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Federal Trade Commission
Office of the Secretary
600 Pennsylvania Avenue, NW
Suite CC-5610 (Annex C)
Washington, DC 20580

**Re: Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices, Docket ID FTC-2023-0026**

Federal Trade Commission:

On behalf of the Franchise and Business Opportunities Project Group[1] of the North American Securities Administrators Association ("NASAA"), we are writing in response to the Request for Information ("RFI") issued by the Federal Trade Commission ("Commission") on March 10, 2023, entitled *Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices,* Docket ID FTC-2023-0026.[2] The Commission requests information on topics related to significant aspects of the franchise relationship. We appreciate the opportunity to share our perspective on these matters.

## Who We Are

Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership includes the securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Guam, Canada, and Mexico. In the United States, NASAA is the voice of state securities agencies responsible for grassroots investor protection and responsible capital formation. NASAA develops model statutes, rules, and guidelines for adoption by individual states, and NASAA members also participate in cooperative enforcement projects, information-sharing, and training and education of member securities regulators.

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[1] The following comments reflect the views of the Franchise and Business Opportunities Project Group and do not necessarily represent the views of NASAA.

[2] The RFI is available at https://www.regulations.gov/docket/FTC-2023-0026/document.

Fourteen[3] NASAA members administer and enforce state franchise registration, filing, and disclosure laws. As part of those duties, those states require that franchisors file their Franchise Disclosure Documents ("FDDs") with state franchise agencies prior to offering or selling in the state. Those states with registration requirements also employ franchise examiners to review and comment on those FDDs before the state grants the franchisor a registration of its franchise offering. As a result, state franchise regulators review thousands of franchise agreements and FDDs each year. Our experience with reviewing these documents affords us an insight into current trends in franchising and the unique nature of the franchisor/franchisee relationship.

More than 30 years ago, NASAA established a standing committee, now called the Franchise and Business Opportunities Project Group (the "Project Group"), to provide a forum where regulators could address issues relating to franchises and business opportunities. The Project Group studies and makes recommendations to NASAA about model acts, statements of policy, and interpretive commentaries that will benefit investors of franchises and business opportunities and those industries.

## Nature of State Laws

Of the 14 states[4] with franchise registration or filing requirements, seven include post-sale franchisee protections. Because these laws govern post-sale conduct between the franchisee and the franchisor, they are known as "franchise relationship laws."[5] These protections commonly include franchisor prohibitions on terminating their franchise agreements prior to the end of their terms except for good cause,[6] restricting or inhibiting franchisees' rights to join franchisee associations,[7] and discriminating between franchisees on fees or royalties, goods, services, etc.,

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[3] California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Oregon has a general disclosure law but does not register the disclosure document or require it to be filed with a state agency.

[4] Id.

[5] Another eight states and two territories have franchise relationship laws but no registration or filing requirements.

[6] *E.g.*, Michigan:

> Each of the following provisions is void and unenforceable if contained in any documents relating to a franchise: . . . A provision that permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause. Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.

Mich. Comp. Law § 445.1527(c).

[7] *E.g.*, California:

> It shall be a violation of this division for any franchisor, directly or indirectly, through any officer, agent or employee, to restrict or inhibit the right of franchisees to join a trade

except for on reasonable grounds.[8] Some states also include a general authority for the state franchise regulator to (i) deny registration to an offering where the terms of the franchise agreement are unfair, unjust, or inequitable to franchisees,[9] (ii) imbed in the law a broader prohibition on the franchisor imposing standards of conduct on franchisees unless the franchisor is able to prove they are reasonable or necessary,[10] or (iii) create a duty for the parties to deal with each other in good faith.[11]

In general, these franchise relationship laws stem from a similar moment in history. While the seeds of the modern franchise can be found as far back as the 1840s, it was not until the 1950s that these arrangements, known more specifically as "business format" franchises, proliferated

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> association or to prohibit the right of free association among franchisees for any lawful purposes.

Cal Civ. Code § 31220.

8 *E.g.*, Minnesota:

> All franchise contracts or agreements and any other device or practice of a franchisor shall conform to the following provisions. It shall be unfair and inequitable for any person to: . . . discriminate between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any business dealing, unless any classification of or discrimination between franchisees is based on franchises granted at different times, geographic, market, volume, or size differences, costs incurred by the franchisor, or other reasonable grounds considering the purposes of Minnesota Statutes 1973 Supplement, sections 80C.01 to 80C.22.

Minn. R. 2860.4400(B) (2007).

9 *E.g.*, North Dakota:

> The commissioner may summarily issue a stop order denying the effectiveness of any registration or of any exemption under section 51-19-05 if the commissioner finds: . . . That the method of sale or proposed method of sale of franchises or the operation of the business of the franchisor or any term or condition of the franchise agreement or any practice of the franchisor is or would be unfair, unjust, or inequitable to franchisees.

N.D. Cent. Code § 51-19-09(1)(i).

10 *E.g.*, Washington:

> For the purposes of this chapter and without limiting its general application, it shall be an unfair or deceptive act or practice or an unfair method of competition and therefore unlawful and a violation of this chapter for any person to: . . . Impose on a franchisee by contract, rule, or regulation, whether written or oral, any standard of conduct unless the person so doing can sustain the burden of proving such to be reasonable and necessary.

Wash. Rev. Code § 19.100.180(2)(h).

11 *E.g.*, Hawaii:

> Without limiting the other provisions of this chapter, the following specific rights and prohibitions shall govern the relation between the franchisor or subfranchisor and its franchisees: . . . The parties shall deal with each other in good faith.

Haw. Rev. Stat. § 482E-6(1).

across the United States to a significant degree.[12] These arrangements were resistant to regulation under antitrust or labor law,[13] and with the expansion of these arrangements came abuses of the close relationship between franchisor and franchisee.[14]

Washington's Franchise Investment Protection Act was enacted in 1971 due to "bulging" complaint files in the state's attorney general's office, an analysis of which indicated that the issues were "illustrative of the problems which run throughout the franchising industry; e.g., price fixing, exclusive supply contracts, captive markets, overcharges, unreasonable quotas, and unfair terminations or failure to renew a franchise on terms then available to all franchisees."[15] A major issue was the lack of full and fair disclosure given to franchisees, but, critically, the drafters of the Washington Act found that, even with full disclosure, the "disparity between the bargaining power of the franchisor and the franchisee was so great that the franchisee was stuck with these terms."[16] These issues are still present today.[17]

## Preliminary Notes about the RFI

Before we respond to the topics covered by the RFI, we note that the Commission limits its inquiry to the actions of the franchisor entity. In our experience, however, no inquiry into franchising can ignore the crucial role of franchisor affiliates. A franchisor's affiliates can be responsible for numerous aspects of the franchise relationship. For instance, affiliates may supply the financial statements reviewed by prospective franchisees (which are used to guarantee the franchisor's performance), may provide the majority or all products or services that franchisees

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12 *See, e.g.,* Francine Lafontaine & Roger D. Blair, *The Evolution of Franchising and Franchise Contracts: Evidence from the United States*, 3 ENTREPRENEURIAL BUS. LAW. J. 381, 385-87 (2009). The term "business format" franchise separates these arrangements from "traditional" franchising arrangements (such as for gas stations and automobile dealerships) which are exclusive product distribution arrangements that do not impose the payment of a royalty fee. *Id.*

13 *See* Brian Callaci, *Control Without Responsibility: The Legal Creation of Franchising, 1960-1980*, 22 ENTER. & SOC'Y 156 (2021). Callaci describes state legislation, the "main concern [of which] was the gross power imbalance between the parties," as efforts to "step[] into the breach to propose regulations to control this new business form, which had escaped the grasp of traditional doctrines."

14 As the California deputy attorney general testified in 1969, "[t]he number of complaints received by the Attorney General's office indicates that in the investment field franchise problems have now replaced promotional subdivision problems as the number one area of concern of California investors." Killion, William L., *The History of Franchising*, (2013) in Franchising: Cases, Materials, and Problems 28 (Alexander Moore Meiklejohn ed., 2013).

15 James Fletcher, *Franchise Investment Protection Act* 5-6 (1971) (unpublished manuscript available at the University of Washington School of Law library).

16 *Id.* It was also observed, "[i]n short, too often and too late franchisees have come to the distressing realization that the franchise agreement can be used by the franchisor as an instrument of repression."

17 Also, using Washington state as an example, much of its examiners' review is spent on commenting on provisions that are inconsistent with the justified expectations of franchisees, are drafted in ways that violate standards of fairness or reasonableness, are inconsistent with state law, or seek an unconscionable advantage. These provisions live on in franchise agreements used in states that do not have this authority.

are required to buy or are required to offer to the public, or own the marks associated with the franchise system. In our review of franchisor offerings, the operational requirements attributable to affiliates by which franchisees are required to abide can be difficult to ascertain. This is because the Commission's Franchise Rule ("FTC Franchise Rule" or "Rule") limits the disclosures required of a franchisor's affiliates, and franchisors can avoid making many disclosures if an affiliate is instead the acting entity.

Additionally, to the extent that the RFI bears on disclosure considerations under the FTC Franchise Rule, the Rule is based on the disclosure of franchise terms that were typical at the time the rule was promulgated. But, because of the continuous development of these terms by franchisors, any updated disclosure requirements should be flexible enough to ensure that material information about the franchise relationship is disclosed regardless of franchisors' future market conduct. At the same time, modifications to the Commission's disclosure requirements should not preclude the Commission's consideration of substantive franchise regulation undertaken in partnership with the states.

## Topic #1: The Franchise Relationship

In the review of franchise offerings, state franchise regulators have noted that some franchisors impose certain requirements on prospective franchisees or franchisees that appear to be unfair, lack good faith, or are considerably out of step with what franchisors in similar industries require. The state regulators have noted provisions that dissuade, or even preclude, franchisees from negotiating terms in franchise agreements. In some offerings, franchisors require franchisees to reimburse the franchisor for any attorneys' fees that the franchisor may incur in connection with drafting negotiated amendments to the franchise agreement. A prospective franchisee, particularly one that cannot afford to be represented by an attorney in reviewing the franchise offering, would think twice about negotiating terms if they must bear the costs of negotiation, and perhaps even more so when negotiations might not ultimately result in beneficial changes to the agreement. In addition, franchise salespersons may apply high-pressure sales tactics that seek to limit the time a prospective franchisee has to consider a franchise offering. In some cases, state regulators have been contacted by prospective franchisees who report that they have been told by a franchisor or third-party franchise broker that the franchisor is about to file a renewal application with a state franchise administrator[18] and that the soon-to-be filed offering materials will increase fees or otherwise make the terms of the franchise agreement less favorable to franchisees. This pressure to quickly sign an agreement limits a prospective franchisee's ability to fully understand the terms of the franchise agreement and then negotiate those terms.

[18] "In some registration states, if the franchisor does renew its registration (some states refer to it as an annual report and amendment of registration) prior to the expiration date but the renewal is not yet approved by the state, the franchisor will go "dark" in that state. This means that the franchisor cannot offer to sell franchises in that state until its renewal is declared effective by the state regulator." Leonard Vines, Halima Madjid & Dale Cantone, Best Practices for State Franchise Registration, 32nd ABA Forum on Franchising (2009).

In part because of the obstacles prospective franchisees face in negotiating franchise agreement terms, some franchise agreements reviewed by state regulators are remarkably one-sided in favor of franchisors and against franchisees. For instance, many franchisors commonly require franchisees to reimburse the franchisor for reasonable travel costs associated with required or optional on-site assistance. However, state regulators have noted offerings where franchisors have included provisions beyond this reasonable reimbursement. One franchise agreement required franchisees to reimburse the franchisor for, and in some instances, advance, costs for first-class airfare and accommodations for senior executives of the franchisor when traveling to the franchisee at the franchisor's sole discretion. The one-sided nature of the franchise agreement gives franchisees little leverage to bargain away such terms.

Many franchise agreements require franchisees to acknowledge that the prospective franchisee has read and understands the franchise agreement.[19] Some franchisors, however, require an even broader acknowledgment, requiring franchisees to acknowledge that they have read and understand the terms of a binding arbitration provision (one paragraph in a 70-page agreement, not including exhibits) and affirm that the provision was entered into willingly and voluntarily without fraud, duress or undue influence on the part of franchisor or any of franchisor's agents or employees. A franchisor could later use this acknowledgment to argue the franchisee waived state site of arbitration requirements in states with such requirements.[20] A franchisor could also use this acknowledgment to argue the franchisee waived claims under state anti-fraud provisions. This is a troubling requirement by the franchisor because a victim of fraud only becomes aware of the fraud after it has occurred. Yet the acknowledgment asks a franchisee to acknowledge that no fraud occurred related to this individual provision, when a franchisee, and even a franchisor, might not learn of fraud on the part of a franchisor or a third-party broker until a controversy arises. While these terms may be present in arm's length transactions, such terms are ripe for abuse when they govern the franchise relationship.

Further, some franchisors seek to have prospective franchisees acknowledge that all terms in a franchise agreement are reasonable before the principals have attended training, have started their business, or have seen the contents of the operations manual, when they may have no basis to assess whether the terms are reasonable or not. One franchise agreement that state regulators reviewed asked a prospective franchisee to acknowledge the prospective franchisee had "carefully considered the nature and extent of the restrictions" set forth in the agreement and that the rights and remedies conferred upon the franchisee and franchisor under the franchise agreement were reasonable, were required to protect the franchisor's legitimate business interests, and did not confer benefits upon the franchisor that were "disproportionate to the franchisee's detriment." Particularly because many of these systems have no or few units in operation, prospective

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19 Such terms have been used in practice by franchisors to attempt to disclaim liability for misrepresentations or omissions, and their use in franchisee questionnaires, acknowledgements, or similar documents have been prohibited through the NASAA Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments, which became effective on January 1, 2023. These prohibitions do not apply in states that do not register franchise offerings.

20 For example, Indiana, North Dakota, and Washington.

franchisees have little basis for assessing whether the agreement is reasonable until after they have started operating the business. And even a current franchisee most likely cannot assess whether the restrictions placed upon them are required to protect the franchisor's legitimate business interests, as this analysis requires intimate knowledge of the franchisor that the franchisee probably does not have. This acknowledgment has no legitimate purpose; instead, its sole purpose is to get the prospective franchisee on the record as concluding the franchise agreement is fair before the franchisee has the information necessary to reach such a conclusion. This acknowledgment is analogous to asking a jury to deliver a not-guilty verdict before a trial has begun.

Other terms that speak to the one-sided nature of these agreements include those that prohibit the franchisee from naming the franchisor's officers, employees, agents, or other representatives as parties to any legal proceeding. These terms seek to waive individual liability for any potential misrepresentation or omission in the sales process and any potential post-sale liability.[21] An example of such provision goes so far as to require the franchisee, if the franchisee does include these individuals in the complaint, to correct its complaint and holds it "responsible for all expenses incurred by the other party or the improperly named persons or entities, as a result of the violation, including attorneys' fees, and liable for abuse of process."

Franchisors routinely reserve the right to make changes to the system operations manuals as they see fit, and in most cases, franchisors can impose these new obligations even if the changes result in substantial expenses or business disruption for franchisees.[22] A franchisor's ability to modify the manual is necessary to a certain extent and allows franchisors to stay flexible and respond to unexpected challenges and opportunities. However, some franchisors appear to misuse their ability to make changes through the operations manual to change material contract terms. Such unilateral, material changes to the franchise agreement run counter to the intent of state and federal franchise disclosure rules.[23] An example of such a franchisor is one that reserved the right to change, by means of the operations manual, all fees disclosed in its FDDs, *except* those that were marked with an asterisk. Out of 35 fees disclosed in the FDD, only 11 were so marked.[24] The unfettered right to modify fees may materially change the terms of the contract, especially when the adjustments are not simply accounting for increases or decreases in costs borne by the franchisor or other suppliers in providing services and products.

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[21] These provisions also circumvent the FTC Franchise Rule by seeking, as an initial matter, to prevent complaints that would otherwise be required to be disclosed in the FDD from being filed against the relevant individuals.

[22] In fact, some franchisors submit applications for franchise registration before developing or completing the operations manual, calling into question the franchisor's ability to successfully train franchisees to join and be successful in the system.

[23] This practice may also violate filing requirements under state law. California law requires franchisors to file material modifications to existing franchise agreements. *See* Cal. Corp. Code § 31125.

[24] The annual manager training fee, additional in-person training or assistance fee, late fee, NSF fee, interim management fee, interim training fee, technology fee, transaction processing fee, de-identification fee, document preparation fee, and marketing assistance fee were not marked.

Despite the changes that franchisors are able to make to the manual, and despite the fact that most prospective franchisees are only provided the table of contents to the operations manual before signing their franchise agreement,[25] some franchisors require franchisees to acknowledge that the manual is "commercially reasonable in all respects." As a matter of reason, a prospective franchisee cannot know whether a manual that they have not seen is commercially reasonable. Even if a prospective franchisee could review the operations manual before signing, most prospective franchisees cannot know whether it is commercially reasonable without first operating the business for a period of time. These types of acknowledgments appear to be another attempt by the franchisor to insulate itself from liability should franchisees latter challenge system requirements once they learn of them and see if they align with operational realities in practice. Other franchisors reserve the right to change the system in *any* manner not expressly prohibited by the franchise agreement. In connection with this right, or more broadly, franchisors reserve the right to make decisions or exercise their rights based on what is in their best interest, without regard to whether such decisions or exercise of rights are adverse to the interest of franchisees. Some of the same franchisors that reserve this right require franchisees to agree that the franchisor will have no liability for any decision or action except as may be provided by statute or regulation.

Finally, some franchisors attempt to limit a franchisee's ability to complain to any governmental entity, including the Commission, state securities and franchise regulators, and other government consumer protection authorities. We do not believe this language serves any legitimate purpose. The only purpose of such provisions is to silence aggrieved franchisees by restricting them from complaining to regulators. We discuss such provisions in more detail in Topic #2 below, but for the purpose of this topic, their existence in these franchise agreements is indicative of the one-sided nature of the agreement.

**Topic #2: Provisions of the Franchise Agreement**

The provisions the Commission inquires about in Topic #2 of its RFI are present in almost all franchise agreements reviewed by our Project Group member agencies. Further, the inclusion of these provisions in the franchise agreement demonstrates the level of control that franchisors generally have over franchisees' operations. Below are some considerations related to specific areas of inquiry in the RFI:

- Regarding no-poach agreements, the issues they present have been well-documented through actions taken by multiple state attorneys general. Illinois, California, the District of Columbia, Iowa, Maryland, Massachusetts, Minnesota, North Carolina, New Jersey,

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[25] The NASAA Guidelines require franchisors to "disclose the table of contents of the franchisor's operating manual provided to franchisees as of the franchisor's last fiscal year-end or a more recent date. State the number of pages devoted to each subject and the total number of pages in the manual as of this date. This disclosure may be omitted if the franchisor offers the prospective franchisee the opportunity to view the manual before buying the franchise." A manual's table of contents and the number of pages devoted to each subject provides no indication of the quality of the materials. Prospective franchisees should be provided access to the franchisor's entire manual prior to the sale, subject to necessary mechanisms to ensure confidentiality of the information.

New York, Oregon, Pennsylvania, Rhode Island, and Vermont reached settlements with eight major franchisors regarding their no-poach agreements due to the non-competitive and wage-suppressing nature of these provisions.[26] Of particular note, the Washington Attorney General's Office started a two-year sweep in 2018 to examine the agreements of national franchisors with more than three units in the state. These efforts led to eliminating no-poach provisions at 237 national franchisors and passing state legislation banning this practice.[27]

- Regarding provisions that require franchisees to purchase or lease goods, services, real estate, or other items and that prohibit the sale or purchase of unapproved products or services, of particular concern in these areas are those franchise systems that are more similar in their characteristics to a distribution agreement than a brand format franchise. These provisions require franchisees to purchase required inventory solely from the franchisor or its affiliates, which are also the producers of the goods. They also require franchisees to purchase these goods at amounts required by the franchisor.[28] This marriage of a model more in line with a "traditional" franchise and a brand format franchise is concerning because it can allow an unscrupulous franchisor in such arrangements to offload product on the franchisee without concern for the franchisee's need for those items or their economic health.[29] Additionally, even for purely brand format franchises, it is common for a franchisor, when it requires franchisees to purchase goods or services from it or an affiliate, to mark up those goods and services to franchisees and not disclose this mark-up. Further, franchisors will generally require franchisees to pay them a fee to review products or services that are not part of the franchisor's existing approved or designated product or services list. While there are business reasons regarding quality and uniformity

[26] Press Release, Office of the Illinois Attorney General, Attorney General Raoul Reaches Agreement to End Use of No-Poach Agreements (Mar. 2, 2020), https://illinoisattorneygeneral.gov/News-Room/2020-Press-Release-Archive/202003-02%20AGREEMENT%20TO%20END%20USE%20OF%20NO%20POACH%20AGREEMENTS.pdf.

[27] Wash. Rev. Code 49.62.060. We are not aware of other states that have prohibited the use of these provisions in the franchise relationship.

[28] *See*, *e.g.*:

> Franchisee shall, at all times during the term of this Agreement, purchase inventory of products, either from Franchisor or one of its Affiliates or from an approved supplier of such products, in such categories and minimum quantities as are specified by Franchisor ("Inventory Plan") and as are sufficient to sustain and grow the Franchised Business. Franchisor may require Franchisee to purchase any or all of Franchisee's Store inventory, including [Franchisor/Affiliate's brand products] and non-[Franchisor/Affiliate] brand products, exclusively from Franchisor, in Franchisor's sole discretion.

[29] Such arrangements can also create a franchise without any explicit fees being imposed on the franchisee. *See Digital Equipment Corp. v. Uniq Digital Technologies, Inc.*, 73 F.3d 756, 760 (7th Cir. 1996) ("An excessively large inventory transfers cash to the seller without producing benefits for the buyer; and the interest the seller earns by making the sales earlier is a kind of fee.").

for franchisors to engage in this review, these fees can become excessive or further shift the cost of the franchisor's development of its system onto franchisees.

- Regarding provisions that mandate that franchisees maintain certain hours of operation; these requirements can limit franchisees' ability to adapt their operations to match the reality on the ground. It is a common complaint from convenience store franchisees that they are forced to operate late into the night, despite producing little revenue for their stores while increasing risks to franchisees and their employees from theft or violent crime. Further, a franchisor's power to set minimum operating hours is a fact frequently omitted from the FDD.

- Regarding provisions that restrict or do not restrict the territory or sites where the franchisee may operate its business, some franchise systems are designed with no territorial protections and allow unlimited competition by the franchisor or other franchisees in the same geographic area. This can create unfair competition between the franchisor—who can exert strict control over the basis on which franchised units may distinguish themselves—and franchisees, or between small franchisees and franchised units operated by entities with the economic sophistication to negotiate concessions from the franchisor. Particularly for food and beverage franchises, the lack of a franchise territory is inconsistent with the general expectation of franchisees to have at least a nominal territory that prevents units from being "doubled up." Such doubling up of units has been the topic of media attention over the years, which reveals how this practice can significantly impact the ability of franchisees to operate a business under a franchisor's trademarks.[30] Other reports on this topic also provide information about maximum, minimum, or specific pricing controls.[31] These franchisor-imposed requirements can prevent franchisees from adapting to geographic differences in costs or require franchisees to sell their products at a loss, particularly when required to honor promotional prices set by the franchisor. In combination with the above lack of territorial requirements, this can enable unfair competition by the franchisor's units, which can sustain these promotional prices through

[30] *See, e.g.,* The Washington Post, *The Rise and Fall of Subway, the World's Biggest Food Chain* (May 30, 2015), https://www.washingtonpost.com/business/economy/the-rise-and-fall-of-subway-the-worlds-biggest-food-chain/2015/05/29/0ca0a84a-fa7a-11e4-a13c-193b1241d51a_story.html; Insider, *Experts And Insiders Say Subway is Haunted By A Fundamental Flaw That is Forcing The Chain To Close Hundreds Of Locations* (Sept. 25, 2019), https://www.businessinsider.com/subway-franchise-model-forces-locations-to-close-2019-9. Reports about these issues with this particular franchisor attracted enough attention as to even find themselves synthesized in a segment last year on the satirical news show, "Last Week Tonight with John Oliver." *See* The Guardian, *John Oliver on Subway Franchisees: 'Dream Turned into a Nightmare'* (May 23, 2022), https://www.theguardian.com/tv-and-radio/2022/may/23/john-oliver-subway-franchisees.

[31] Office of Senator Catherine Cortez-Masto, *Strategies to Improve the Franchise Model: Preventing Unfair and Deceptive Franchise Practices* 30 (Apr. 2021), https://www.cortezmasto.senate.gov/imo/media/doc/Franchise%20Report%20from%20the%20Office%20of%20Senator%20Cortez%20Masto.pdf.

lower costs due to the franchisor's wholesale purchasing power that is not extended to franchisees.

While the provisions inquired about by the Commission in its RFI impose controls on the franchisee's operations, they still maintain a formal separation between the franchisor and the franchisee's business. However, many franchise agreements can include provisions that, as an operational reality of the relationship, blur this distinction. One type of provision the Commission does not seek information about is that which empowers franchisors to operate the franchised unit directly at the franchisor's discretion while charging the franchisee a management fee.[32] Despite the franchisor or its representative assuming direct control of the franchised business, these provisions commonly require the franchisee to indemnify the franchisor for any action the franchisor takes in the unit's operation. Many such provisions are vaguely drafted to ostensibly allow the franchisor to control the unit's operations indefinitely.[33] These provisions sideline franchisees in their own businesses while maintaining their liability for actions that are not their own. If the Commission develops proposals regarding the substantive franchise relationship, it should examine these types of provisions in its efforts.

Non-disparagement and goodwill clauses are also ubiquitous in franchising. Those agreements that limit franchisees' ability to complain to government agencies are of particular concern. One such agreement states that the franchisee "must covenant never to commence any action or proceeding against [the franchisor], file any complaint with any regulatory authority concerning [the franchisor] or otherwise assert any claim against [the franchisor]." Other agreements may go further and include this general language and additional provisions covering specific areas, such as the franchisor's operations manual or system standards.[34]

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32 While such clauses appear initially focused on the franchisee principal's death or disability, they can also include language that goes far afield of these circumstances. One such provision allows the franchisor to assume control if "your business activities are having, or are likely to have, a negative impact upon the value of our marks, goodwill, or the franchise system (as we determine at our sole discretion)." There was no contractual provision indicating when the franchisee could be eligible to resume control of the unit.

33 A provision that allows franchisors to take control of the unit in instances where a health or safety issue has arisen and then creates a clear pathway to the resumption of control by the franchisee or the termination of the unit, if necessary, would appear to be a reasonable restriction on franchisees' control of their unit. Unfortunately, in many instances these provisions are not so narrowly drafted.

34 *E.g.*:

> To the extent that we have furnished to you, or otherwise permitted you to inspect, the Brand Standards prior to your execution of this Agreement, you hereby irrevocably affirm and attest that you have reviewed our Brand Standards in detail and in its entirety; that the Brand Standards is commercially reasonable in all respects; that the Brand Standards does not in any fashion exceed our ability to promulgate requirements in the Brand Standards under this Agreement; and that, accordingly, you irrevocably promise and agree never to begin or join in any legal action or proceeding, or register a complaint with any government entity, directly or indirectly contending otherwise or in any way complaining that our Brand Standards is in any fashion commercially unreasonable or

While the enforceability of these provisions is doubtful,[35] they clearly have a chilling effect on franchisees who have legitimate complaints from alerting federal and state regulators. In addition, these provisions directly contradict disclosures mandated by the FTC Franchise Rule and the NASAA Guidelines that alert franchisees that they may contact state regulators with concerns and complaints. A franchisor that does not provide a financial performance representation in Item 19 of the FDD is required to disclose: "If you receive any other financial performance information or projections of your future income, ***you should report it*** to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies." In Item 23, the franchisor is required to disclose in its receipt pages that violations of federal and state franchise law should be reported to the Commission and the relevant state agency. It is inconsistent with these requirements for a franchisor to then attempt to limit a franchisee's ability to make a complaint with state or federal regulators. Additionally, these provisions communicate to franchisees that they are giving up an important right and, along with it, their ability to hold franchisors to account. This is particularly important because the contours of their franchise agreements provide franchisees with few other avenues through which to assert their interests. Further, these provisions could serve to limit the ability of the Commission and other government agencies to collect information to shape the administration of their regulations—such as through this RFI—because current or former franchisees are unable to share their stories out of fear of the consequences of sharing information with the agency.

For those of our member agencies with the authority to comment on the substantive franchise relationship, inquiries made to franchisors about any of the provisions in their franchise agreements that appear unfair, unreasonable, or that seek an unconscionable advantage are commonly responded to with little to no justification or with conclusory explanations. This lack of a meaningful response increases the difficulty of assessing the fairness of these provisions to franchisees.

**Topic #3: Franchisor Business Practices**

Despite the number of state laws preserving the right of franchisees to join franchisee associations, in our review of franchise filings, few franchise systems have franchisee associations, and even fewer of these associations are independent of the franchisor. And, despite these laws, retaliation is still present. A consent order entered by the Securities Division of the Washington State Department of Financial Institutions in November 2022 included among its allegations a violation of state law prohibiting the restriction or inhibition of franchisees joining such an

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> exceeds our authority to promulgate same under this Agreement. It is unclear how the average franchisee would understand the reasonableness of many of these standards until they have commenced the operations of their franchise or understand how future changes to the system standards will specifically affect their business.

35 Beyond public policy arguments, in states with anti-waiver provisions in their franchise laws, such language constitutes an impermissible waiver.

association.[36] After the association was formed, the franchisor allegedly ignored attempts by the association to discuss matters of shared interest until the association identified its leaders.[37] Once the leaders were identified, the franchisor almost immediately sent a "final" notice informing one of the franchisee leaders that the franchisor could terminate his agreement based on breach of the franchise agreement. The franchisee's termination was later finalized, and he was forced to either sell his unit or let it close. Such practices by franchisors have a chilling effect on franchisees from seeking to join such associations, and because of such retaliation, some franchisees have to resort to anonymously joining an association through legal counsel.[38]

In our review of franchise offerings, state franchise regulators regularly see examples of the significant control exercised by franchisors over franchisees. This control is an integral part of the franchising model and helps ensure consistency and uniformity in the delivery of products or services. As a result, many franchisees face potential termination of the franchise agreement if they fail to follow franchise system standards. Despite this control, many franchise agreements contain provisions that create the impression that franchisees have sole responsibility for their operations. Some franchise agreements do this by requiring franchisees to acknowledge that the requirements to follow system standards do not "directly or indirectly constitute, suggest, infer or imply" that the franchisor controls "any aspect or element of the day-to-day operations" of the franchised business. This acknowledgment is at odds with franchisor policies that prescribe, with great detail, what a franchisee can sell, how much it can charge, when it must be open, and how it must advertise. Further, some franchisors require the franchisee to indemnify the franchisor for any claims against the franchisor, even if the franchisee is following the system standards and the franchisor's requirements gave rise to the liability. In light of the control exerted by franchisors and the potential ramifications of noncompliance, it is not surprising that a franchisee might seek guidance from the franchisor. Yet, some franchise agreements also require franchisees to acknowledge that franchisees cannot rely on this advice.

In their advertising materials, many franchisors tell prospective franchisees that their system and their training are superior to their competitors. Franchisors contend that their franchise system is "tested" and "established," and franchisors tout the quality of their training. Yet, these same franchisors routinely require franchisees to acknowledge a statement similar to the following in the franchise agreement:

> Do you understand the success or failure of your franchise will depend in large part upon your skills, abilities, and efforts and those of the persons you employ, as well as many factors beyond your control such as

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36 Wash. Rev. Code 19.100.180(2)(a).

37 F45 Training, Inc., DFI Order No. S-19-2681-19-CO01, https://dfi.wa.gov/documents/securities-orders/S-19-2681-19-CO01.pdf.

38 American Association of Franchisees & Dealers, *Can I join anonymously?*, https://www.aafd.org/faq-items/can-i-join-anonymously last accessed May 9, 2023).

> competition, interest rates, the economy, inflation, labor and supply costs, and other relevant factors?

This statement is wholly silent on how the actions of the franchisor could potentially impact a franchisee's success or failure. In many cases, a franchisor is permitted under the terms of the franchise agreement to change the focus of the business or alter or discontinue the use of the trademarks. These changes could prove to be beneficial to the system, but they could also be detrimental, despite the franchisor's best intentions. For instance, a franchisor could pursue an advertising campaign that alienates customers or it could select a supplier that provides a defective product. The acknowledgment's silence on the potential impact a franchisor could have on its own system is illustrative of the attempt by franchisors to have it both ways; i.e., to exercise significant control yet avoid liability for anything negative that occurs in the system. To be clear, some franchisees fail because they do not follow system standards or for reasons that have nothing to do with the franchisor. Yet there are also franchisees that have failed because of actions taken by the franchisor.[39] Yet the pervasive language in the acknowledgment does not accurately reflect that, in many cases, franchisees and franchisors are very often crucial to each other's success.

Additionally, there are many franchise systems where a third-party exerts significant control over franchisees—such as sushi counter franchisees who must meet the requirements of the host venue grocery store or janitorial franchisees that must meet the requirements of the lessees of corporate office space. In one sushi counter offering reviewed by state regulators, the franchise agreement required the franchisee and its employees "to comply with all rules, procedures and food safety requirements of [the] host venue," and some sushi counter franchisees must meet minimum performance requirements set by the host venue. These examples illustrate that the host venues exercise significant control over the day-to-day business of the franchisees, and the franchisee may not receive material disclosures about this control in the materials provided by the franchisor. In some offerings reviewed by state regulators, the host venue has the ability to close the franchisee's business without cause, and without notice, by terminating its contract with the franchisor. In some ways, this makes the third party more powerful than the franchisor because the vast majority of franchisors, even if they are not operating in a state with a franchise relationship law, do not include in their franchise agreements the ability to terminate a franchise without notice or cause. If the host venue exercises the right to terminate the contract with the franchisor, this would leave the sushi counter franchisee without a space to operate and without recourse against the host venue, as many franchisees do not have a contractual relationship with the host venue.[40]

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[39] Jonathan Maze, *A brief history of Quiznos' collapse*, REST. BUS. (June 13, 2018), https://www.restaurantbusinessonline.com/financing/brief-history-quiznos-collapse

[40] These arrangements potentially attempt to replicate an employment relationship by way of a franchise agreement, contributing to workplace "fissuring." *See, e.g.,* David Weil, *Understanding the Present and Future of Work in the Fissured Workplace Context*, 5 RSF: THE RUSSELL SAGE FOUND. J. OF THE SOC. SCIENCES 147-65 (2019), https://doi.org/10.7758/RSF.2019.5.5.08.

While there are issues with these arrangements substantively, they are compounded by the fact that there is little to no disclosure of material information about those third parties and their requirements to franchisees. Moreover, despite the efforts of state franchise regulators to acquire this information, there have been instances when franchisors have refused to provide the underlying contract between the franchisor and third party to examiners for their review of the offering as examiners attempt to determine if the disclosures in the FDD are sufficient and accurate.

**Topic #4: Payments to Franchisors from Third Parties**

In its RFI, the Commission sought comment on franchisor practices with respect to supplier relationships. This includes whether franchisors receive payment or other consideration from third parties related to the purchase of goods or services from those third parties by franchisees. And whether franchisors direct or steer franchisees to purchase goods or services from third parties that are owned, in whole or in part, by an entity that has an ownership stake in the franchisor.

In the experience of the Project Group, franchisor-imposed supplier restrictions are ubiquitous in franchise relationships. Franchisors typically reserve the right to require that equipment, supplies, products, and services used or sold by the franchisee meet the specifications established by the franchisor and/or be purchased only from expressly approved suppliers, which may include the franchisor or its affiliates. Franchisors also typically reserve the right to arrange with suppliers to receive revenue or non-cash benefits based on franchisee purchases and leases[41] or to benefit from these arrangements by acquiring these products and selling them to franchisees at a mark-up.[42] While the extent of these arrangements is made apparent in the franchise agreements, the Project Group notes that franchise systems are not marketed in this manner; indeed, many franchise opportunities are touted as opportunities for entrepreneurs to buy into a "proven business model" and to receive training and ongoing support.[43] Franchise marketing and disclosures typically fail to highlight the fact that the franchisor may impose supplier restrictions beyond those which are necessary to ensure brand quality and consistency, which may prevent the

[41] A beer garden franchisor discloses in Item 8 of its FDD that it reserves the right to receive payments, manufacturing allowances, marketing allowances, rebates, credits, monies, or other benefits.

[42] An automotive parts distribution franchisor states the following in its franchise agreement: "In addition [to reserving the right to act as a purchasing agent for the franchisee], we have the right to designate ourselves as an approved supplier and to make a profit from the sale of accessories, equipment, parts and supplies by us or third parties to you if we serve as a manufacturer, assembler or *distributor in a product sourcing role*." (Emphasis added). Read broadly, this would allow the franchisor to benefit from supplier restrictions by acquiring parts and supplies from a supplier, and then turning around and reselling them to franchisees at a markup, regardless of whether the franchisor added a benefit or value to these products.

[43] One franchise broker site states, "A core tenet in the world of franchising is that when you go into business for yourself, you're never by yourself, in a manner of speaking. Because the essence of a franchise opportunity is that the franchisee has the support and experience of an established brand backing their efforts throughout the process." *Being in Business for Yourself, but NOT by Yourself (Benefits of Being a Franchisee)*, FranNet, https://frannet.com/resources/general/business-for-yourself/.

franchisee from sourcing products at a lower cost, or which may otherwise serve as a hidden profit center for the franchisor or its affiliates.[44]

In connection with these supplier restrictions, franchisors often include in their franchise agreements broad disclaimers of liability or limitations on damages that the franchisee can recoup in the event the franchisee suffers harm. These provisions typically disclaim liability for claims related to any products, even if the franchisor supplied them, and even if the franchisor was aware that damages may arise.[45] Even if these terms are borrowed from other types of commercial arrangements, franchise agreements are distinct in that they are not typically a product of arm's length bargaining between two sophisticated entities of equal bargaining power.[46] Rather, these provisions, coupled with sourcing restrictions, reflect the overwhelmingly stronger bargaining position occupied by the franchisor. At least one state has attempted to alter the imbalance of power by imposing restrictions on franchisor control over franchisee sources of supply.[47]

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[44] *See* Rachel Abrams, *Links in 7-Eleven's Chain Threaten to Snap as Store Owners Balk at Contract*, N.Y. TIMES (July 30, 2018), https://www.nytimes.com/2018/07/30/business/7-eleven-franchisees-dispute.html (discussing tensions between 7-Eleven and its franchisees over supplier restrictions, and citing a franchisee who stated he could buy bottled water more cheaply at a local beer distributor, or pay less for bananas from a big box store. As vendors recommended by 7-Eleven are required to give rebates to 7-Eleven, the franchisee questioned whether the vendors were charging franchisees more to help pay for those rebates).

[45] A wax franchisor that requires franchisees to purchase proprietary wax and other proprietary products from its affiliate includes the following disclaimer of liability in its franchise agreement:

> Without limiting any other limitations of liability set forth in this agreement, except due to franchisor's or any franchisor affiliates' gross negligence or willful misconduct, in no event shall franchisor or its affiliates or representatives be liable for consequential, indirect, incidental, special, exemplary, punitive or enhanced damages, lost profits or revenues or diminution in value, arising out of or relating to any order of products, including delays in delivery, regardless of (a) whether such damages were foreseeable, (b) whether or not the party was advised of the possibility of such damages and (c) the legal or equitable theory (contract, tort or otherwise) upon which the claim is based, and notwithstanding the failure of any agreed or other remedy of its essential purpose.

[46] The Project Group noted that a moving company franchisor that included a provision in its software license agreement that disclaimed liability for any of the following: (a) indirect, incidental, or consequential damages, including, but not limited to, loss of business, revenue, profits or investments from any cause arising out of or in any way connected with the software; (b) any claim or demand by or against a franchisee arising out of or in any way connected with the software; or (c) damages relating to failures of telecommunications, the internet, electronic communications, corruption, security, loss or theft of data, viruses, or spyware. In response to a Project Group member's comment that this broad disclaimer of liability implicated state anti-waiver statutes, the franchisor asserted that this limitation of liability is industry standard in software license agreements. However, the franchisor is not a software developer, nor is it in the business of licensing software to third parties in arm's-length transactions. Instead, franchisees are *obligated* to use this proprietary software due to the franchisor's overwhelmingly powerful bargaining position. Broadly drafted provisions like these allow a franchisor to avoid liability even when it was aware that damages may result from use but forced a franchisee to use its products anyway.

[47] Under Washington law, it is unlawful for any person to: (a) offer, sell, or offer to sell to a franchisee any product or service for more than a fair and reasonable price or (b) obtain money, goods, services, anything of value, or any other benefit from any other person with whom the franchisee does business on account of such business unless such benefit is disclosed to the franchisee. *See* RCW 19.100.180.

Regardless of the ubiquity of these restrictions, the Project Group notes that it is difficult to receive specific information about the precise benefits that flow from these arrangements. The Project Group notes that the FTC Franchise Rule does not expressly require franchisors to provide detailed information about the different sources of revenue that are derived by the franchisor from required purchases or leases (for example, if a franchisor earned revenue from selling products to franchisees and also earned rebates, separate disclosure is not expressly required), nor does it expressly require that the franchisor disclose the percentage of an affiliate's total revenues that are from required purchases or leases. As noted above, many affiliates are created to act as the supplier for certain goods or services, and this legal distinction may allow franchisors to avoid disclosing the full extent to which payments to these separate entities flow to the same owners. In addition, the FTC Franchise Rule does not expressly require any information about mark-ups charged on products or services sold by franchisors or their affiliates to franchisees; this information may assist state regulators and prospective franchisees in determining whether the franchisor is charging more than a fair and reasonable price, or whether this serves as a hidden profit center for the franchisor.

With respect to the disclosures that the FTC Franchise Rule requires, the Project Group notes that franchisors often provide vague details about the types of benefits they receive from supplier restrictions, and these details are often clarified only after significant back-and-forth with state regulators. Even then, these details may be modified in the future. The Project Group believes that the extent to which a franchisor or affiliate benefits from a supplier restriction is material information and encourages the Commission to consider ways that additional disclosure would bring these matters to light.

**Topic #5: Indirect Effects on Franchisee Labor Costs Related to Franchisor Business Practices**

With respect to the portion of non-labor operating costs that are determined by a franchisor, as an initial matter the Project Group notes that it can only speak to a portion of these costs. This is so because, as noted above, franchisors routinely reserve the right to specify or change components of the system through the operations manual or other documents,[48] the contents of

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[48] In the experience of the Project Group, franchisors will often disclose that franchisees must use only those products, supplies, equipment, technology systems, and services that the franchisor authorizes and designates in writing. These products, supplies, equipment, or services are typically identified in the operations manual only and may be changed or modified from time to time as the franchisor deems necessary. Franchisors may fail to provide a detailed list of what types of products, supplies, equipment, technology systems or services are source-restricted in the FDD, and therefore a prospective franchisee may not fully appreciate the extent to which the franchisor's specifications influence their ongoing costs. For instance, a fast casual dining franchise that features a menu of chicken sandwiches states in Item 8 of its FDD:

> You must develop your Restaurant premises and purchase or lease and install all equipment, supplies, fixtures, furnishings, décor, signs, goods, and services for your Restaurant according to our standards and specifications, contained in the [operating manuals] or that we otherwise

which are not required to be disclosed in the FDD or provided to franchisees as part of pre-sale disclosure. In addition, the Project Group notes that this lack of visibility is compounded when the franchisor collects all revenues earned by the franchisee and remits back to the franchisee their portion after deducting expenses.[49] Costs to comply with a franchisor's specifications may constitute a significant financial obligation,[50] or may relate to specifications that reach beyond reasonably anticipated methods used to ensure brand consistency or quality control related to the brand,[51] and the Project Group questions whether it is consistent with the purpose of the FTC Franchise Rule to allow such omissions.

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> provide in writing, solely from the suppliers we have approved in writing… We may modify our standards and specifications from time to time.

However, the franchisor fails to detail the *types of* required equipment, supplies, fixtures, furnishings, décor, signs, goods, or services. Franchisors may also include a blanket statement in their franchise agreement that allows the franchisor to modify franchise system components as frequently as needed, the costs of which will be borne by the franchisee. For example, a Mexican restaurant franchisor states in its franchise agreement:

> During the term of the Franchisor Agreement, we may modify the [franchise system] as frequently as we feel is in our best interests in order to keep our brand relevant and competitive to consumers and will make corresponding changes to the [operations manual]. We will notify you of all changes to the [operations manual] by written or electronic bulletins or emails, and you must conform to all changes at your expense within the time we allow…

[49] In an example involving a franchise business that sells print advertising in a real estate publication, the franchisor of this system collects revenue and remits to the franchisee a "commission" calculated using a complicated formula. The franchisor keeps a 15 percent royalty fee that is based on the "advertising value" of each issue of the publication and discloses that the "advertising value" is the greater of (1) the minimum market value of each print ad, *as determined by the Franchisor or its affiliate in its sole discretion*; (2) the contract price for which the print advertising actually sold, (3) the cash value of services that the franchisee barters in exchange for print advertising; or (4) the combined amount/value of (2) and (3). Accordingly, franchisees cannot reasonably determine the amount that will be retained by the franchisor when this fee is based on factors that may be determined in the franchisor's sole discretion.

[50] An envelope-based direct marketing franchisor states the following in its FDD: "The amounts you pay to [Franchisor] for the production and publication of [envelopes and postcards] are a significant part of the cost of operating the franchised business. Depending on the volume of business, a franchisee's payments to [Franchisor] for services typically range between 50% and 70% of total revenue." This not only demonstrates that costs to comply with required purchase requirements can present a significant financial obligation but also demonstrates the fact that franchisees are not provided with information in the FDD that can materially impact these financial obligations: in this instance, current price information. Given the significant portion of potential revenue that a franchisee must dedicate to paying these fees, the Project Group believes that it is material to a prospective franchisee that franchisors disclose more precise information about the nature and extent of their financial obligations to the Franchisor.

[51] In Item 8 of a beer garden franchise offering, the franchisor states, "The types of products and services that you must purchase from approved suppliers, designated sources, us or an affiliate, or according to our specifications, include (among other things): restaurant design and image items, such as décor, color schemes, signs, fixtures, and furniture; cash register and POS; food, beverages, and paper products; restaurant services such as linen supplies and services, *pest control, landscaping, trash removal, grease removal, hood cleanings*, and other restaurant maintenance; bookkeeping and accounting services; inventory management services; insurance coverage; and advertising materials." (Emphasis added). The Project Group notes that the italicized specifications do not appear to relate to brand consistency or brand-specific quality control, and questions whether franchisees could source less expensive services on their own.

As far as the portion of costs that state regulators can review, the Project Group notes that many franchisors (and their affiliates) charge a multitude of fees beyond traditional royalty fees, all of which serve to increase a franchisee's non-labor costs and eat away at the franchisee's bottom line.[52] While the Project Group understands that some of these fees may be paid in connection with products or services provided by the franchisor to ensure brand quality and consistency or to provide marketing value, the Project Group has observed franchisors charging fees that are unreasonably calculated or otherwise provide little to no value to the franchisee. These fees can materially impact a franchisee's operating costs and ability to make a profit.

In particular, the Project Group is aware of practices such as franchisors calculating revenue-based fees based on revenue that does not flow to the franchisee or who seek to collect duplicative fees on revenues earned by franchisees. Project Group members have seen instances where franchisors seek to charge royalty fees based on sales from delivery or catering fees, *inclusive of* fees paid by the customer to the delivery service.[53] Project Group members have also observed franchisors that charge royalty fees based on gross sales earned by the franchisee *and* fees based on a percentage of operating profit.[54] In the view of the Project Group, these types of

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52 A vitamins and supplements retail store franchisor discloses in Item 6 the following fees: a royalty fee; a national advertising fee; a transfer fee (one fee for the transfer of a single franchise agreement and one fee for the transfer of an area development agreement); a store relocation fee; an insurance reimbursement fee; a late payment fee; an insufficient funds fee; a store technology maintenance fee; a network connection fee; a credit card processing fee; an in-store Wi-Fi fee; a "financial services" fee for data processing, accounting and other operational services; a renewal fee; a requirement to reimburse the franchisor for the cost of an audit in the event the franchisee underreports gross sales on at least one occasion; indemnification requirements if the franchisor is held liable for damages or other expenses related to the franchisee's operations; liquidated damages; a default cure fee; an annual inventory fee; a non-compliance management fee; an operating management fee; and a securities offering fee. While some of these fees are conditioned on certain events taking place or at the franchisee's option, many of these are ongoing required fees, well beyond a standard royalty fee paid in connection with an ongoing trademark license. In the view of the Project Group, a number of these fees go beyond payment for continuing use of the system or ensuring compliance with system standards.

53 A burger franchisor states in its Item 6 that for the purposes of calculating "Gross Sales" (on which royalty fees are based), the term includes all ancillary charges and fees, including delivery fees or other service charges charged in connection with the third-party delivery service or catering service. The Franchisor further states, " . . . . (recognizing that though the Third-Party Service may pay you an amount equal to the purchase price charged to the customer less a commission, other fees . . . such commission, fees *will not be deducted from the [franchise restaurant's] Gross Sales*)." (Emphasis added). A Korean fried-chicken franchisor states in Item 6 that the term "Gross Sales" means all sales made from the operation of the franchised restaurant, "including but not limited to, sales from delivery/catering services and other third-party companies (including, without limitation Uber Eats… *inclusive of any fees charged by such third- party companies*) . . . ." (Emphasis added). It is unclear from these franchisors' FDDs whether the use of third-party delivery services is required, however, with the increasing use of third-party delivery services it is likely that franchisees will rely on these services to supplement or increase revenues.

54 Project Group members commented on a bubble tea franchise offering, where the franchisor sought to charge royalty fees based on "Gross Sales" *and* a fee based on 50 percent of the franchisee's "Operating Profit," which was calculated on the amount by which the franchisee's Gross Sales exceeded "Approved Expenses." Notably, "Approved Expenses" was not defined to mean the actual expenses incurred by the franchisee, but instead

fees not only materially impact a franchisee's operating costs but also allow the franchisor to "double-dip" by collecting fees on gross revenues *and* net profit.

In addition, the Project Group has observed many fees that serve to pass the cost of doing business as a franchisor onto the franchisee, rather than provide value to the franchisee. The Project Group notes that it is not uncommon for a franchisor to require that a franchisee reimburse it for taxes imposed on the franchisor in connection with fees and other payments made by the franchisee.[55] Similarly, the Project Group has encountered franchisors who require payment of fees to support administrative functions of the system that do not appear to provide any specific value to the franchisee,[56] and even those that may provide indirect value to the franchisee are used to support the franchisor's operations.[57]

Beyond fees and expenses typically associated with operating the franchise, the Project Group notes that certain provisions in the franchise agreement may further materially impact the costs associated with operating a franchise. Franchisors routinely include broad disclaimers of liability in their franchise agreements that bar the franchisee from recouping damages caused by the franchisor.[58] These disclaimers of liability may be paired with sweeping indemnification

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the amount determined by the franchisor be ordinary and necessary expenses. In the view of the Project Group members, charging a duplicative fee was unreasonable and not a requirement made in good faith.

[55] A mental health clinic franchisor discloses the following in Item 6: "If your state, or any governmental body in your state, charges a tax on any fee you owe to us or to our affiliates, then you must pay an additional amount equal to this amount of tax."

[56] The Project Group has encountered franchisors that require the *franchisee* to pay the cost of registering the franchisor's FDD in the state as a condition for renewing the franchise agreement, or that require the franchisee to cover the cost of the franchise broker's commission in connection with the sale.

[57] Typically, franchisees pay marketing fees into a national marketing fund for the purpose of promoting the brand, which may ultimately benefit the franchisee. The Project Group notes, however, that some portions of these fees are typically used to support the franchisor's operations, such as employee overhead associated with administering the marketing fund. In one instance, a pizza franchisor disclosed that during the most recent fiscal year (2020), 95 percent of the Brand Fund was spent on "administrative costs."

[58] Project Group members reviewed an FDD where a clinical franchisor included the following disclaimer of liability in its franchise agreement:

> Franchisee hereby releases Franchisor, any owners of a direct or indirect interest in Franchisor, all employees of Franchisor, its affiliated companies, and all agents of Franchisor from liability based on any such warranties, guarantees, representations, or agreements to the extent permitted by law.
>
> Franchisor shall not be liable to the Franchisor for, nor shall the Franchisee's obligations hereunder be affected by, any loss, claim, liability, cost, damage, or expense of any kind caused or alleged to be caused, directly or indirectly, by the System, or any Services, or by the inadequacy of the System for any purpose, or by any defect in, the use or maintenance of, any repairs, servicing or adjustments of, or any interruption or loss of service of or use of, the System, or any loss of business, profits, consequential or other damage of any nature.

In the view of the Project Group, sweeping provisions like these are beyond what is necessary to safeguard the franchisor against legal actions that arise through no fault of the franchisor and violate the anti-waiver provisions of state franchise laws.

provisions that require franchisees to pay for damages incurred by the franchisor, even when the franchisor may be at fault. The Project Group has observed janitorial franchisors who require indemnification for claims related to the franchisee being determined to be an employee of the franchisor – even if this determination is solely due to the arrangement created by the franchisor.[59] In extreme instances, Project Group members have observed *counsel* for the franchisor attempting to insulate themselves from liability and require indemnification from the franchisee.[60] Unlike ongoing fees and expenses associated with operating the business, these limitations of liability and indemnification provisions can be material and difficult to predict.

## Topic #6: Language Barriers

With respect to language barriers, as international and domestic franchisors seek to attract and recruit diverse communities of prospective franchisees, the Project Group has encountered non-English advertising for a range of offerings. In these instances, the FDD has been prepared in English, however, it is unclear whether franchisors offer translated versions of the FDD in the language used in advertising materials. In at least one instance, a janitorial franchisor required franchisees to acknowledge that the meetings between the franchisor and franchisee were conducted in Spanish, but that all of the documents and other communications are in English, and that it is the responsibility of the franchisee to fully understand the contents of the FDD. This acknowledgement was the only portion of the FDD that was presented in Spanish. In the experience of the Project Group, in the limited instances in which the franchisor *has* expressly

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59 In one janitorial subfranchise offering, members of the Project Group objected to a requirement that unit franchisees indemnify the subfranchisor or the master franchisor if these entities were required to pay any amounts on behalf of the franchisee – including claims related to the franchisee being determined to be an employee of the subfranchisor by any federal or state agency. In particular, the subfranchisor required indemnification for all actions, judgments, damages, liabilities, claims, losses, costs, and expenses "to which [the franchisor or master franchisor] becomes subject, or that either incurs, arising from or relating in any manner to [the franchisee's] ownership or operation of [the franchisee's franchise]." Members of the Project Group noted that the broad reach of this indemnification provision would cover circumstances in which the franchisor or master franchisor was at fault – even circumstances in which the franchisee was determined to be an employee solely due to the arrangement created by the franchisor or master franchisor, particularly under employment tests that focus on the conduct of the putative employer.

60 The provision at issue stated the following:

> **Indemnification of Document Preparer**. Franchisor represents and Franchisee acknowledges that all representations of facts made by Franchisor contained in this Agreement and Franchisor's Uniform Franchise Disclosure Document are made solely by Franchisor based on its knowledge and reasonable belief and its independent investigation. All documents, including this Agreement, the exhibits attached hereto and the Uniform Franchise Disclosure Document and the exhibits attached thereto, have been prepared solely in reliance upon representations made and information provided on behalf of Franchisor by its duly authorized officers, agents and representatives. Franchisee further agrees to indemnify and hold harmless the preparer of any and all such documents referenced herein from any and all loss, costs (including court costs), expenses (including attorneys' fees), damages and liabilities resulting from any representation(s) and/or claim(s) made by Franchisor in such documents.

offered a translation, the prospective franchisee must bear the cost.[61] The Project Group has also noted instances in which the original franchise agreement has been translated into English, but the franchise agreement states that the non-English version controls in the event of a conflict. These instances may create a mismatch between what a franchisee is being told and how the franchise relationship is actually governed.

While the Project Group acknowledges the importance of reaching diverse communities using a variety of languages, our ultimate concern is that prospective franchisees may not receive – and may not be able to comprehend – all material information regarding the franchise business. There are documented instances in which franchisors have failed to meaningfully disclose material facts to prospective franchisees who did not have the necessary English language skills to understand information provided in writing.[62] Accordingly, the Project Group supports any efforts by the Commission to ensure that any discrepancies between the language in which an opportunity is marketed and the language in which the offering documents are prepared do not deprive prospective franchisees of the ability to comprehend all material information regarding the franchise opportunity.[63]

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[61] A Mexican restaurant franchisor states in its FDD, "The Brand Standards Manual may be in Spanish or English. If you choose to translate into another language any materials that we furnish to you, you are solely responsible for the cost and accuracy of the translations and, upon request, shall provide us with a copy of all translated materials without charge." These costs may dissuade franchisees from seeking a copy of governing documents in their native language.

[62] In a lawsuit brought by the Attorney General of Washington against a janitorial franchisor alleging violations of franchise and consumer protection laws, the Attorney General referenced a prior Consent Decree finding that this franchisor had made misrepresentations to franchisees about how much money they would earn under the franchise agreement, among other things, and failed to meaningfully disclose material facts to prospective franchisees who did not have the necessary English language skills to understand information provided in writing. In the current lawsuit, the Attorney General alleged that the franchisor took advantage of immigrants with limited English proficiency and promised them the independence of business ownership. In reality, the franchisor locked its franchisees into contracts that often left them earning less than minimum wage, paying exorbitant fees, and with little ability to advocate for themselves. *See* Complaint, *State of Washington v. National Maintenance Contractors, LLC*, 2021 WL 3886833 (W.D. Wash. Aug. 31, 2021) (No. 2:21-CV-638-BJR), https://agportal-s3bucket.s3.amazonaws.com/uploadedfiles/Another/News/Press_Releases/2021_04_06Complaint.pdf.

[63] The Project Group notes that the Commission's Business Opportunity Rule requires that sellers who conduct the offer for sale, sale, or promotion of a business opportunity in languages other than English to provide translations. *See* 16 C.F.R. § 437.5.

## Conclusion

We reemphasize our appreciation for the opportunity to participate in this RFI. The provisions discussed above are only a sample of those relevant to the Commission's inquiry. We are eager to discuss these issues further and to collaborate on improving fairness and opportunity for small business owners. Should you have any questions about this letter, please feel free to contact either the undersigned (theresa.leets@dfpi.ca.gov) or NASAA's General Counsel, Vince Martinez (vmartinez@nasaa.org).

Very Truly Yours,

Theresa Leets

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