Gutman Vision financial and operations reports and the false stories of the Gutmans, lied to us repeatedly while bragging about the deception in internal emails, lied to our bank and signed false assertions in order for us to secure an SBA loan to buy the franchises, and lied to our landlords in order to transfer the leases.").

[27] FTC-2023-0026-0312, Comment from Clean Juice, Clean Juice.

[28] FTC-2023-0026-1109, Comment from Gerrick, Brandon.

[29] FTC-2023-0026-0174, Comment from Anonymous (reporting that "marketing help, training, hiring assi[s]tance, project management, installation ability" never materialized).

[30] FTC-2023-0026-0244, Comment from Anonymous.

[31] FTC-2023-0026-1576, Comment from Bearden, Aimee.

These concerns can implicate both state and federal laws prohibiting unfair or deceptive acts or practices.[32] The Franchise Rule also requires financial performance representations to "have a reasonable basis and written substantiation."[33]

#3 Franchisee Concern: Fees and royalties

Many franchisees commented on high fees and royalties imposed by franchisors, particularly credit card processing fees and technology fees. Reported fees for one commenter "went from an additional 3%, 5%, 7%, 10% to now . . . 14%" making it "impossible for [them] to earn a good living anymore."[34] Commenters also noted that mandatory royalties also lock them into failing businesses, even after the franchisee ceases operations.[35] How franchisors collected fees was also an issue, as one franchisee discussed their franchisor "[not] even allowing us to pay for [a] convention out of our own pockets in the manner we decide, but pulling $25 a week out of our sales money for the next five months."[36] Different commenters described "surprise fees" not properly disclosed, with one referring to them as "junk fees."[37] Franchisees discussed new fees not being tied to new services: "They just came out with a $75 tech fee. Didn[']t ask or tell anyone about it. . . We don[']t get anything new from this."[38]

[32] 15 U.S.C. § 45(a)(1) ("Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful."). *See also* 16 C.F.R. § 436.6(a) ("It is an unfair or deceptive act or practice in violation of Section 5 of the FTC Act for any franchisor to fail to include the information and follow the instructions for preparing disclosure documents"); Va. Code Ann. § 13.1-563; and 19 R.I. Gen. Laws Ann. § 19-28.1-17.

[33] 16 C.F.R. §§ 436.5(s)(3) and 436.9.

[34] FTC-2023-0026-0114, Comment from Anonymous.

[35] FTC-2023-0026-1859, Comment from 9Round Wisconsin Franchisee ("My franchise agreement is for 10 years, and if I shutdown early, I am still required to make the franchise royalty payments for the remainder of my agreement term.").

[36] FTC-2023-0026-0124, Comment from Anonymous.

[37] FTC-2023-0026-0159, Comment from Anonymous ("The use of surprise fees is a significant issue. Franchisors often impose additional fees that were not previously disclosed to franchisees. These fees can include charges for training, marketing, property improvement, or any other product or service required by the franchisor.") and FTC-2023-0026-0145, Comment from Patel, Rakesh ("Choice Hotels International practices deception by adding 'junk' fees, limiting transfer of business to family, not honoring a 1 year old franchise agreement from Seller to a new Buyer, imposing penalties for a delay in installing new furniture by their own 'approved' vendors, infringing on protected territory by adding more and more brands under the disguise of each brand being different.").

[38] FTC-2023-0026-0355, Comment from Anonymous; FTC-2023-0026-0544, Comment from Patel, Sam ("Keeps increasing outrageous price of technology fees and the service they provide is not sufficient") and FTC-2023-0026-1079, Comment from Anonymous ("no service for our royalties with all the cuts made to support for the franchisee.").

However, some commenters described franchisor fees as being fair,[39] and others said that fee changes during the lifetime of an agreement were "not typical" outside of "inflation clauses" or "reserve disclaimers" disclosed in the FDD.[40]

Legislators have targeted fees as a potential area for franchise reform. "Overpriced Fees and Missing Services" was cited as one of the top problems facing franchisees in a report by Senator Catherine Cortez Masto,[41] which noted that franchisees "report paying fees for marketing, computer, or training services that are never provided, and certainly not reported in a transparent manner."[42]

State laws requiring good faith and fair dealing might be implicated by unpredictable fluctuations in fees. For example, Arkansas requires franchise transactions "be consistent with the governing principles and obligation of good faith and fair dealing."[43] Additionally, one franchisor suggested a solution to problems with fees, noting that relationships between franchisors and franchisees were improved through input from "an elected franchisee Advisory Council" on "technology choices and fees."[44]

#4 Franchisee Concern: Franchise supply restrictions and vendor kickbacks

Many franchisees expressed frustration with being forced to buy from a short list of franchisor-approved suppliers.[45] Several commenters expressed that these required vendors charged prices exceeding those in the open market, and/or involved products that were not core to brand consistency. As one franchisee explained, "[j]ust simply looking online or going to Walmart, Tom Thumb, Kroger, etc … will show these exact same items from the exact same suppliers at a lower price [and that] local stores are 15 to 30% cheaper."[46] For another, "the exact same equipment from other suppliers was at least $80k cheaper than with the supplier they were making us go with."[47]

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[39] FTC-2023-0026-0401, Comment from PROVO, JAMES ("So ... in summary, the FTC seems to be asking whether the fees charged by a Franchisor are fair for the services they provide. While I am certain there are exceptions ... from my personal experience as a Franchisee and as a Business Advisor the answer is a clear and resounding YES.").

[40] FTC-2023-0026-1031, Comment from Anonymous.

[41] The Office of Senator Cortez Masto, *supra* note 3, at 33.

[42] *Id*.

[43] Ark. Code Ann. § 4-72-212(a).

[44] FTC-2023-0026-0319, Comment from Wall, Jeff.

[45] FTC-2023-0026-0776, Comment from Anonymous ("As we built our studio, we ran into issues trying to save costs. For example, we were able to find the flooring the franchise required cheaper, but were told we could not get it from the alternate supplier as we were required to go through the PMA supplier.") and FTC-2023-0026-0161, Comment from Signature Two Company ("We're uncomfortable with the ability of a franchisor to compel franchisees to purchase products and services - either directly from the franchisor, or from a third party selected by the franchisor. If allowed to continue, then changes are needed").

[46] FTC-2023-0026-1804, Comment from Cox, Greg.

[47] FTC-2023-0026-1918, Comment from Gayon, G.

One commenter observed that this concern is exacerbated when the franchisor receives kickbacks from their franchisees buying from preferred suppliers that are not passed on to the franchisee.[48]

Franchisors and some franchisees countered that brand consistency and access to the franchise supply chain is one of the key benefits of the franchise model, giving franchisees "purchasing power" and "consistent quality."[49] One franchisor described the symbiotic relationship: "It frees [franchisees] up to focus on their people and their restaurants and business, knowing that they have support in strategic supply chain, operations, marketing, development, and the technology areas that they then don't have to worry about as much."[50]

The Franchise Rule requires disclosure of goods and services franchisees are obligated to purchase from certain suppliers, including the franchisor's financial interest in and payments from mandated suppliers.[51] Some state franchise laws substantively limit supply requirements (i.e., include requirements in addition to transparency). For example, Indiana prohibits franchisors from receiving any kickback or rebates from vendors providing goods and services to franchisees unless the payment is "promptly accounted for, and transmitted to the franchisee."[52] Indiana's franchise law also prohibits exclusive supply arrangements where comparable goods are available from non-franchisor channels.[53] Similarly, Hawaii prohibits supply restrictions "unless such restrictive purchasing agreements are reasonably necessary for a lawful purpose justified on business grounds."[54]

#5 Franchisee Concern: Actual and feared retaliation

About one quarter of franchisee comments were anonymous, with about a quarter of those commenters specifically citing retaliation fears as the reason for their anonymity.[55] Many began

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[48] FTC-2023-0026-1687, Comment from Anonymous ("Items can be purchased at the same or much lower costs through 3rd party vendors such as WebRestaurant, Sams Club, and Costco. Dickey's keeps all rebates for the items purchased by the franchisee, thereby siphoning off monies that would otherwise make a significant portion of the franchise's profit margin. DBRI is not motivated to keep the price of items low they are motivated to receive as much as they can from rebates. This arrangement incentivizes companies to do business with DBRI, knowing they can increase prices and rebate back to DBRI a given percentage ensuring ongoing business with DBRI. This seems unethical since the franchisee's interests are not being served.") and FTC-2023-0026-1758, Comment from Anonymous (calling for "clear limits" on franchisor-required purchases with kickbacks not going to franchisees, and arguing "at the very least, there should be transparency with respect to the franchisor's financial gain").

[49] FTC-2023-0026-0274, Comment from CRAIGO INVESTMENTS INC. DBA:FASTSIGNS.

[50] FTC-2023-0026-0456, Comment from Tropical Smoothie Cafe, LLC.

[51] 16 C.F.R. § 436.5(h).

[52] Ind. Code 23-2-2.7-1(4) and Ind. Code 23-2-2.7-2(6).

[53] Ind. Code 23-2-2.7-1(1).

[54] Haw. Rev. Stat. § 482E-6(B).

[55] FTC-2023-0026-0106, Comment from Anonymous ("I am commenting anonymously because I am fearful of retaliation from my franchisor."); FTC-2023-0026-0166, Comment from Anonymous ("I am in fear of my franchisor and their ability to financially destroy my business and thus choose to remain anonymous in CA.") and FTC-2023-0026-0245, Comment from Anonymous ("I will not disclose my name for fear of retaliation, they have targeted and defaulted owner/operators many times for much less than this."). FTC-2023-0026-2153, Comment from Anonymous ("Honor has already demonstrated that they will retaliate with litigation or contract termination against owners that speak up publicly which is why I'm submitting these comments anonymously.").

with some version of this emblematic disclaimer: "I am writing this anonymously, because I am afraid of retaliation."[56] Commenters described, among other scenarios, retaliation for franchisees' active participation in an independent franchisee association[57] or reporting unscrupulous franchisors to law enforcement.[58] Blocked expansion, early/unjust terminations, and surprise inspection failures were tools franchisors reportedly used to threaten franchisees.[59] One trade group summed up some franchisors' message to their franchisees: "If you fight any battle, you will lose the war."[60]

Commenters discussed how non-disparagement clauses can exacerbate retaliation fears.[61] These clauses "effectively silence[] franchisees, preventing them from speaking out against franchisor misconduct and concealing the true extent of unfair practices."[62] Whether these provisions are strictly enforced can be immaterial. "The mere threat of losing one's business just for telling the truth is a huge disincentive to speaking. No franchisee, with their entire life savings and net worth on the line is going to take a chance."[63]

As noted below, concurrent with issuing this Issue Spotlight, the FTC has issued a policy statement making clear that it is unlawful for franchisors to use non-disparagement, goodwill, or confidentiality clauses to directly or indirectly restrict franchisees' communications with state or federal law enforcement or regulators. FTC staff are also concurrently reopening the RFI period, to give franchise participants a further opportunity to provide their comments or concerns (whether anonymously or otherwise).

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[56] *See, e.g.*, FTC-2023-0026-0085, Comment from Anonymous; FTC-2023-0026-0089, Comment from Anonymous; and FTC-2023-0026-0355, Comment from Anonymous.

[57] FTC-2023-0026-0052, Comment from Anonymous ("My franchisor also engages in retaliation for my participation in non-franchisor endorsed or sponsored franchisee associations, which has had a negative impact on my business. I have seen auditors and on-site inspections that have disrupted my operations and have been a significant financial burden."). Several state laws prohibit franchisors inhibiting franchisees from participating in franchisee associations. *See, e.g.*, Ark. Code Ann. § 4-72-206(a)(2); Mich. Comp. Laws Ann. § 445.1527(a) and Wash. Rev. Code Ann. § 19.100.180(2)(a).

[58] FTC-2023-0026-0042, Comment from Anonymous ("Even submitting comments such as this one, to a governmental agency, is fraught due to the non-disparagement clauses included in all Franchise Agreements.").

[59] FTC-2023-0026-0633, Comment from Mericle, David ("The most common retaliations have been: subjectively block franchisees from expansion. subjectively exclude franchisees from [] new programs and initiatives. Currently, the franchisor is retaliating against me by threatening to terminate all of my franchise agreements because I am filing arbitrations agains[t] them.") and FTC-2023-0026-1941, Comment from Bundy & Fichter PLLC ("A franchisee may have gone years without a negative inspection or other claimed 'breach'. Suddenly, they are involved in an association, and they start getting frequent inspections and claimed breaches and audits over things that previously would have been petty—or handled with an informal verbal re-training.").

[60] FTC-2023-0026-1938, Comment from Comment from Asian American Hotel Owners Association, Inc.

[61] FTC-2023-0026-1943, Comment from Independent Association of Home Instead Franchisees, Inc ("We are aware of cases in our network where [a non-disparagement clause] has been enforced but have been asked not to detail them as those franchisees fear retaliation.") and FTC-2023-0026-1952, Comment from Ayres, Thomas ("The franchisor has ruthlessly enforced confidentiality, non-disparagement, and goodwill clauses in the franchise agreement to squelch dissent among franchisees.").

[62] FTC-2023-0026-1082, Comment from Cianci, Tiffany.

[63] FTC-2023-0026-1941, Comment from Bundy & Fichter PLLC.

Some state laws also address levers that franchisors reportedly use for retaliation: premature terminations and transfer restrictions.[64] For example, Minnesota bans termination or failure to renew a franchise "except for good cause."[65] Tennessee prohibits premature termination "except for good cause asserted in good faith."[66] New Jersey is similar.[67] Minnesota law also makes it "unfair and inequitable for a person to unreasonably withhold consent" for a qualified franchise transfer.[68] Tennessee specifies franchisor transfer qualifications must be "nondiscriminatory, material, and consistently applied and reasonable."[69] California makes it "unlawful for a franchisor to prevent a franchisee from selling or transferring a franchise . . . to another person provided that the person is qualified under the franchisor's then-existing standards."[70]

#6 Franchisee Concern: Non-competes and no-poach clauses

Several commenters stressed the inherent unfairness of a non-compete as an additional restraint on leaving a franchise.[71] In the words of one franchisee commenter, non-competes are "unfair to franchisees and can limit competition in the marketplace" given that they "can severely limit the franchisee's ability to pursue other opportunities and earn a livelihood, especially if they have invested a significant amount of time and money into the franchised business."[72] Vague wording can exacerbate the harm to franchisees; one discussed an "18-month period after the termination

[64] *See, e.g.*, FTC-2023-0026-2171, Comment from Small Business Majority ("Retaliation—in the form of terminating the contract agreement on spurious grounds—is a real threat and the reason why the comments provided by small business owners in our network are anonymous."); FTC-2023-0026-2105, Comment from Anonymous ("There are parts of my story that I cannot tell even anonymously because I fear that it might be recognized, and I could suddenly become ineligible for purchasing new restaurants and my locations that are scheduled to be renewed for new 20 year terms might be taken away from me.") and FTC-2023-0026-1938, Comment from Asian American Hotel Owners Association, Inc. ("Because AAHOA respects its members' requests for confidentiality of the many reports of retaliation/retribution it has received, it can instead point the FTC to a Franchise Agreement that explicitly states a Franchisor will hold a grudge against any Franchisee who dares to challenge its authority. The excerpt below is from a Franchise Agreement's transfer provision, within a structure that requires the Franchisor's consent to transfer. Without that consent, the Franchised hospitality property cannot be bought or sold to any third party.").

[65] Minn. Stat § 80C.14.

[66] Tenn. Code § 47-25-1503(a).

[67] N.J. Stat. § 56:10-5 ("It shall be a violation of this act for a franchisor to terminate, cancel or fail to renew a franchise without good cause.").

[68] *Id*.

[69] Tenn. Code § 47-25-1508(b)(3).

[70] Cal. Bus. & Prof. Code § 20028(a).

[71] FTC-2023-0026-0036, Comment from Lubeznik, Samuel ("These terms restrict my (and all other franchisee's) ability to start a new business or use my experience/expertise in any way to work in a similar industry. Yet when the franchisees contract expires, they have no guarantee of an extension and even if they are granted one the terms can be significantly different.") and FTC-2023-0026-0077, Comment from Anonymous ("Worse still, they use the non-compete to make sure if we don't fall in line, we will have no way to support ourselves when we leave, even though we have taken on debt to finance and invest in their business, while their risk is non-exist[e]nt. But, if we step out of line, assert our rights, or advocate for our protections and brand, we will be terminated, and if we comply we may go out of business because of significant cost increases. Regardless, the non-compete will ensure we have no means of employment despite our financial and time investment. This is grossly unfair.").

[72] FTC-2023-0026-0092, Comment from Gifford, Charles.

of the agreement for any reason where I am not allowed to be involved with another restaurant that is vaguely worded 'similar.'"[73]

Franchisors stated that non-competes were needed "to protect both the new operator … and other nearby franchisees, and to preserve the sale value of the restaurant for the departing owner." They also asserted that non-competes protect "against misappropriation of trade secrets."[74] Franchisees advocated for "the elimination (or drastic reduction)" of non-competes, as one was "2 years. I can't go a 2 full years without income, so it might as well be 10 years."[75]

The FTC recently banned non-compete agreements between businesses (including franchised businesses) and their workers, but the rule does not apply to non-compete agreements between franchisors and franchisees as the evidentiary record in that rulemaking proceeding related primarily to non-competes that arise out of employment. However, the Commission made clear that "[n]on-competes used in the context of franchisor/franchisee relationships remain subject to State common law and Federal and State antitrust laws, including section 5 of the FTC Act."[76]

State non-compete bans can implicate franchise agreements. California's franchise law explicitly requires that "[u]pon expiration of the franchise, the franchisor agrees not to seek to enforce any covenant of the nonrenewed franchisee not to compete."[77] Other states that ban non-competes have exceptions for "a person that sells the good will of a business," which may permit enforcement of those non-competes against franchisees.[78]

Franchisees also commented about negative impacts of no-poach clauses that prevent franchisees from hiring workers employed by their fellow franchisees. Franchisees discussed how no-poaches can be unfair and hurt franchisees by narrowing "the pool of qualified candidates for employment and can lead to a lack of competition for talented individuals."[79]

Washington state banned non-solicitation and no-poach restrictions in franchise agreements in 2019.[80] In response to the FTC staff RFI, a comment from the Washington State Attorney General discussed how no-poach agreements can "put artificial downward pressure on wages" and can "have the same anticompetitive effects in labor markets as mergers do in product markets."[81] Supporting this view, a recent economic study found a 6.6% increase in earnings

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[73] FTC-2023-0026-0090, Comment from Anonymous.

[74] FTC-2023-0026-1077, Comment from McDonald's USA, LLC.

[75] FTC-2023-0026-0183, Comment from iBreck Property Management dba iTrip Breckenridge, CO.

[76] Non-Compete Clause Rule, 89 Fed. Reg. 38342, 38451-52 (May 7, 2024) (to be codified at 16 C.F.R. pts. 910, 912).

[77] Cal. Bus. & Prof. Code § 20025(b)(2).

[78] N.D. Cent. Code § 9-08-06. Okla. Stat. Ann. tit. 15, §§ 218, 219 (similar). Minnesota's recent non-compete ban also has similar exceptions though is limited to "employees." S.F. No. 405, 93rd Leg., (Minn. 2023) https://www.revisor.mn.gov/bills/text.php?number=SF405&version=latest&session=ls93&session_year=2023&session_number=0.

[79] FTC-2023-0026-0049, Comment from Anonymous.

[80] Wash. Rev. Code Ann. § 49.62.060.

[81] FTC-2023-0026-1146, Comment from Office of Washington State Attorney General Bob Ferguson.

from job vacancy data and a 4% increase in worker-reported earnings following the adoption of the prohibition on no-poach clauses in Washington state.[82]

In May 2023, Minnesota similarly banned non-solicitation and no-poach restrictions in franchise agreements.[83]

#7 Franchisee Concern: Franchise renewal problems

Although the franchise term can be lengthy, sometimes several decades, several commenters described the renewal process as an area in need of reform. One franchisee explained: "My franchisor has too much leverage at the time of renewal. If I do not like the terms of the renewal agreement, I have 2 very bad choices: 1) Sign the agreement or 2) refuse to sign the agreement and lose my business altogether."[84] Franchisees are often presented with materially different terms than those they originally agreed to, with one terming their renewal contract "ludicrous as the fee is higher than previously."[85] Another discussed "substantial changes to the franchise agreement, such that it no longer even remotely resembles the franchise agreement that I originally signed."[86] Comments centered on franchises that had seen a change in leadership (or a private equity buyout) that fundamentally changed the business model that franchisees initially agreed to.[87]

In contrast, franchisors characterized making changes upon renewal as proper responses to "market changes, competitive changes, technology changes, and changes in customer demand."[88]

Sixteen states have "franchise relationship laws that regulate the franchisee's right to renew to some extent."[89] For example, Mississippi requires franchisee notification "in writing at least ninety (90) days in advance of the cancellation, termination or failure to renew."[90] In Wisconsin, no dealer "may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor."[91] Iowa has a similar termination good-cause protection.[92]

Authors have also highlighted good faith and fair dealing requirements, along with unconscionability, as potential franchisee protections from renewals based in state franchise

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[82] Brian Callaci, et al., *The Effect of Franchise No-poaching Restrictions on Worker Earnings*, SSRN (July 2023) (finding a 6.6% increase in earnings from job vacancy data and a 4% increase in worker-reported earnings after removing no-poach clauses in Washington state).

[83] S.F. No. 3035, 93rd Leg., (Minn. 2023) https://legiscan.com/MN/text/SF3035/2023.

[84] FTC-2023-0026-2029, Comment from Anonymous.

[85] FTC-2023-0026-0177, Comment from Anonymous.

[86] FTC-2023-0026-1086, Comment from Anonymous.

[87] FTC-2023-0026-1167, Comment from Michael, Seth ("This new agreement has brought all kinds of changes as listed above. It[']s shocking that a franchisor can do this to us and make us change our entire business model.").

[88] FTC-2023-0026-2013, Comment from FASTSIGNS International.

[89] Keith J. Kanouse, Evan M. Goldman, Scott D. Salmon*, Are Material Changes to Renewal Franchise Agreements Subject to the Implied Covenant of Good Faith and Fair Dealing?*, 36 FRANCHISE L.J. 661, 665 (2017).

[90] Miss. Code § 75-24-53.

[91] Wis. Stat. § 135.03.

[92] Iowa Code Ann. § 523H.7(1).

laws.[93] One author argues that if "changed terms are not specified in the renewal provision of the existing franchise agreement, any changes made unilaterally by the franchisor ought to be measured against the implied covenant of good faith and fair dealing to determine their reasonableness."[94] This author further notes that given the "disproportionate bargaining power" in franchise contracts, courts may find them to be a "'contract of adhesion' that contains many unconscionable terms."[95]

#8 Franchisee Concern: Franchisor refusal to negotiate contract terms

Many commenters expressed frustration that their franchise agreements were presented as "take-it-or-leave-it" contracts.[96] As one franchisee discussed, "[t]he franchise agreement was not negotiable in any way, shape, form, or fashion."[97] This was also discussed as a disincentive to fully reading and understanding the FDD and franchise agreement, since the terms are non-negotiable.[98] Some franchisees reported regretting caving to what they characterized as franchisor pressure to hastily agree to these non-negotiable contracts.[99] These non-negotiable contracts often include provisions allowing unilateral changes by franchisors. Franchisees explained that they cannot negotiate lower fees and simultaneously face the prospect of unilateral fee raises later into the agreement.[100]

Franchisors commented that "[i]t is inherently unfair to allow individual franchisees to negotiate major items in a franchise agreement - to do so introduces wholesale discrimination. It creates a much healthier and more fair relationship when everyone agrees to the same terms."[101] They state that lack of negotiation "is to the overall benefit of franchisees" by "saving them time and

[93] *See* Kanouse et al., *supra* note 89.

[94] *Id*. at 674.

[95] *Id*. at 671.

[96] FTC-2023-0026-0044, Comment from Anonymous.

[97] FTC-2023-0026-1699, Comment from Anonymous.

[98] FTC-2023-0026-2071, Comment from Doble, Karly ("Regarding the Franchise Agreement – it was made clear to us more than once that the document isn't up for negotiation, so to keep that in mind when deciding if we should spend money to have an attorney review it.").

[99] FTC-2023-0026-0174, Comment from Anonymous ("Feeling the pressure, I sent them the signed FDD, in my name only, and $50,000. . . My career, savings and retirement future have all been jeopardized.") and FTC-2023-0026-0039, Comment from Anonymous ("I was told I would be throwing money down the drain by hiring an attorney to review the contract. 'If you don't want it, we already have someone to take your place' is what I was told as a way to pressure me into accepting the agreement.").

[100] FTC-2023-0026-0602, Comment from Vosseler, Kevin ("The royalty fees, call center fees, I couldn't negotiate the agreement, we are making no money and I am stuck in this agreement.") and FTC-2023-0026-0003, Comment from Anonymous ("As to unilateral changes to the system, I have witnessed multiple instances of this, all of which led to higher costs of doing business for me. One example was that the franchisor changed the service provider for an add-on service, which doubled my cost for that add-on service. Another change was to add a new service, which is included in around 40% of my jobs, leading to a higher cost per job for me. Another change happened last fall in response to 'inflation.' Due to inflation, all of the previously mentioned fees were raised: the per job fee I noted earlier, and both the add-on and new service fees I mentioned in this paragraph went up. The justification was that the franchisor's costs were going up.").

[101] FTC-2023-0026-0262, Comment from Home Run Franchises LLC.

money knowing that the franchisees are on an even playing field" and a "lack of uniformity" can lead to an "inability to enforce brand standards hurt[ing] the franchises."[102]

Virginia allows franchisees to void franchises within 30 days if they have "not [been] afforded the opportunity to negotiate with the franchisor on all provisions" provided negotiating "shall not result in the impairment of the uniform image and quality standards of the franchise."[103]

#9 Franchisee Concern: Franchise Disclosure Document issues

Franchisors are required to comply with the Franchise Rule's disclosure requirements. However, many franchisees complained of incomplete or misleading FDDs. For example, one franchisee says the FDD indicated a "41% profit margin," but those numbers were from "using a different business model" so "81% of owners are profiting less than $2,500 a month or losing money (51% losing more than $2.5k/mo)."[104] Some franchisees complained of new fees that should have been disclosed in the FDD.[105] Others reported that build-out cost estimates were artificially low, resulting in stark differences in franchisee profitability. Another reportedly was told in the FDD that "cost to build out would be about $270,000 to $350,000" yet the final "build out totaled $535,000."[106] One franchisee felt these differences were due to location: "[s]ome costs were low given they [operate] everything out of South Carolina. Build out is definitely more [costly] here in the West."[107]

Other commenters discussed shortcomings in the current FDD and offered ideas for potential reforms. These included calling for standardization in the financial reporting required by Item 19, "avoiding exclusion of significant locations" and with more "comprehensive financial information"[108] and requiring more up-to-date disclosure of franchisee associations.[109] One franchisee suggested an annual "accompanying red-line of the changes" to the FDD would be useful to both current and prospective franchisees.[110] Other reform ideas were to include an executive summary of the FDD[111] and strengthen disclosures around franchise brokers.[112]

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[102] FTC-2023-0026-0319, Comment from Wall, Jeff.

[103] Va. Code Ann. § 13.1-565.

[104] FTC-2023-0026-1098, Comment from Anonymous.

[105] FTC-2023-0026-0074, Comment from Patel, Naresh ("AHLA membership fee franchisors have been collecting for years and have not been disclosed in any agreement.").

[106] FTC-2023-0026-0243, Comment from Anonymous.

[107] FTC-2023-0026-0252, Comment from AlphaNiner LLC.

[108] FTC-2023-0026-0613, Comment from Anonymous.

[109] FTC-2023-0026-1694, Comment from Anonymous ("The Tutoring Center Franchise Corp. did not include the TTCFA in the most recent FDD despite the request being submitted and being included in the previous FDD. Some franchisees are afraid to join due to the possibility of retaliation from the franchisor.").

[110] FTC-2023-0026-0589, Comment from Anonymous.

[111] FTC-2023-0026-2176, Comment from Manning, Fulton & Skinner, P.A. ("An executive summary of material terms and information, including the nature of the franchise relationship and the roles of the operations manual compared to the franchise agreement.").

[112] FTC-2023-0026-2037, Comment from Pizinskii, Fred ("Before the internet came along Franchisors were solely responsible for the disclosures, and since the internet the proliferation of coaches, brokers and 3rd party

Fourteen states have registration laws that generally require a franchisor to "register its FDD and submit a copy to the state regulator for approval prior to offering or selling franchises in the state, absent an applicable exemption."[113] Four of these states make the FDDs publicly available in databases operated by state regulators.[114] Many states have state-specific FDD cover sheets.[115] Michigan requires a state-specific FDD addendum, listing "unfair provisions" such as prohibitions on franchisee association membership, in franchise documents and informing prospective franchisees that "the provisions are void and cannot be enforced against you."[116]

#10 Franchisee Concern: Private-equity takeovers

Many comments illustrated why the franchise business model is often an appealing investment for private-equity firms and how the private-equity business model can incentivize business decisions that benefit franchisors and their investors at the expense of franchisees.[117] Private equity's reliance on debt and the mandate for growth can shift franchisor resources toward interest payments, rather than to strengthening the brand or providing franchisees with operational support. Indeed, many franchisee comments noted decreased levels of franchisor support after acquisition by a private-equity fund. These commenters noted increased fees,[118] cost-cutting measures that harmed long-term franchisee interests,[119] loss of renewal

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representatives have sprung up at a meteoric rate. Licensed business brokers are REAL brokers. Franchise 'brokers' are not licensed, regulated or disclosed, they are motivated to oversell the consumer for self-serving purposes This is the problem the FTC needs to address in disclosure.").

[113] U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-105338, FEDERAL TRADE COMMISSION: ACTIONS NEEDED TO IMPROVE EDUCATION EFFORTS AND AWARENESS OF COMPLAINT PROCESS FOR FRANCHISE OWNERS 8 (2023). The states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

[114] California, Indiana, Minnesota and Wisconsin.

[115] NASAA, *New Franchise State Cover Sheet Instructions*, https://www.nasaa.org/wp-content/uploads/2019/06/New-Frachise-State-Cover-Sheets-Instructions.pdf.

[116] Mich. Comp. Laws § 445.1508(3)(i).

[117] Two characteristics that typify private equity investments are leverage and short-term investment periods. Private equity takes private funds to purchase target companies. EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET 43 (2014). After fund formation, private equity fund managers must identify investments and put capital to use on a timely basis or return the cash to investors. *Id.* at 46. PE investors expect to realize returns by the end of the private equity fund's life span, which means that private equity investments are inherently short-term. Private equity funds generally finance their acquisitions with debt for which the acquired company's assets and cash flows serve as collateral. *Id.* at 43. As a result, private equity firms target companies with recurring revenues and predictable cash flows in order to cover subsequent interest payments. Achieving rapid growth is critical because a profitable investment generally requires that private equity funds sell their portfolio companies for more than the initial purchase price. *Id.* at 58–65.

[118] FTC-2023-0026-0015, Comment from Anonymous ("The 'business operations manual' is becoming a blank check for the private equities to add numerous additional monthly fees, require only their approved vendors with no financial benefit to the franchisee, increase royalty percentages, increase royalty minimums, forced marketing spend, forced tech spend, forced convention spend.").

[119] FTC-2023-0026-2170, Comment from American Association of Franchisees and Dealers ("The model itself is brilliant, but we believe it is falling apart due to pressures for franchisors, which in recent years are often owned by private equity or public companies, to maximize the return only for the franchise company, not the franchisee investor. This trend must reverse itself if the model is to succeed long term.") and FTC-2023-0026-0044, Comment

opportunities,[120] and compromising product or service quality to maximize short-term profitability.[121] For example, one commenter said that "Private Equ[]ity companies are ruining franchising. . . We have no protection, no support, no options – just punitive restrictions and way higher fees."[122]

The focus on maximizing revenue, from which franchisee royalty fees are calculated, rather than franchisee profitability is also an issue highlighted in the comments. One example that several commenters noted is excessive use of discount promotions that maximize revenue, on which franchisor royalty fees are often based, while decreasing franchisee profits. For one franchisee, "discount percentage is 20% of revenue vs industry standard of 3% . . . if not accepted the franchisees has to deal with angry customers . . . [t]he franchisor wins every time however the franchisee always loses."[123]

Franchisees also noted concerns that arise from the tension between private equity investors' desire for short term profits and franchisees' desire for long term, stability, sustainable profits, and positive reputation with customers. As one commenter noted, "private equity firms often implement cost-cutting measures that negatively impact franchisees and their employees. These measures can include reducing labor costs, downsizing staff, and compromising product or service quality to maximize short-term profitability."[124]

#11 Franchisee Concern: Marketing strategy and marketing fund transparency issues

Under the Franchise Rule, marketing fund information is a required disclosure in Item 11 of the FDD, which requires disclosure of required franchisee contributions, types of marketing used, and whether the funds collected must be spent in the franchisee's area or can be used to solicit new franchisees.[125] Although such disclosures are required prior to entering a franchise

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from Anonymous ("Private equity firms are known for their aggressive cost-cutting measures, and they often focus on maximizing profits at the expense of franchisees.").

[120] FTC-2023-0026-0679, Comment from Anonymous ("Our right to renew the franchise agreement has been removed. After signing the new agreement, we no longer have the option to renew, regardless of our adherence to all obligations. This new provision, coupled with the noncompete agreement, empowers the franchisor to shut down our businesses or seize control, disregarding the years of effort and investments made by franchisees to establish, maintain, and expand their businesses. This aligns with Honor's strategy of delivering care through its centralized business platform rather than independent businesses like mine.").

[121] FTC-2023-0026-0756, Comment from Home Instead Tucson ("I appeal to your sense of decency to help restrict these flagrant violations of common decency which will rob the franchise owners of what could be a lifetime of building their biggest asset and an assumed retirement strategy into a fire sale of desks and computers with no recourse whatsoever. The franchisor needs greater limitations on their ability to harm the franchisee for their short-term gains and investors satisfaction.")

[122] FTC-2023-0026-2196, Comment from Anonymous.

[123] FTC-2023-0026-0085, Comment from Anonymous. *See also* FTC-2023-0026-0356, Comment from JBL Subs Inc ("I am unhappy that corporate can dictate the constant coupons that make our profitability tank because they want their bottom line to look good to sell.") and FTC-2023-0026-1938, Comment from Asian American Hotel Owners Association, Inc. ("According to one AAHOA Member, one Franchisor pays just $30 for award nights redeemed any time hotel occupancy is less than 96% (e.g., the vast majority of nights in a year), which means Franchisees effectively lose revenue almost every time a guest redeems a stay.").

[124] FTC-2023-0026-1644, Comment from D, J.

[125] 16 C.F.R. § 436.5(k)(4).

agreement, concerns about transparency in how marketing funds are used were among the top concerns raised by franchisees.

Some franchisees commented that their franchisors' ability to collect marketing fees and advertise on behalf of the franchise brand writ large is a valuable service provided by the franchisor, citing the "pooling of resources" and relative sophistication of the franchisor with respect to "advertising and marketing depth" as a benefit of the franchise business model.[126] However, other franchisees disagreed that pooled marketing benefited franchisees.[127] Fees can be high; one franchisee decried a "4.5% advertising fee of which we have been refused any accounting information on how these funds are being used."[128] In the words of another, "[w]e pay a 2% marketing fee to the 'Brand Fund'. We have never received any type of information where this money goes to."[129] Some stated that the funds were used for advertisements not in their area while others stated that funds were used to disproportionately benefit franchisors and corporate-owned locations.[130] Others similarly stated marketing funds were used to recruit other franchisees, not customers to franchisee businesses. For example, one commenter stated that "all [the marketing] I see is 'Buy a franchise.'"[131] At least one commenter expressed that disclosures were not detailed enough to assess the utility and impact of the marketing, noting that they merely contained "pie charts and graphs from a few years ago [without a] balance sheet, [information about] ad spend, or effectiveness."[132] Several franchisees used the term "slush fund" to describe the marketing fund, which they believe is used to enrich the franchisor without clear benefits to the franchisees.[133] Some franchisees claimed their franchisors weren't performing promised marketing fund audits, in violation of their franchise agreements.[134]

Arkansas is the only state with a franchise statute that provides substantive limits on marketing funds. It prohibits collecting "a percentage of the franchisee's sales as an advertising fee and not us[ing] these funds for the purpose of advertising the business conducted by the franchisee."[135]

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[126] FTC-2023-0026-1030, Comment from Carson, Greg and FTC-2023-0026-0666, Comment from Bharmal, Hussain (Hank).

[127] FTC-2023-0026-0062, Comment from Anonymous ("There is a lack of transparency on how our advertising funds are used.") and FTC-2023-0026-0097, Comment from Anonymous ("I would like Subway Franchisor looked into. They do not have transparency with what they do with the advertising fees.").

[128] FTC-2023-0026-1540, Comment from Anonymous.

[129] FTC-2023-0026-0312, Comment from Clean Juice, Clean Juice.

[130] FTC-2023-0026-0016, Comment from Anonymous ("The concern is [D]ickey[']s uses these funds to unequally distribute funds, benefiting [D]ickey[']s corporate stores in a disproportionate manner. In addition, the overall opinion is Dickey[']s used these funds as a slush fund, for [D]ickey[']s family travel and disbursing funds based on corporate desires, needs and wants versus owner/operator needs.").

[131] FTC-2023-0026-0232, Comment from Anonymous.

[132] FTC-2023-0026-0252, Comment from AlphaNiner LLC.

[133] FTC-2023-0026-0168, Comment from Anonymous and FTC-2023-0026-0016, Comment from Anonymous.

[134] FTC-2023-0026-0111, Comment from Anonymous ("Per our agreements, we were always supposed to get an accounting of the ad fund. To my memory we have rec[ei]ved one or two in the last 15 years") and FTC-2023-0026-1761, Comment from Elahi, Forrest ("Intentionally hiding marketing fund accounting from franchisees (Our franchise agreement states we are able to request this)").

[135] Ark. Code Ann. § 4-72-206(7).

However, other state franchise laws may limit misuses of marketing funds, such as laws requiring franchisor good-faith dealing, non-discrimination provisions, and supply restriction prohibitions that could be applied to advertising suppliers.[136]

One commenter suggested addressing the issue by creating a fiduciary duty for franchisors' use of franchisee funds, including for advertising.[137] One franchise author and attorney called for expanded use of franchisee-represented advertising councils to govern marketing spending, along with fuller and more frequent accounting.[138] One franchisee reported success with this model, stating that their "collective advertising fees are democratically directed through our Franchisee Counsel composed of Franchisee elected representatives."[139] Notably, concerns about the need to ensure fair mechanisms of allocating collectively pooled marketing resources are not unique to the franchise context. For example, in the agricultural sector, transparency and accountability in the use of pooled marketing funds has been a subject of bipartisan concern.[140]

#12 Franchisee Concern: Liquidated damages clauses and early termination fees

Several franchisees singled out liquidated damages clauses as trapping them in unprofitable franchise systems. Many franchise agreements require fees when the franchisee prematurely terminates the agreement, which can include unpaid royalties or pre-calculated damage sums, known as liquidated damages.[141] Franchisees reported being locked into losing investments, as they are unable to afford the early termination fee. As one franchisee said, they face "a very tough choice of keeping a money losing store open and losing money slowly . . . or com[ing] up with a large sum of money" to exit.[142] Another saw liquidated damages as "strong arming franchisees to pay future royalties on a business they can't sustain."[143] Others reported liquidated damages clauses being used to keep franchisees in line with threats of premature default.[144] As one commenter explained, they "can also serve as the final trap that forces franchisees to submit to the anti-competitive practices of the franchisor without any ability to cancel without

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[136] *See, e.g.*, Iowa Code § 523H.10 (good-faith dealing); 815 Ill. Comp. Stat. 705/18 (non-discrimination); and Haw. Rev. Stat. § 482E-6(2)(B) (supply restrictions).

[137] FTC-2023-0026-2182, Comment from Purvin, Robert. Currently, many franchise agreements specifically disclaim a fiduciary duty with a franchisee. Lauren Smith Madden, *Not Your Mama's Advertising Fund: Best Practices in the Use of Franchise System Advertising Funds*, 38 FRANCHISE L.J. 379, 390–91 (2019).

[138] *Id*. at 396–99.

[139] FTC-2023-0026-0299, Comment from FASTSIGNS of Asheville.

[140] Sens. Cory Booker & Mike Lee, *Government checkoff programs should work for farmers, not industry lobbyists,* THE HILL (Dec. 20, 2023), https://thehill.com/opinion/congress-blog/lawmaker-news/4369224-government-checkoff-programs-should-work-for-farmers-not-industry-lobbyists/.

[141] FTC-2023-0026-0633, Comment from Mericle, David ("The franchise agreement stipulates that you can be held accountable for minimum royalties for the life of the contract even if your store must close. It[']s reasonable to have a fee for terminating early, but the fee should be reasonable and should not cause a franchisee to be burdened to, or near the point of foreclosure.").

[142] FTC-2023-0026-0464, Comment from Anonymous.

[143] FTC-2023-0026-1088, Comment from Anonymous.

[144] FTC-2023-0026-1938, Comment from Asian American Hotel Owners Association, Inc. ("If Franchisees step out of line, push back against fees, or otherwise 'stick out' as a 'problem,' they find themselves facing a 'Notice of Default' backed by a threat of termination, triggering these Liquidated Damages provisions.").

significant harm."[145] One franchisee argued "liquidated damages should be eliminated or limited to only a few months and paid only after paying other creditors" to "try to avoid bankruptcy."[146] Others went further, arguing "the only damages that should be allowed is the forfeit of the un-used term of the agreement."[147]

Supporters of liquidated damages clauses argue they promote efficiency, add predictability for all parties, and can promote settlement.[148]

Courts have generally upheld liquidated damages awards in franchise agreements so long as they are compensatory, not punitive and reasonably related to a franchisor's actual damages.[149] State laws around calculating and enforcing liquidated damages are "relatively similar from state to state" [150] with two notable exceptions: Minnesota and North Dakota ban liquidated damages in franchise agreements.[151]

IV. SBA Loan Data Analysis

To gain further insight into the frequency that franchisees face financial problems, FTC staff has reviewed data published by the SBA about SBA loans to franchisees and other businesses that are made through the SBA's 7(a) and 504 loan programs.[152] Staff analyzed 66,291 SBA-backed loans for investment in franchises. The loans dated from January 1, 2013, to September 30, 2023. The data showed rates of defaults and charge offs. The SBA loan data, and Staff's analysis of that data, may be a useful resource for borrowers when assessing how to limit potential risks and maximize rewards when deciding whether to purchase a franchise.

Staff's analysis found that franchise borrowers had a slightly higher default rate on their loans than non-franchise borrowers (i.e., small business loans that were not franchises). The default rate for franchise loans was 3.9%, as compared to 3.5% for other borrowers.[153] Franchise loan

[145] FTC-2023-0026-0159, Comment from Anonymous.

[146] FTC-2023-0026-0464, Comment from Anonymous.

[147] FTC-2023-0026-0395, Comment from Anonymous.

[148] Paul J. Ferak and Christopher A. Mair, *Liquidated Damages Provisions: Best Practices & Key Considerations*, INTERNATIONAL FRANCHISE ASSOCIATION 50TH ANNUAL LEGAL SYMPOSIUM 3–5 (2017).

[149] Ferak and Mair, at 5–11.

[150] Benjamin B. Reed, *Liquidated Damages Provisions: Strategic Drafting and Enforcement Issues*, 37 FRANCHISE L.J. 523, 552 (2018).

[151] Deborah S. Coldwell, Altresha Q. Burchett-Williams, Melissa L. Celeste, *Liquidated Damages*, 29 FRANCHISE L.J. 211, 218 (2010) (appendix containing a chart of each state's laws on liquidated damages).

[152] The SBA's 7(a) program is designed to encourage business lending that would otherwise be too costly or unavailable to small business startups. The data concerning loan defaults is available at https://data.sba.gov/en/dataset/7-a-504-foia. FTC staff thanks SBA staff for their assistance in helping FTC staff identify and interpret this dataset. FTC staff also notes that the loans in these SBA programs may not be representative of franchise investment loans through private lenders outside the SBA's 7(a) and 504 programs.

[153] Although this difference is statistically significant, FTC staff cannot say with certainty that franchise loans are necessarily riskier simply because they are franchise loans. This difference remained statistically significant when controlled for loan amount, location, general industry, and time of loan approval. Other factors not fully available to Commission staff, such as business age, might impact the analysis.

default rates did not meaningfully vary based on location and median household income for the relevant area.

Smaller franchise loans had a higher default rate than larger ones; each time the loan amount increased by 100%, defaults fell by 0.8 to 1.4%. Newer businesses and start-up loans were associated with slightly higher rates of default than loans older than 2 years (around a 1 to 2% higher default rate).[154]

There generally was no meaningful variation in default rates among different franchise industries.[155] However, among Accommodation and Food Services franchise loans, rates of default varied widely, with bar, tavern, and nightclub loans 9 times more likely to default (9% rate) than hotel franchises (1%). Restaurants had about a 5% default rate while special food services (food delivery and caterers) had an 8% default rate.

Default rates for SBA-backed loans generally did not vary widely by franchise. The majority of franchises had default rates of 1% or less. However, there were a few notable outliers: Franchises with the highest default rates included Dickey's Barbecue Pit (20% defaulted), Edible Arrangements (9%), and Massage Envy (8%), compared with the average default rate of 3.9%.

Most banks that originated SBA-backed franchise loans had similar default rates on franchise investment loans. However, there were a few notable outliers. Banks with the highest default rates of loans included Celtic Bank Corporation (19% loans defaulted), First National Bank of Pennsylvania (11%) and United Midwest Savings Bank (9%), compared with the average default rate of 3.9%.[156]

V. Supporting a Fair and Healthy Franchise Ecosystem

Protecting small businesses and entrepreneurs from abuse and ensuring honest businesses can compete on a level playing field is at the core of the FTC's mandate.

In addition to continuing to vigorously enforce the FTC Act, concurrent with releasing this Issue Spotlight, the FTC announced three new actions to help protect franchisees:

- *Ensuring franchisors' contracts don't chill reporting to law enforcement*: The FTC issued a Policy Statement making clear that it is unlawful for franchisors to use non-disparagement, goodwill, confidentiality, or similar clauses to directly or indirectly restrict or chill franchisees' communications with regulators.
- *Issuing guidance undisclosed fees*: FTC staff has issued guidance on undisclosed fees imposed on franchisees. That guidance makes clear that if a franchisor imposes or collects a new fee, through its operating manual or otherwise, that was not disclosed in

[154] Approximately 40% of loans did not have data on business age and were not a part of this calculation.

[155] Industries were analyzed under the two-digit NAICS sector classifications used by the Census Bureau. *See* https://www.census.gov/programs-surveys/economic-census/year/2022/guidance/understanding-naics.html for a full list of sectors.

[156] The degree of variance in default rates by these banks is notable and important, but this analysis does not control for some factors potentially impacting defaults because the data is not available to FTC staff. This includes the composition of these lender's loan portfolios in terms of loan size and reliance on revolving lines of credit.

the FDD and included in the franchise agreement, the franchisor may be engaging in an unfair act or practice in violation of Section 5 of the FTC Act.

- *Launching ftc.gov/franchise*: On our new website, franchisees and prospective franchisees can find Commission guidance and links to other helpful resources. The new website also includes a link to reportfraud.ftc.gov, where stakeholders can quickly file a franchise-related complaint. We are reopening the public comment period to welcome any additional comments pertaining to our 2023 Request for Information.

These new actions build on other recent activities:

- In March 2024, Choice announced it was abandoning its tender offer and withdrew its nominees to replace the Wyndham Board of Directors with its own hand-picked slate of nominees. This followed FTC scrutiny of the offer.[157]
- In March 2023, the FTC launched the RFI on franchise agreements and franchisor business practices discussed in this spotlight.
- In February 2023, the FTC brought its first Franchise Rule case in 16 years. Filing on behalf of the FTC, the Department of Justice sued fast-food chain BurgerIM and its owner, Oren Loni, for allegedly making false promises and withholding material information required by the Franchise Rule.[158] More than 1,500 consumers purchased BurgerIM franchises. On November 20, 2023, the court entered a stipulated permanent injunction against Loni. Among other things, the order bans Loni from selling franchises and includes a suspended monetary judgment of $43,000,000. In January 2024, the court entered a default judgment order against the corporate defendants banning them from selling franchises and includes a monetary judgment of $56,226,689.[159]
- In August 2022, the FTC's Bureau of Consumer Protection Director, Sam Levine, made clear that nothing in the FTC Act or the Franchise Rule would preclude franchisees from exercising their legal rights under state law.[160]
- In December 2021, the FTC filed an amicus brief in a class action suit by 7-Eleven franchisees alleging claims under Massachusetts wage laws where defendants argued that being classified as a franchisee under the FTC's Franchise Rule rendered the franchisee an independent contractor exempt from state wage laws. The FTC explained to the court that franchisees either "may or may not be

[157] *See* FTC's Statement Regarding the Termination of Choice Hotel's Proposed Takeover of Wyndham Hotels & Resorts, available at, https://www.ftc.gov/news-events/news/press-releases/2024/03/statement-regarding-termination-choice-hotels-proposed-takeover-wyndham-hotels-resorts.

[158] FTC Sues Burger Franchise Company that Targets Veterans and Others With False Promises and Misleading Documents, https://www.ftc.gov/news-events/news/press-releases/2022/02/ftc-sues-burger-franchise-company-targets-veterans-others-false-promises-misleading-documents.

[159] Jonathan Maze, *Burgerim, and its founder, are banned from selling franchises in the U.S.*, RESTAURANT BUSINESS ONLINE (Feb. 22, 2024), https://www.restaurantbusinessonline.com/financing/burgerim-its-founder-are-banned-selling-franchises-us.

[160] Samuel Levine, *Holding franchisors accountable for illegal practices*, FTC BUSINESS BLOG (Aug. 3, 2022), https://ftc.gov/business-guidance/blog/2022/08/holding-franchisors-accountable-illegal-practices.

classified as employees under the state statute," but that either way franchisors can and must comply with both.[161]

- In November 2021, the Commission approved an order settling charges that 7-Eleven's acquisition of Marathon's Speedway violated antitrust laws. Among other things, the order prohibits 7-Eleven from enforcing any noncompete provisions as to any franchisees or employees working at, or doing business with, the divested assets.[162]
- In October 2021, the FTC issued Notices of Penalty Offenses (NPOs) regarding endorsements and money-making opportunities to more than 700 and 1100 businesses respectively, including franchisors.[163] These NPOs put recipients on notice that, if they deceive or mislead consumers about potential earnings or use endorsements in ways that run counter to FTC administrative cases, they may be liable for hefty civil penalties.
- In September 2021, the FTC modified its ReportFraud.ftc.gov website to make it easier for franchise stakeholders to file franchise-related reports. The changes resulted in an over threefold increase in franchise reports.[164]
- In February 2019, the FTC initiated a regulatory review of the Franchise Rule.[165] As part of the review, the Commission sought public comment on a wide range of topics, including: (1) whether prospective franchisees have benefitted from the Rule; (2) whether the Rule should be modified; (3) the costs of compliance; and (4) whether the Rule should be amended to account for technological or economic changes. The FTC subsequently held a workshop to explore some of the issues commenters had raised.[166] The regulatory review is ongoing.

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[161] FTC Files Amicus Brief in *Patel, v. 7-Eleven, Inc.*,https://www.ftc.gov/news-events/news/press-releases/2021/12/ftc-files-amicus-brief-patel-v-7-eleven-inc. *Patel v. 7-Eleven, Inc.*, 489 Mass. 356, 370 (Mar. 24, 2022).

[162] FTC Approves Final Order Requiring Divestitures of Hundreds of Retail Gas and Diesel Fuel Stations Owned by 7-Eleven, Inc., https://www.ftc.gov/news-events/news/press-releases/2021/11/ftc-approves-final-order-requiring-divestitures-hundreds-retail-gas-diesel-fuel-stations-owned-7.

[163] FTC Puts Businesses on Notice that False Money-Making Claims Could Lead to Big Penalties, https://www.ftc.gov/news-events/news/press-releases/2021/10/ftc-puts-businesses-notice-false-money-making-claims-could-lead-big-penalties; FTC Puts Hundreds of Business on Notice about Fake Reviews and Other Misleading Endorsements, https://www.ftc.gov/news-events/news/press-releases/2021/10/ftc-puts-hundreds-businesses-notice-about-fake-reviews-other-misleading-endorsements.

[164] FEDERAL TRADE COMMISSION, CONSUMER SENTINEL NETWORK DATA BOOK 2023 86 (Feb. 2024) (chart showing "Franchises & Distributorships" complaints rose from 1,027 in 2021 to 3,232 in 2023).

[165] *FTC Seeks Public Comment on as Part of its Review of the Franchise Rule*, https://www.ftc.gov/news-events/news/press-releases/2019/02/ftc-seeks-public-comment-part-its-review-franchise-rule.

[166] https://www.ftc.gov/news-events/events/2020/11/reviewing-franchise-rule-ftc-workshop.