American Association of Franchisees & Dealers
The Center for Total Quality Franchising℠

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October 23, 2024

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 – Reopened Request

Dear Chair Khan,

The American Association of Franchisees and Dealers (AAFD) thanks the Federal Trade Commission for reopening its Request for Information, specifically the Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices, Docket: FTC-2023-0026, and allowing additional comments. The AAFD also appreciates all the franchise related announcements on July 12, 2024, and is honored to submit the following on behalf of its franchisee chapter members, considering the focus from those July 12 announcements.

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 fifty 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*^{sm}. 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.

It is worth repeating a paragraph from our previous 2023 submission because it incapsulates our thoughts so well and the reason we need to keep working on the work done to date.

> *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.*

Regarding the Policy Statement on July 12, *Franchisors' Use of Contract Provisions, Including Non-Disparagement, Goodwill, and Confidentiality Clauses*, AAFD appreciates the intent to stop the chilling effect these clauses have. As you will see in numerous submissions made anonymously on this Request for Information, the fear of making statements to the FTC is still real. The bad franchisors that use retaliation as a practice have not changed, and will not change, until they see the FTC, or state agencies, act against these practices. The retaliation we see is often obvious, but often disguised as protecting brand standards, through the use of extra detailed inspections or audits against the franchisees that have spoken out. It is amazing how often franchisees go into default soon after they become a leader of their franchisee association. We urge the FTC to take the next step here, investigate specific claims and show franchisors that there will be a cost to these bad practices.

Regarding the *Staff Guidance on the Unlawfulness of Undisclosed Fees Imposed on Franchisees*, AAFD believes this may be the most impactful statement on behalf of franchisees. Franchisees are being constantly hit with new fees, often without proper disclosure, and almost never with full transparency. We are pleased to note that since the July 12 announcement, one of our chapters did push back on their franchisor on a new fee, using the Staff Guidance as a reference, and the franchisor pulled back on the new fee. Unfortunately, that has been the exception, and most franchisors have not changed their practices, and most will not until they see enforcement. In fact, what we are seeing is new definitions of these fees, attributing the fees to “training” which has been disclosed. Or, trying to disclose that some new fees may be added in the future. These fees are big money to many franchisors, especially when trying to value the worth of these franchise brands. While the guidance talked about undisclosed fees, transparency is just as big an issue. Even if the fee was disclosed, was the collected fee used for its intended purpose? In this case, the franchisor is acting like big government, imposing a new tax and providing no details of how it was spent. These fees, disclosed or not, must have transparency to the franchisee, otherwise they are nothing more than an undisclosed additional royalty. Like the Policy Statement, the FTC must show a willingness to enforce this Staff Guidance. This is critical as most franchise agreements give franchisors Automated Clearing House (ACH) access to franchisee bank accounts, giving them unfettered access to franchisee funds. Once funds have been withdrawn, franchisees have little leverage to dispute them.

Now to add additional comments on the effects of the items noted in the Issue Spotlight.

1. <u>Unilateral changes to franchise operating manuals</u> – As noted, this is a top concern. While franchisors complain about big government and over regulation, they themselves often act like big government by imposing unilateral and costly changes on franchisees. Many of these changes negatively affect the business model franchisees bought into, ultimately diminishing the value of the franchise business.

2. <u>Franchisor misrepresentations and deception</u> – We continue to hear complaints about what franchisees were sold, and what they bought. This is especially true when unregulated franchise brokers/consultants were involved. These third-party sellers often shield the franchisors from improper disclosure, including financial representations outside of the FDD. There is also widespread misinformation in general about franchising that needs to be reined in, for example, frequent misleading social media comments and

posts making claims as to the success of franchises versus independent businesses. These claims are never verified or sourced. Further, we frequently hear of large underestimations in opening costs, inflated expectations in revenue, and the concealment of franchisees that have failed or are failing. The 'sell at all costs" mentality in franchising creates this environment, but don't worry, it is someone else's money at risk.

3. Fees and royalties – As previously discussed in the comments of the Staff Guidance, new fees can adversely impact profitability, and business viability. There are a couple of issues with Royalties. First, what are royalties being charged on. One example is a franchisor charging royalty on the sales amount before discounts. These discounts have been put on the app by the franchisor. The consumer may buy $8.99 worth of product, a $10 discount is applied, and the consumer gets the product for free. Yet the franchisee now is forced to pay royalties on the $8.99. Another example is the extra royalties earned on delivery apps. If a product ordered is $10, and the delivery app charges 20%, the price listed to the consumer will likely be $12. After the delivery and the app keeps its $2, the franchisee will be paid $10 for the order, never seeing the $12 the customer paid. However, most franchisors collect royalties on the $12. This kind of royalty application is not reasonable or fair. The second issue is when a franchisor raises royalties on their new franchise agreements. While it's true franchisees are not obligated to sign the new agreement, if the franchisee wants to sell the franchise and the new franchisee must sign the new agreement, the franchisee's business has been devalued because of that higher royalty. In this case, the franchisor has effectively transferred equity from the franchisee to the franchisor. It's worth noting that by charging royalties as a percentage of revenues, the franchisors already have built-in inflation protections, so any royalty rate increase is unnecessary and should only be done with a fair and balanced bargaining process.

4. Franchise supply restrictions and vendor kickbacks – **The sales argument that a benefit of joining a franchise is the group purchasing power has become one of the biggest myths in franchising.** We often see franchisors limiting vendors in the supply chain, which leads to costs rising above market rates for common items. While it may be necessary to limit suppliers to proprietary items, that is not what we are seeing. It's hard to believe that putting a logo on the outside of a box of toilet paper makes it a proprietary item. These increases in the costs to franchisees can be significant and can only be attributed to the franchisor using the supply chain as a profit center. This is not the free market we were taught. The FTC needs to expand the disclosure in Item 8 to provide more detail on what rebates the franchisor is receiving and limiting the number of future rebates to what has been disclosed. Otherwise, franchisors view this as a blank check that they can increase their revenue, always at the expense of the franchisee. While not classified as a fee, the effect is the same. Tighter restrictions and more disclosure are also needed on revenue to vendors that are affiliated companies of the franchisor. Currently, the disclosure only requires revenue but knowing that tells a prospective franchisee little. They don't know if that affiliated company is marking that item up by 10% or 90%, and if that will change. Again, it gives a blank check to the franchisor's affiliate to charge whatever they want.

5. Actual and feared retaliation – This impact of this was previously noted in the discussion of the Policy Statement. Retaliation is alive and well in the franchising community. We have many examples of franchisees receiving increased inspections and audits when they speak out or become a leader in their franchisee association. Franchisees pay the ultimate price and may lose their business over speaking

out. Even posting a public story on an owners' Facebook group can bring non-disparagement claims and retaliation against a franchisee.

6. Non-competes and no-poach clauses – Non-competes have had a significant impact on many of our chapters. One chapter in particular was faced with having to renew with a drastically different business model with the franchisor threatening them with enforcement of the non-compete clause. While there are some valid reasons for these clauses in franchise agreements, these clauses are being used as handcuffs on franchisees, either sign new agreements that often bear little resemblance to their previous agreement or give up your business and not continue your profession for the next couple of years. It is hard to argue that the franchise model can't survive without these clauses. Commercial franchising continues to flourish in California where non-competition clauses are generally unenforceable. California makes up approximately 10% of the franchise businesses in the United States. These non-competes allow the power imbalance the franchisors already have in the relationship to exert extreme leverage on the franchisee.

7. Franchise renewal problems – We are encountering more issues with franchise renewals. Franchisees are being asked to sign a completely new agreement with additional terms and requirements, rather than simply renewing their existing agreement. These new terms are often not in the best interest of the franchisee. As a result, we now advise potential franchisees to invest in the franchise with the understanding they need to recoup their investment within the initial term, and their equity may be significantly decreased at the end of that term. due to unrestricted changes in the new contract upon renewal.

8. Franchisor refusal to negotiate contract terms – Very few franchisors allow negotiations on key items in franchise agreements. The notion that a franchisee always has the ability to walk away from the revised deal is really a canard—to do so would be an unfair forfeiture of hard-earned equity. Coupled with the use of non-compete clauses, the power imbalance makes it an unfair negotiation with the franchisor holding all the cards. While a franchise brand must always evolve, the franchisee should not be backed into a corner and be forced to sign terms significantly different than the business they bought into. Another impact on this subject is the consolidation of brands through mergers under a common mega company that limits the market competition on franchises in a specific industry.

9. Franchise Disclosure Document issues – We need to look at a few primary issues. First, issues that likely violate current disclosure in the Franchise Rule. Except for a few states, there is little to no enforcement of the Rule. Without enforcement the franchise model is not regulated. Common examples we see are:

    - Missing key personnel or background information on them. There are some serial bad franchisors in franchising and their past failures are not being disclosed.
    - Key litigation that is not listed.
    - Initial costs are underestimated. Many franchisees that fail, fail because they spend far more than anticipated to get open, and are literally so far under water when they open, they can never recover.
    - Outlets open listed without good contact information. In one case, the phone numbers provided all were forwarded to the franchisor's call center.

- Past franchisees not properly listed. Either not listed at all, or listed with the contact information of their outlet, which they are no longer associated with. Non-disclosure agreements also stop valuable due diligence possibilities from past franchisees.
- The franchisee association requested to be included, but not.

The second need around disclosure issues revolves around the need to update the disclosure requirements, which AAFD and others have previously submitted comments to and would like to further engage with updating the existing Franchise Rule. But without franchisees having a private right of action on Franchise Rule violations it is imperative that the FTC also commit to more vigorous enforcement.

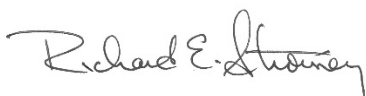
10. Private equity takeovers – Not all private equity takeovers are equal. It is important to scrutinize mergers and buyouts to assess the possible impact on franchisees, who are generally the primary investor in the franchise. We were glad to see that franchisee input was considered in two recent mergers deals. In many cases, private equity firms do not take a long-term view of the franchise. Franchisees have 10 to 20-year agreements, yet private equity may be looking at a 5-year window to extract profits and then flip the brand. Things like the previously discussed new fees and increases in costs to the supply chain are often heard when private equity takes over, all to increase revenue to make their return on investment., Moreover, we often hear about the reduction of support to cut costs. However, it is not just private equity; it's the significant shift in the franchise business, to not focus on the brand business and to use franchising for expansion. Gone are the days of a founder creating a concept, building a successful brand, and then using the franchise model to expand. Today we see too many brands created, sometimes not even opening a single outlet, before they aggressively sell franchises. In this case, the model that is sold is not 'proven', and the support systems for the franchisees that were promised are frequently not present. Private equity publicly takes the heat for a lot of these failures, and rightly so at times, but it is a broader problem of the aggressive selling of franchises, the myths surrounding franchise success, and the push for the quick and easy profit by franchisors.

11. Marketing fund transparency – For most franchises, transparency of the marketing fund is a pipe dream. You have the basic issue that the franchisees primarily fund the marketing fund, yet the franchisors control it. And the fact that franchisors make most of their profit on the top line revenue against the franchisees profit on the bottom line. This creates an inherent tension. We hear rumors, but because of lack of transparency, they are difficult to confirm, of executive travel or other perks being charged to the fund in the guise they are "promoting the brand." Brands have also used the fund to promote selling new franchises, which seldom benefits the franchisees that contributed to the fund. Misuse of the fund to benefit only the franchisor through promotions that drive top line revenue, at the expense of the franchisees bottom line are often heard. Besides having little transparency, most franchisees have little say or input on how the fund is used. Finally, a newer issue is the use of loyalty/rewards programs as part of the marketing. In a sense, the brands are creating an internal currency, a currency funded by the franchisees, but used to profit the franchisor, and again, fully controlled by the franchisor. In most cases, the franchisee pays a percentage of revenue when the consumer receives points. The franchisee may receive some reimbursement when the consumer redeems the points. However, franchisees have little to no insight into the accounting of these points. Franchisors are free to sell loyalty/rewards points to consumers, pocketing this revenue while giving the franchisees a small percentage of the proceeds as reimbursement. The truth is these programs are extremely profitable for the franchisor, but included as part of marketing, ignoring the fact that it is really an undisclosed additional royalty.

12. Liquidated damages clauses and early termination fees – Like many sections of the franchise agreement, there is good reason to have these clauses and fees, but they are also being overused as weapons. While the franchisor can close under performing outlets that it owns, franchisees are often required to keep failing outlets open, even if it is not their fault it. Historically, it is hard to blame bad franchisees for the failings in a brand like Quizno's, when thousands of outlets closed, yet in many cases, this franchisor sought liquidated damages. There are brands that if you are a multi-unit operator, they will not let you close a money losing outlet because they feel your other outlets can subsidize it. Why? Because franchisors never lose money on an open franchised outlet. One respected franchisee lawyer calls these franchisees "zombie franchisees" because they are in the position of calculating how much they are losing to remain open versus the cost of closing. Either way they are losing. They are trying to determine which results in the least loss. Like non-compete agreements, these clauses often restrict franchises and lead to unfavorable outcomes.

To summarize, the AAFD fully supports the historic announcements made on July 12, 2024. It is important that we look at that day as a new beginning, not the closing of the subject. We look forward continuing our efforts with the FTC to not only enforce the Policy Statement and Staff Guidance, but to build on and implement changes to address the items outlined in the Issue Spotlight.

Respectfully submitted,



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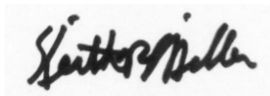

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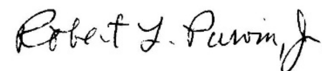

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