Christine M. Todaro
General Attorney
Division of Marketing Practices
Bureau of Consumer Protection
Federal Trade Commission
600 Pennsylvania Ave., NW
Washington, DC 20580

Re: Keith R. Miller, Principal, Franchisee Advocacy Consulting
Response to FTC Franchise Rule, Matter No. R511003

Dear Ms. Todaro:

Franchisee Advocacy Consulting specializes in working with franchisees and franchisee groups to make sure their voice is heard. Because of the fear of retaliation, many franchisees are afraid to speak on issues such as the Franchise Rule and are fearful of ever lodging a formal complaint against their franchisor. I formed this advocacy company after serving as Chairman of the Coalition of Franchisee Associations (CFA) for six years, and it is an organization I am still active in.

I am writing regarding the March 13, 2019 request for public comment made by the Federal Trade Commission (FTC) regarding the Franchise Rule, specifically: Franchise Rule Regulatory Review, 16 CFR part 436, Matter No. R511003.

Since I was the primary author to the CFA's submission after receiving input from many fellow board members and attorney friends of the association, many of my comments are taken directly from the CFA's submission, but I will pull out and highlight those most important to me, often adding additional commentary. After reviewing many of the already submitted comments, I must make this distinction that is quite evident. Those that profit from the selling of franchises, and those that support that side of the industry, are asking for the status quo, that the current Rule and enforcement work. Those that are buying franchises, and those that support that side of the industry, while supportive of the Rule, largely feel significant changes need to take place. This distinction is critically important. The Rule was put in place to protect those risking the investment into the franchise industry, not those who profit from the sale. Those the Rule was designed to protect are asking for change, because they feel there are serious gaps and lack of enforcement in the current Rule. They, after all, are the heartbeat of the industry. Without their investment risk, there is no franchise industry.

First, is there continuing need for the Rule? Yes, there is absolutely the need for the Rule to continue, but with modifications that increase transparency to prospective franchisees. While there is a wealth of information available, several changes are needed to increase the value of that information and the clarity of the Franchise Disclosure Document (FDD). The importance to the prospective franchisee and the lending community is simple - investing in a franchise likely carries more risk and liability than any other investment they will make in their lifetime. Investing in a security puts the investment at risk, investing in a franchise puts all the franchisee's assets at risk, and failure most often brings on financial destruction.

General Areas to Improve the Franchise Rule

- <u>Provide adequate resources to provide for full oversight and enforcement of the Franchise Rule ("Rule").</u> As part of the Rule, the FTC requires the FDD to be provided but completes no verification process to validate the

Rule has been satisfied. This leaves prospective or new franchisees to individually determine whether all necessary information has been properly disclosed. However, in efforts to sell the franchise, prospects often rely on statements such as "Be your own boss, no experience necessary, proven business model". Based on this, and the fact that the FTC considers this a consumer transaction, a more comprehensive level of oversight is needed.

- <u>Provide for an FTC-designated "whistleblower" status for complaints.</u> If an active franchisee files a formal complaint with the FTC, that franchisee puts his or her livelihood at risk. Disclosing possible Franchise Rule violations is often followed by franchisor retaliation in the form of increased franchise agreement violations and risk of termination. Because of this fear, few complaints are filed by franchisees, and by the time it is safe to file complaints, the statute of limitations has often passed.
- <u>Prevent the FDDs from disclaimers which allow franchisors to amend their policies outside the four corners of the franchise agreement.</u> The language contained in the FDD is binding as of the day it is provided to the prospective franchisee. With the increase in private equity and public ownership, past policies and disclosures are often not followed, and new policies can create a far different business model than disclosed. For example, Operations Manuals are often used to modify practices far outside the scope of the expectations for an Operations Manual, and in fact change the terms of the franchise agreement. I'll give a direct example in my brand, Subway. A few years ago, an item was added to the Operations Manual that restricted the number of stores you could sell to a buyer. It is limited to three stores to an existing franchisee, one to new franchisee. First, I think it is easy to argue that the clause is not related to operations. Second, if this would have been disclosed upfront, many franchisees would not have continued to expand. If they have built their company to 10 or 20 outlets, they could not sell their company, but have to break it into smaller pieces, which yields a much lower sales price.
- <u>Eliminate the mandate that franchisees must waive their private right of action for Franchise Rule violations and eliminate pre-dispute binding arbitration clauses in FDDs.</u> Without a private right of action, and limited resources at the FTC, franchisees have little recourse against the harm due to violations of the Franchise Rule. Without the private right of action, franchisees are limited to the court system where they would need to prove franchisor intent to violate the Rule, an almost impossible standard required under common law fraud.
- <u>Require the FDD (including the franchise agreement) to be a legally binding document for the term of the agreement, regardless of changes in franchisor ownership.</u> Currently, the FDD is only valid the day it is received by the franchisee. Franchisors are currently free to change the business model unilaterally, as they see fit. An example is the largest failure in franchise history, Quizno's. Quizno's, using an affiliated distribution channel, over time increased and excessively marked up required product purchases to franchisees, to the point the business model filed and over 4000 outlets closed, the franchisees losing their investments. As a note, they were only required to list the total revenue of this affiliated company, not how much profit it was making, which would have provided disclosure as to what they were doing. Since the franchisee is buying into the franchise based on the information provided in the FDD, that FDD should be binding, otherwise their investment is at risk.
- <u>Prohibit disclosures outside of the FDD, both informally and by third parties.</u> **This is a huge problem!** Prospective franchisees ARE getting earnings claims, most outside the FDD and Item 19. Franchisees receive false earnings claims from franchise brokers or consultants who claim to work on behalf of the prospective franchisee but receive all their compensation from the franchisor upon the signing of a franchise agreement. Additionally, the prospective franchisee is often provided, by the franchisor, with a loan consultant who provides earnings figures so the franchisee can qualify for a loan to purchase the franchise. These loan consultants are prevalent in helping franchisees obtain government guaranteed SBA 7(a) loans. In these cases, revenue and profit numbers are being provided to the prospective franchisee with no consequences to the franchisor or third parties who profit from these transactions.

Specific Suggestions for Improving the Franchise Rule

- Make all FDDs publicly available on the FTC website on a 10-year rolling basis. Currently, the FTC does not require proof of an FDD to comply with the Franchise Rule, since one is not required to be submitted to the FTC; confirmation of an FDD only occurs if a complaint is filed with the FTC. In today's electronic age, franchise companies should be required to submit an electronic version of the FDD and post on the FTC website where it is easily located by a public search engine. California, Minnesota, and Wisconsin all provide this capability for franchises selling in those states and the technology is readily available. It is amazing to me that this industry claims to be "heavily regulated" when the agency that "regulates" the industry doesn't even require a document to be submitted, much less reviewed.
- Require documentation to substantiate figures so as to reduce the frequency of false earnings claims, investment requirements, and other monetary outlays. Franchisors should be required to provide all information needed to justify the figures provided in the FDD. While we understand this process maybe time consuming, franchisees are often investing their life savings into a business based on these figures.
- Item 19 improvements:
  - Mandate the disclosure of detailed revenues, costs, and profits. Given the monetary risk for a prospective franchisee, and the potential income for the franchisor these numbers should be required. For emerging franchises, franchisors should provide these disclosures from even one outlet to show the model they're selling works. While the time and cost of meeting this higher standard may be significant, the cost of not providing this data to prospective franchisees and the risk to the economy is even higher. There also needs to be strict enforcement of numbers being given outside of Item 19. It's very rare for a prospective franchisee not to be given a "hint" or some other indirect source of numbers. For example, one franchisor that put nothing in an Item 19, sent out an article from an industry magazine stating what average unit volume was. Isn't that saying the agree with that number printed in the article? And how did the magazine get that number? Most likely the franchisor provided it, the magazine printed it, then the franchisor passed on the article, all outside the legal requirements of the Rule and Item 19.
  - Provide first year mean (average) and median (midpoint) revenues for the previous three years. Many brands have a "ramp-up" period to get to reported average sales. Loans - specifically SBA 7(a) loans - often used in franchising require a first-year revenue estimate. Using the average for all outlets may give false information for that first-year estimate and without valid information, the franchisee may not have enough working capital to survive the ramp-up period. Franchisors can easily provide these figures at no additional cost. I have seen many franchisees lose everything because they qualified for an SBA 7(a) loan based on false revenue numbers, especially first year revenue numbers, from either franchisor personnel or from a loan consultant recommended by the franchisor.
- Item 20 improvements:
  - Include a multi-year list (including contact information) of franchisees who are no longer in the franchise system. Providing contact information of prior franchised outlets is worthless as part of the due diligence process, since that outlet is either closed or has transferred to a new franchisee. Prospective franchisees should have the opportunity to not only hear from current franchisees but also from those who have left the franchise. This list should provide the forwarding information for franchisees that have left the system at the time they left the system.
  - Include a rolling 10-year review of cumulative turnover. Turnover, if the form of terminations, ceased operations, and transfers is one of the most important measurements of how a franchise is performing as well as the status franchise relationship. Too often, the industry measures success based on the

time period the outlet has remained open. If a franchisee, however, loses his or her investment and transfers to a new owner for a significant loss, this information should be made available to prospective franchisees. Disclosure of 10-year cumulative turnover will better measure success.

- Mandate disclosure of first-year ceased operations and transfers. A high initial number is often a "red flag" for prospective franchisees and the franchisor can provide this data at no additional cost. Often, success is measured by units open. It's hard to justify success on a unit that didn't make it one year with the original franchisee.
- Require disclosure of mandated transfers or transfers due to franchisee termination. Many franchises, upon termination, allow for a franchisee to sell within a limited timeframe However, this also creates a situation where the franchisee is unable to fully monetize the value of their franchise. A franchise with many terminations will likely be viewed differently than one with significant transfers, and this should be properly reported. Again, looking at my own brand, the FDD reported that in 2018, Subway took 718 franchisor-initiated actions against franchisees, yet only 17 terminations. However, there were 1403 transfers and 1477 ceased operations. It's hard to believe that only 17 were forced out with that many actions taken, but more believable that many are forced out via transfer or ceased operation. We need more transparency here to let prospective franchisees understand what type of system they are buying into.
- Specifically list former franchisees who signed nondisclosure and/or confidentiality agreements. If former franchisees are forbidden to discuss their experiences, that information should be included in the FDD. A high number of nondisclosure and/or confidentiality agreements can be a concern to prospective franchisees. How can due diligence be done if you can't talk to the past franchisees that left unhappy.
- Detail the causes for terminations. If franchises have excessive terminations, it may point to an unstable system. For example, reasons for termination could include abandonment (which is really a ceased operation), nonpayment of royalties (which points to an unprofitable business), standards violation (which could be a bad operator or an aggressive franchisor if the number is high), etc. Requiring disclosure of the cause for termination may provide a lot of insight to prospective franchisees.

I appreciate this opportunity to provide input on changes needed the Franchise Rule and hope this is the beginning of the process to evaluate and improve the Rule. Just remember who the Rule is designed to protect and listen to those sources protecting that group of people.

Sincerely,

Keith R. Miller
Principal, Franchisee Advocacy Consulting
Franchise Owner – Subway of Auburn & Grass Valley, CA
Past Chair, Coalition of Franchisee Associations
Past President, North American Association of Subway Franchisees