American Association of Franchisees & Dealers

The Center for Total Quality Franchising℠

P. O. Box 10158
Palm Desert, CA 92255-1058
(619) 209-3775
Direct Line: 619-649-0748
Fax: 866-855-1988
E-mail: rpurvin@aafd.org
Website: www.AAFD.org

June 7, 2023

Honorable Lina Khan
Federal Trade Commission
600 Pennsylvania Avenue, NW
Washington, DC 20580
Submitted electronically

RE: Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices
Docket: FTC-2023-0026

Dear Chair Khan,

The American Association of Franchisees and Dealers (AAFD) thanks the Federal Trade Commission for its Request for Information, specifically the Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices, Docket: FTC-2023-0026. The AAFD is honored to submit the following on behalf of its franchisee chapter members.

AAFD is the oldest and largest national not for profit trade association advocating the rights and interests of franchisees and independent dealer networks. The AAFD supports more than 50 independent franchisee associations and trademark specific chapters, representing thousands of franchisee operated business outlets. Since our establishment in 1992, the AAFD has focused on its mission to define, identify and promote collaborative franchise cultures that respect the legitimate interests of both franchisors and franchisees, cultures we describe as embracing our vison of *Total Quality Franchising*℠. The AAFD came into existence in response to a franchising community that has been evolving towards increasingly one-sided and controlling franchise agreements and cultures whereby franchisee equity and business ownership has been continually eroding such that many modern franchise systems have lost all vestiges of business ownership.

AAFD supports and believes in the franchise business model. It allows many to get started in business, including many minorities, immigrants, seniors, and veterans. 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. Only when all stakeholders succeed will the model succeed, and that is what we believe this Request for Information is all about -- gathering information to swing the pendulum back so that the franchisee investor is protected as we move forward. In fact, the AAFD has, for over thirty years, felt

that the FTC has not used their full authority under Section 5 of the Federal Trade Act to investigate unfair and deceptive practices within the franchise model.

For almost a century, the body of US law dealing with consumer protection has moved away from the Nineteenth Century standard of "Let the Buyer Beware" and embraced a fairly uniform concept of consumer protection from unfair business practices as embodied by the Federal Trade Act. The Act created the Federal Trade Commission and empowered the FTC, under Section 5 of the Act, to address and combat all forms of unfair business practices that damage consumers. Unfortunately, the Commission has historically NOT regarded 'franchisees' as 'consumers' once the relationship has been established, and the Commission has determined that its only authority under the Act is to mandate presale disclosure under the Franchise Rule first adopted in 1979. *Remarkably, only in franchising does the standard of "Let the Buyer Beware' still prevail!* Once the franchise relationship is established, franchise agreements are 'assumed' to be negotiated bargains between businesspersons who are expected to able to fend for themselves.

The Commission is asking the overriding question, "Is Franchising Fair?" The simple and overarching answer is that the franchise relationship is governed by contracts that, for good and proper reasons, extend significant power to franchisors, and as such the potential for abuse and profiteering is huge. The following are examples of many abuses perpetuated by franchising companies, based on agreements that have given wide authority to franchisors to build and grow their brands. Much of the authority and power reserved by franchisors is justifiable, but only government oversight will provide a brake against abuses. Sadly, that oversight has been absent, and we cannot overstate how pleased and impressed we are that the FTC is now taking a hard look at franchising, keeping the franchising community honest and promoting the legitimate interests of all of its stakeholders.

To be clear, many of the examples of overreach and abuse that we identify in this response are rooted in legitimate concerns of the franchisor. The ability to evolve a brand to remain fresh and competitive, to dictate suppliers as essential to maintain brand standards, the important goal of utilizing group buying power to keep prices low, to efficiently fund the system to keep current with technology, and to exact rebates for volume purchasing to further lower the costs of business for all stakeholders – all of these examples are powers customarily reserved by franchisors that have the capacity to improve the brand and stakeholder profitability. But as will be seen, the reservation of these powers has an enormous potential for abuse that can only be held in check by an impartial umpire who can set and enforce boundaries.

The Franchise Relationship

What we have seen from our chapters is extraordinarily little willingness on the part of franchisors to negotiate terms in the franchise agreements. Historically, AAFD is pleased to have worked with a handful of brands, and on behalf of that brand's AAFD Chapter, to negotiate a mutually beneficial franchise agreement. These brands have earned AAFD accreditation in the form of the AAFD's Fair Franchising Seal when at least 75% of the brand's franchisees voted to ratify the negotiated agreement and to approve AAFD accreditation. But in 25 years, the AAFD has accredited just 19 brands, a very small number of franchise systems that have embraced a collaborative culture intending to benefit all stakeholders.

Sadly, too many franchise systems are engineered as one-sided contracts of adhesion with little protection of franchisee interests or equity. There are those that argue the franchisee signed the contract and as a result, they need to simply honor the terms of the agreement. But even if the argument has merit upon the inception of the

franchise relationship, many of these non-negotiable contracts are being signed as renewals, and the incorporated amendments cannot be rejected without forfeiture of years of investment in time and money. At renewal, the franchisee has virtually no leverage, because the choice is to walk away from the business that they have already spent years developing, and with non-competes often limiting their ability to make a living, or sign contracts that often bear little resemblance to their original franchise agreement. Often, the new franchisee, even with legal counsel, fails to fully understand the extent of control that the franchisor will have through the various devices and mechanisms mentioned below.

Once in the contract, our chapters are often seeing changes made to their business model, often by use of the operating manual. Some changes require modifications to the business practice, like adding a kiosk or during the pandemic, delivery services. The ability to evolve the system is important and justified, but the potential to overreach needs the ability for negotiation and collaboration between franchisors and franchisees, and oversight that the Commission exercises in all of the industries it supervises. The above does not account for the more recent trend of Private Equity purchase/control over the franchise, which may not have existed previously – many franchisees originally purchased their franchise under the original owner, aka, founder. This ownership change typically creates a completely different culture and business dynamic, which in turn impacts the contractual terms at renewal and ongoing business practices.

Often these new processes include an increased cost to the franchisee that was not disclosed in the FDD, including changes that are a blatant addition of new fees. The most common seem to be technology/IT fees, cyber insurance fees, "green" fees, etc. It does not seem to matter if the fee was disclosed in the FDD or not, the franchisor adds them and extracts the payments for them. The attitude seems to be, if you do not like it, sue us, or if you do not sign it, you won't have access to other franchisor provides services and systems. Of course, they know franchisees can ill afford a legal battle against the mighty resources of their franchisor. Another issue with the collection of these "fees" is are they really fees or just another royalty source. There is zero accountability as there is no transparency as to how that collected fee is spent. For example, if a brand collects $20 million in technology fees, are they spending $20 million on technology? If they are spending short of that collected amount, isn't that just another royalty in their pocket? And do the franchise owned outlets pay a comparable share of those fees?

What is interesting now is that we are starting to see disclosures and contracts specifically state that the franchisor has the right to modify the system at any time, and that those changes may come at a cost to the franchisees. It begs the question as to whether there is even a contract when one side can change the terms unilaterally at any time. It is simply a blank check. We do understand that times change, and business models need to be updated. Ten years ago, who was using apps on their phones? That said, changes that go beyond the normal day-to-day operating procedures should not occur unilaterally. If a change needs to be made, the franchisor needs to make the business case to the franchisees, and the franchisees agree to said changes.

The impact of these changes can be minor to devastating, not only to the franchisee, but also to their staff. We are seeing unhappiness in many of our chapters due to shrinking margins. As margins shrink, the financial stability of the franchisee can be threatened. We hasten to make note that shrinking margins do not impact the franchisor whose profits a simply a percentage of gross revenues, so only the franchisee is impacted. To add insult to injury, many of the franchise brands are called out in the media because of low wages, but many times the low wages are a direct result of the policies dictated by franchisors.

Provisions of the Franchise Agreement

Contractual terms, such as “no-poach”, while still seen, are reducing in numbers due to some states taking action against them. We do still see some limitations on franchisees being able to hire employees from the franchisor, but that limitation is not reciprocal, and franchisors can hire away a franchisee’s employee. Making matters worse in this case is when the franchisor requires the franchisee’s employees to be trained at the franchisee’s cost, then the franchisor hires that employee away after training is completed. We know of no examples of employee training, whether mandated or optional, where the franchisor bears any of those costs.

Historically, the promise of group purchasing power has been touted as one of the great advantages of franchising. Indeed, many franchisors tout that their purchasing power for goods, services and marketing more than fully offsets the burden of paying royalties. The sales pitches to prospective franchisees still include these benefits. However, group purchasing power has become one of the most complained about issues amongst our chapters. Franchisors should have the right to set specs and even approve vendors that meet those specs. But that should not result in costs to franchisees often being significantly higher than market rates, often for common items, like toilet paper and office supplies. “Pay to play” requirements, sponsorships, and piece rate kickbacks all contribute to increased product costs. Franchise agreements put no caps on these costs either. Disclosures in the FDD are only a point in time, nothing limits the franchisor from increasing these added costs on the supply chain at any time. It really does not matter if the vendor is an affiliated company with the franchisor or completely third party, the franchisor is often controlling product or service costs to the franchisees. These added costs have become big revenue sources for far too many franchisors. Some franchisors even label items as proprietary, even though it is a common item, but because they slap a logo on it.

Franchisors often require longer hours, or being open 7 days a week, which is not customary in some industries. This is another provision often changed via the operating manual. It is always free revenue for a franchisor as there is no cost to the franchisor to increase the franchisees’ hours. Franchisees usually find these added hours and days unprofitable, or marginally profitable. These added hours are often during periods when it is less safe for employees to be working, and because of the lower profit margins, are often staffed alone.

Remodels, upgrades, or rebranding are often terms added to the operating manual. These are often done with little to no business case for the franchisee, and without time for an adequate return on investment. Most franchisors contribute little or nothing to these improvements. For many franchisees, these required ‘upgrades’ keep them in a constant state of debt. By the time the debt is paid on the last upgrade, it is time for the next. And, for the majority of our chapters, they do not own the real estate they are operating at, therefore are not really improving an asset they own. Again, it is always a win for the franchisor. If revenue from the upgrade only increases 5%, the franchisor’s revenue has increased 5% at no cost to them. For the franchisee, a minor increase in revenue never gives them the return needed to justify the upgrade. To make matters worse, the required products for these upgrades often have the previously mentioned added costs added to them to provide even more revenue to the franchisor.

Franchisors also put in market development requirements wherein if the annual goals are not met, the franchisee can be considered in default of the multi-year agreement. The issues with this are multi-faced. First, the franchisor arbitrarily identifies the annual growth target – this can be franchise territory specific or more broadly, the same target for all franchises, regardless of geographic and market conditions. Secondly, on a multi-year contract, the franchisee is forced to meet annual targets instead of over the life of the contract. For

example, a franchisee may be required to grow 2% per year for each of the 5 years of the contract. If they fail to grow 2% in any one year, they can be put in default and have 90 days to rectify; failing to do so results in the loss of their franchise. This action turns a 5-year contract into 5 one-year contracts, whereas giving the franchisee the five years to fully develop their franchise with the overall growth goal representing average growth of 2% or more. Very few markets can have consistent growth, especially when a market requires development or faces market forces beyond the franchisee control (each year).

Non-disparagement clauses are an interesting subject. They are often used in threats against a franchisee for simply saying anything counter to the "company line" and are they are wide ranging with respect to how they are worded. Yet, we rarely see them identified as a reason for termination. Many franchise agreements now consider anything said negatively about the brand, no matter who it is said to, a violation of the non-disparagement clause. This includes between franchisees that are part of a chapter or franchisee association or a franchisee post on their private discussion groups. Often any negative discussion is followed by a threatening legal letter to the franchisee which quickly silences them. But it often does not stop there; increased inspections follow and amazingly, these franchisees are found in default for another reason. The retaliation is obvious, but often hard to prove, especially since in many businesses it is not that hard to find some level of default. What is really sobering about these strict non-disparagement clauses is the impact on potential franchisees. During the due diligence period, franchisors, their lobbyists and the FTC state a key step is to contact current and former franchisees. Yet in most cases, these franchisees have contracts or restrictions as to what they can say if it is negative. Any negative feedback to a prospective franchisee could put the franchisee in default of the non-disparagement clause or non-disclosure agreement upon termination. In fact, an individual or association making a comment on this request for information, at the sole discretion of the franchisor, could be considered in default of their non-disparagement clause. Pro-franchisor forces post statistics showing that franchisees are happier than ever. We see the opposite and think that these franchisor surveys are heavily skewed by the fear of retaliation based on non-disparagement clauses. Yes, franchisees are definitely afraid to tell their franchisor they are unhappy.

Franchisor Business Practices

It has become customary practice for franchisors to receive monies from third party vendors. This in and of itself, is not bad or corrupt, and often helps support initiatives that benefit franchisees. Franchisors may have costs associated with managing their supply chain. What is wrong is when franchisors create rules or processes that bear little resemblance to the free market. Limiting suppliers, which drives up the competitive costs, only so the franchisor can collect rebates or kickbacks.

Franchisors often require or approve vendors that are affiliated companies. While this is required disclosure within the FDD, like so much, it is only at a point in time. There is no transparency requirement to existing franchisees to let them know if new vendors are affiliated, or if the franchisor buys out a vendor. On top of that, if properly disclosed, the franchisor must only list the revenue received by the affiliated company. While this number has good intentions, it does not really give the prospective franchisee an idea of how much a product is marked up and how much of a profit source this is for the franchisors. For example, if this affiliated company sold one million $1 items to franchisees, they would have $1 million in revenue. If the true cost of that item was $.02, there would be a $980,000 gross profit to the franchisor. However, if the true cost was $.90, the gross profit to the franchisor would be $100,000. Same disclosure, much different scenario.

Payments to Franchisors from Third Parties

As stated previously, franchisors absolutely do receive payments from third parties, and franchisors do limit approved vendors that franchisees are allowed to buy from. Most goods and services required to run the franchised business are likely mandated by the franchisor, with few exceptions can the franchisee independently seek goods or services. What we see from our chapters is not how much the franchisors are profiting from these rebates, but how the franchisees are paying significantly above market price for common goods and services. How this comes about, we are not fully informed, however, we know that many vendors are required to "pay to play" to become approved. Once approved, they are required to pay registration/booth fees at tradeshows and pay for sponsorships at conferences. All of this costs the vendors and those costs must be passed on at some point. This is in addition to the direct rebates they may be receiving. This limitation of vendors, with increased costs, does not match the expected group purchasing discounts and are surely not the free market at work.

What is really lacking on this subject is transparency to the franchisee. In fact, in 2022, AAFD was the sponsor of legislation in California, SB-1247, which would have required franchisors to annually report all monies they receive from vendors based on franchisee purchases. It passed both legislative houses without a single no vote. However, the Governor vetoed the legislation and the International Franchise Association took credit for attaining that veto. Seems the franchisor community does not want true transparency in this area.

Indirect Effects on Franchisee Labor Costs Related to Franchisor Business Practices

What we are seeing, increasingly, is that labor costs are the only thing franchisees can control. Pricing and promotions are increasingly driven by the franchisor. Product costs are set by the contracts the franchisor has made with vendors, including the higher costs due to revenue received by the franchisor that was previously discussed. Initial costs of buildout are being driven by the franchisor through design and in many cases, mandating the contractor for buildout. The problem franchisees face is controlling the tight margins they are given to work with which often drive lower wages. This is not optimal for franchisees as depending on lower wage employees, without offering benefits, creates a less stable workforce for these franchise owners.

As far as impact on consumers, the consumer often benefits from pricing driven by priority to increase revenue versus increase profitability. If you look at the food industry, many will say that Chick-fil-a, Starbucks, and in the west, In-n-Out Burger are three of the most successful brands. What is so different about them? Two are not franchised, the third, Chick-fil-a is built around a different franchise model than most employ. The significant difference is that all three depend on unit level profitability versus unit level revenue. Rarely do these brands offer discounts. Rarely do they remodel. All the things that drive revenue, not necessarily profits.

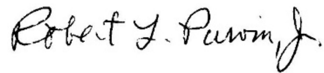
In the end, when unit profit success is not the focus, but driving revenue to the franchisor is, only the franchisor wins in the end because the costs must be absorbed by the franchisee, and by extension, the employees and the consumer.

Language Barriers

Language barriers have not been a specific issue in regard to chapters of the AAFD.

Again, the AAFD thanks the Commission for taking this crucial step in improving the franchise business model, specifically for protecting the primary investor in the model, the franchisees. We look forward to continuing discussion on improvements and the implementation of improvements.

Respectfully submitted,



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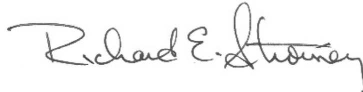

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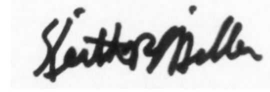

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Public Policy and Engagement