Petition for Investigation of the Franchise Industry

Submitted by:

Service Employees International Union

The Service Employees International Union (the “petitioner”) hereby petitions the Federal Trade Commission (“FTC”) to investigate the franchise industry to determine the existence and extent of abusive and predatory practices by franchisors toward franchisees. The petitioner requests that the FTC issue an order pursuant to FTC Act section 6(b) to no fewer than nine leading franchise companies compelling the production of information about those companies’ relationships with their franchisees. Upon completion of the FTC’s investigation, the petitioner requests that the FTC issue a report detailing the extent of abusive franchisor practices and recommending ways to curb these practices in the future.

This petition describes the franchisor practices that the petitioner believes are most harmful to franchisees and most endemic to the relationship. They are: (1) incomplete or misleading financial performance representations made to prospective franchisees by franchisors; (2) significant capital investments required by franchisees during the course of the franchise agreement or as a condition of renewal; (3) retaliation against franchisees that join franchisee associations; (4) unfair termination or nonrenewal of franchise agreements; and (5) arbitrary denial of franchisees’ requests to transfer the business.

Section I of the petition describes the petitioner. Section II describes the profound imbalance of power in the franchise relationship and how the one-sided franchise agreement frequently capitalizes on this imbalance. Section III explains each of the predatory franchisor practices listed above, providing examples of franchisors that engaged in these practices, and explains how these practices harm franchisees. Some of the practices appear to violate the Commission’s existing Franchise Rule, while others appear to violate section 5’s prohibition against unfair and deceptive practices. Section IV requests that the FTC, pursuant to section 6(b) of the FTC Act, undertake an investigation of abusive practices in the franchise industry and issue recommendations on how to prevent these abuses in the future.

I. Petitioner

The Service Employees International Union (“SEIU”) is an organization of more than two million members and is a leading advocate for working people.

II. The franchise relationship is characterized by a dramatic imbalance of power.

Franchised businesses represent a large and growing segment of the nation's businesses, making up almost 11 percent of businesses with employees,[1] employing an estimated 9.1 million people,[2] and consistently adding jobs faster than non-franchised businesses in recent years.[3] Yet, unlike traditional small businesses, most franchises reflect a profound imbalance of contractual power that favors the franchisor and places franchisees in a financially precarious situation.

Companies that market and sell franchises are professional operations with access to legal advice, finance professionals, and – in most cases – capital markets. In contrast, prospective franchisees are often unsophisticated parties that lack bargaining power and have invested their life savings in the franchise, which makes them susceptible to predatory practices by franchisors.[4] The lack of business sophistication is documented in a March 2015 survey of 1,122 franchisees nationwide conducted by FranchiseGrade.com, Inc., a leading provider of competitive market research and objective analysis for the franchise industry.[5] The poll was commissioned by Change to Win, a federation of labor unions that includes petitioning organization SEIU. According to the survey, 63 percent of franchisee respondents had never owned any type of business before investing in their current franchise system.[6] Further, 69 percent of franchisee respondents had no

[1] U.S. Census Bureau, *Census Bureau's First Release of Comprehensive Franchise Data Shows Franchises Make Up More Than 10 Percent of Employer Businesses*, Sept. 20, 2010, http://www.census.gov/newsroom/releases/archives/economic_census/cb10-141.html.

[2] PricewaterhouseCoopers LLP, *The Economic Impact of Franchised Business: Volume III, Results for 2007*, Feb. 7, 2011, http://www.buildingopportunity.com/download/Part1.pdf.

[3] Int'l Franchise Assoc., Franchise Industry Continues to Grow, http://franchiseeconomy.com/franchise-industry-continues-to-grow/ (last visited May 4, 2015).

[4] Franchisees are much more similar to consumers than sophisticated business operators and are thus deserving of a level of regulatory attention commensurate to that afforded consumers. For example, the FTC bars lenders from including various unfair credit practices in their contracts; bars certain funeral contract terms; and mandates a cooling off period in consumer contracts with door-to-door salespeople, among other protections.

[5] FranchiseGrade.com, *National Survey of Franchisees 2015*, enclosed as Appendix 3.

[6] *Id.* at 9.

management experience in the industry or sector in which their franchise system operates.[7]

This survey supports the findings of prior academic studies that revealed similar levels of franchisee inexperience and lack of resources. These academic studies paint a picture of an industry in which one party operates with significant disadvantages:

- Most franchisees have never owned a business. One study found that only 20 percent of franchisees had been business owners prior to their purchase of a franchise.[8]
- The majority of franchisees have never even worked in the same line of business as their franchise. One study found that 70 percent of franchisees "purchased franchises in business sectors in which they had no specific work experience."[9] Another study found that 62 percent of franchisees had not worked in the same business as their franchise.[10]
- Many franchisees do not consult with an attorney before signing a franchise agreement:
  - A 2014 survey of franchisor attorneys found that a barely one-fourth (26 percent) of franchisees were represented by an attorney at the signing of their franchise agreement. Furthermore, the franchisor attorneys commented that, when franchisees did have attorneys, they were often general practitioners rather than specialists in franchising.[11]
  - A survey of over 300 franchisees in several industries found that most did not consult an attorney before signing. The same survey also found that most

[7] *Id.* at 10.

[8] Kimberly A. Morrison, *An Empirical Test of a Model of Franchisee Job Satisfaction*, 34 J. SMALL BUS. MGMT. 27, 30 (1996).

[9] Patrick J. Kaufmann, *Franchising and the Choice of Self-Employment,* 14 J. BUS. VENTURING 345, 358 (1999).

[10] Robert L. Anderson et al., *Are Franchisees 'Real' Entrepreneurs?*, 4 J. BUS. & ENTREPRENEURSHIP 97, 100-101 (1992).

[11] Robert W. Emerson, *Fortune Favors the Franchisor: Survey and Analysis of the Franchisee's Decision Whether To Hire Counsel*, 51 SAN DIEGO L. REV. 709, 718-719 (2014).

> franchisees did not review the Uniform Franchise Offering Circular, the predecessor to the FDD, before investing in a franchise.[12]

Once they purchase a franchise business, franchisees typically remain small businesses. According to nationally-recognized franchising data sources FranDATA and Franchise Business Review, 81 percent of franchisees own only one unit, and the median income of franchisees is $50,000-$75,000 a year.[13] According to the March 2015 survey of franchisees, 41% of respondents indicated a combined salary and profit of less than $25,000.[14] Franchisors, by contrast, are often large corporations with resources dwarfing that of prospective franchisees. The top 25 franchise systems, by unit count, account for 21 percent of all franchised units in the country[15] and take in a combined $52 billion in revenue.[16]

Moreover, some franchisors specifically market to unsophisticated investors, such as the unemployed, retirees, or immigrants.[17] As Stephen Caldeira, who heads the International Franchise Association, a franchisor-dominated trade group, stated, "For those Americans dealing with long-term unemployment or a lack of growth opportunities in their current jobs, franchise ownership offers a viable way to be in business for yourself, but not by yourself."[18]

Some franchise systems advertise the lack of sophistication required of potential investors. A search of a leading franchise advertising site, FranchiseGator.com, turned up numerous advertisements with language aimed at inexperienced potential entrepreneurs, including these:

[12] Morrison, *supra* note 8, at 30-31.

[13] Elizabeth Garone, *The New Face of Franchisees*, WALL ST. J., Aug. 19, 2013, *available at* http://online.wsj.com/news/articles/SB10001424127887324021104578553580349491440.

[14] Appendix 3, *supra* note 5, at 26.

[15] PricewaterhouseCoopers LLP, *supra* note 2, at I-20-21.

[16] The revenue data was compiled from each company's FDD and SEC Form 10-K or business publication estimates if there were no SEC filings.

[17] Angus Loten, *Franchises Target Immigrants as Buyers*, WALL ST. J., Feb. 3, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702303465004579324104108839042; Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship,* 109 PENN STATE L. REV. 105, 153 (2004).

[18] Matthew Haller & Jenna Weisbord, *December Jobs Report Mirrors Growth Sectors for Franchising in 2013*, Int'l Franchise Assoc., Jan. 4, 2013, http://www.franchise.org/december-jobs-report-mirrors-growth-sectors-for-franchising-in-2013.

- "There's no cooking or frying involved and no experience necessary,"[19] claimed an ad seeking franchisees for the shrinking[20] Blimpie sandwich chain.
- "No experience necessary — we provide full training . . . You do not need to be a CPA, or possess prior tax industry experience to be considered for a Jackson Hewitt franchise."[21]
- "**No experience is needed!** . . . HouseMaster provides you with a turnkey system that is sustainable and scalable, allowing you to grow your business quickly,"[22] claimed an advertisement for a home inspection franchise.

The lack of sophistication is particularly problematic when one considers the complex and lengthy disclosures made to prospective franchisees so that they can ostensibly gauge the financial and other risks associated with purchasing the franchise. The franchise disclosure document ("FDD"), which the Franchise Rule requires franchisors to provide to prospective franchisees at least 14 calendar days before signing the agreement, is the primary source of information about the risks and rewards of purchasing a particular franchise. FDDs contain hundreds of pages of financial and legal information about the franchisor as well as the parties' respective obligations. They are dense and technical documents, making thorough review and understanding difficult for unsophisticated investors, such as the typical franchisee.[23] Crucially, *not* included in the FDD is the franchisor's full operations manual that often lays out in minute detail mandatory operating procedures whose violation can cost franchisees their businesses. The FTC requires franchisors to include only the table of contents of their operating manuals even though franchisors often incorporate their entire manuals by reference in their franchise agreements.[24]

[19] FranchiseGator.com, Blimpie web ad, http://www.franchisegator.com/blimpie-franchise/ (last visited Apr. 29, 2015).
[20] Outlook, 24 RESTAURANT FINANCE MONITOR 9, 6-8, Sept. 18, 2013, http://web.tmcapital.com/tmc/news/RFM_TM_Capital_Advises_Goldco_on_Acquisition.pdf.
[21] FranchiseGator.com, Jackson-Hewitt Tax Service web ad, http://www.franchisegator.com/jackson-hewitt-tax-service-franchise/ (last visited Apr. 29, 2015).
[22] FranchiseGator.com, HouseMaster Home Inspection web ad, http://www.franchisegator.com/housemaster-home-inspection-franchise/ (last visited Apr. 29, 2015).
[23] The typical franchise disclosure document is massive, averaging nearly 500 pages for the set of 14 leading franchise systems reviewed during petitioner's contract analysis.
[24] 16 C.F.R. § 436.5(k)(6) (2007).

Even more troubling is that franchisors often reserve the right to unilaterally change the terms of the operating manuals during the term of the franchise, effectively requiring prospective franchisees to agree to terms they have not seen and that may change at any time. The March 2015 survey of franchisees found that 75 percent had experienced changes in manuals or procedures that increased their operating costs without an offsetting revenue increase.[25] Thus, even if prospective franchisees conduct a thorough review of multiple FDDs, it would be of limited use because the FDDs fail to include the full terms of the franchise.

The profound imbalance in bargaining power is reflected in the terms of franchise contracts, which are drafted to give franchisors the advantage. According to one franchisor advisory firm, franchise agreements are understood by franchising lawyers to be similar to adhesion contracts.[26] A franchisee consultant website emphasizes that franchisors usually state that they have a "rigid" franchise agreement and are "not open to negotiating."[27]

The petitioner reviewed the FDDs, including the franchise agreements, of the top ten business format franchisors by unit count. To ensure representation of significantly franchised industries not represented in the top ten, the petitioner also reviewed the FDDs for any franchise systems that did not make the top ten but were either first or second in unit count among the five sectors where franchised units make the largest contribution to employment, according to the International Franchise Association. This resulted in a set of 14 franchise systems[28] with a total of over 94,000 franchised units, representing nearly

[25] Appendix 3, *supra* note 5, at 21.

[26] MSAWorldwide.com, Negotiating Franchise Agreements – Are the Terms Fixed in Stone?, http://www.msaworldwide.com/Negotiating-agreements.pdf (last visited May 4, 2015).

[27] FranchiseHelp.com, What To Negotiate in the Franchise Agreement, Oct. 15, 2011, https://www.franchisehelp.com/blog/what-to-negotiate-in-the-franchise-agreement/ (last visited May 4, 2015).

[28] These criteria resulted in the inclusion of the following 14 franchise systems in the analysis: sandwich chain Subway, hamburger chains McDonald's and Burger King, fitness franchisor Jazzercise, coffee-snack chain Dunkin' Donuts, convenience store franchisor 7-Eleven, pizza chain Pizza Hut, tax preparation franchisor Jackson Hewitt Tax Service, financial services provider Ameriprise Financial Services, Mexican style fast food chain Taco Bell, salon franchisor Great Clips, hotel chains Holiday Inn and Comfort Inn, and casual dining chain Applebee's Neighborhood Grill & Bar. *See* Appendix 1.

14 percent of the franchised units in the country.[29] The contract analysis revealed that the contracts are strikingly similar and one-sided; all of them grant franchisors broad termination rights while affording franchisees few to no rights to renew or sell their franchise. Key results of the review are summarized and tabulated below.

[29] The 14 systems reviewed had 94,293 franchised units, according to their 2014 franchise disclosure documents. This works out to 13.9 percent of the country's 679,945 franchisee-owned business-format franchise units. *See* PricewaterhouseCoopers LLP, *supra* note 2, at I-20.

Summary of key contract provisions, 14 leading franchise systems

				Franchisor may terminate for:			Renewal restrictions:			Transfer/sale restrictions:				
Franchisor	**Some post-termination/ expiration noncompete provisions**	**Unrestricted right to inspect franchisee premises**	**Franchisor can unilaterally change manual/ procedures**	***Any* violation cause for termination ?**	**Failure to meet franchisor operating standards/ manuals/ procedures**	**Disparagement / behavior reflecting badly on franchisor**	**No renewal rights at all?**	**Renewal may be materially diff from current contract?**	**General release of franchisor required for renewal**	**Broad franchisor discretion to deny transfers/ sales**	**General release of franchisor required for transfer**	**Current franchisee violations can bar transfer**	**Remodel required for transfer**	**Franchisee retains some liability after transfer**
7-Eleven	x	x	x	x	x	x		x	x	x	x	x		
Ameriprise Financial Services	x	x	x	x	x	x		x		x	x	x		
Applebee's Neighborhood Grill & Bar		x	x	x	x	x		x		x	x			
Burger King	x	x	x	x	x			x	x	x	x			x
Comfort Inn		x	x	x	x	x	x							
Dunkin' Donuts	x	x	x	x	x	x		x	x		x	x		
Great Clips	x	x	x	x	x	x		x	x		x		x	
Holiday Inn		x	x	x	x	x	x			x		x		
Jackson Hewitt Tax Service	x	x	x	x	x	x		x	x		x	x		
Jazzercise	x	x	x	x	x	x		x	x	x	x	x	x	
McDonald's	x	x	x	x	x	x	x			x		x		x
Pizza Hut	x	x	x	x	x	x	x			x	x	x		
Subway	x	x	x	x	x	x		x			x	x		
Taco Bell	x	x	x	x	x	x	x				x	x	x	

Source: Franchise Disclosure Documents, 2014

The contract analysis buttresses the findings of a 2002 study of 10 randomly selected franchise agreements, which found “a substantial degree of uniformity” among the contracts. The author of that study concluded: “Most agreements include the same or similar versions of nearly all of the forty-seven provisions under review. Franchisor obligations are few and sharply circumscribed. . . . In contrast to the limited, carefully qualified obligations of the franchisor, franchisee obligations are many and often unqualified. . . . Moreover, many provisions under review are designed to deprive franchisees of legal rights and remedies that they would otherwise have.”[30] As discussed in detail in the next section, these one-sided contracts effectively sanction several predatory and abusive practices by franchisors.

III. Franchisors engage in abusive, deceptive, or misleading practices in their contractual relationships with franchisees.

Enabled by their one-sided contracts, franchisors have engaged in unfair and predatory practices towards their franchisees. This section analyzes the prevalence of certain contract provisions tilted toward franchisors and details harmful practices – incomplete or misleading financial performance representations, unreasonable capital expenditure requirements, retaliation against members of franchisee organizations, arbitrary or pretextual terminations, arbitrary or pretextual nonrenewals, and onerous or arbitrary restrictions on transfer rights – and how they enrich the franchisor companies at the expense of small business owners. As the evidence collected by the petitioner shows, franchisees report these abusive practices occur with alarming frequency and in many sectors of the franchise industry.

A. Misleading Financial Performance Information

The Franchise Rule does not require franchisors to provide information to potential franchisees concerning the financial performance of franchised or company-owned outlets. If the franchisor chooses not to provide such information, termed financial performance representations” (“FPRs”), it must state in Item 19 of the FDD that it makes no “representations about a franchisee’s future financial performance or the past financial performance of company-owned or franchised outlets” and does “not authorize our employees or representatives to make

[30] Peter Lagarias, *Franchising in California: Uniformity in California Franchise Agreements*, 21 FRANCHISE L.J. 136, 139 (Winter 2002).

any such representations either orally or in writing."[31] If the franchisor chooses to make a financial performance representation, the representation must be included in Item 19 of the FDD, and the franchisor must disclose whether the representation is "an historic financial performance representation about the franchise system's existing outlets, or a sublet of those outlets, or is a forecast of the prospective franchisee's future financial performance."[32] The franchisor must also have a "reasonable basis" for the representation and "written substantiation for the representation at the time the representation is made . . ."[33]

Despite collecting financial performance data from franchisees, most of the 14 leading franchise systems reviewed by petitioner provide inadequate financial performance information to prospective franchisees – or none at all:[34]

- Three franchisors provide no financial performance data at all,[35] and an additional seven franchisors provide no information on franchisee expenses, even though many disclose sales data for franchised stores or expense data for company stores only.[36] Thus, 10 of the 14 provide no direct gauge of franchisee profitability.
- For the remaining four systems that provide some franchisee expense data[37] the disclosure varies in quality. McDonald's, for example, provides no data on two major expenses: rent (which McDonald's controls as the landlord for virtually all franchised stores) and royalties (also clearly under McDonald's control), even though typical franchisees pay McDonald's 14.5 percent of their revenues in royalties and rent.[38] By failing to disclose these franchisee costs, McDonald's makes it impossible for prospective franchisees to determine the average franchisee's actual profit and to assess the potential performance of their investment.

[31] 14 C.F.R. § 436.5(s) (2).
[32] 14 C.F.R. § 436.5(s)(3)(i).
[33] 14 C.F.R. § 436.5(s)(3).
[34] The financial performance representations for each of the 14 franchise systems were taken from Item 19 of the respective systems' 2014 FDDs.
[35] The three are Subway, Jackson Hewitt and Jazzercise.
[36] The seven are Ameriprise, Applebee's, Burger King**,** Comfort Inn, Holiday Inn, Pizza Hut and Taco Bell. Of these seven, two systems, Pizza Hut, the country's largest pizza chain and Taco Bell, the biggest Mexican-style restaurant chain in the US – provide sales and expense data for company owned stores only, with no financial information at all on franchised stores. The remaining five systems provide sales data for franchised units but no expense information for franchised units.
[37] The four are 7-Eleven, Dunkin' Donuts, McDonald's and Great Clips.
[38] Mark Kalinowski, MCD: A "Typical" U.S. Franchised Restaurant's Annual Income Statement, Janney Capital Markets, Feb. 8, 2012 (on file with petitioner).

Despite refusing to disclose financial performance data to potential franchisees, franchisors often provide other parties, such as lenders requiring unit financial data to approve franchisees' loans, with detailed franchisee financial performance information. As the author of a law review article put it, "[o]ne of the ironies regarding FPRs is that even those franchisors that do not make FPR claims in their FDD must often create and distribute those exact same numbers to the financial institutions of prospective franchisees seeking financing to purchase the franchise."[39]

Some franchisors provide franchisee lenders with a "Bank Credit Report," which is compiled by franchise industry clearinghouse FranDATA and includes unit operating expenses, unit operating profit, owner compensation and break-even points among other performance metrics.[40] According to one franchisor, it is "easy to gather the data" for the report because "we currently also measure a lot of our franchise units with the metrics in-house. So we had all of this data available for them."[41] The report contains far more information on the profitability of a franchise system's units than is typically included in Item 19 of the FDD. According to FranDATA CEO Darrell Johnson, the report "puts weeks of franchise due diligence in the hands of banks who are not constrained by either the FTC or by FDD limitations, and this analysis of a brand's performance history gives a better prediction of their future performance."[42] Unfortunately, prospective franchisees do not have access to this information. "The report is never shown to franchisees or prospective franchisees. Lenders who access the report are asked to sign a Non-Disclosure Agreement, which prohibits them from showing the report to would-be borrowers."[43]

[39] Marvin E. Rooks, *It is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees,* 11 WAKE FOREST J. BUS. & INTELL. PROP. L. 55, 68 (2010).

[40] FranDATA. com, Franchise Financing PowerPoint presentation, slide 20, http://www.frandata.com/products/samples/Franchise_PPT_EdithWiseman_FRANdata.pdf (last visited May 7, 2015).

[41] Boefly.com, Exploring the Bank Credit Report (Webinar transcript), Mar. 5, 2012, http://www.boefly.com/blog/small-business-lending/exploring-the-bank-credit-report (last visited May 7, 2015).

[42] *Id.*

[43] Int'l Franchise Assoc., Understanding and Utilizing the SBA Financing Process, at 39, presented at Int'l Franchise Assoc. Legal Symposium, May 5-7, 2013, http://emarket.franchise.org/2013ls/Understanding%20and%20Utilizing%20the%20SBA%20Financing%20Process.PDF (last visited May 7, 2015).

Although the Franchise Rule prohibits making financial performance representations outside Item 19 of the FDD, a web search turned up numerous advertisements making financial claims. Examples include:

- An ad for carpet cleaning franchise Chem Dry has the heading "Make more Money." The ad highlights an average annual revenue figure of $263,779 and states, "The revenue means you can quickly recoup your initial investment of $40,000 to $139,500 (depending on the number of territories and equipment packages you purchase)."[44] While Chem Dry's FDD does, in fact, include the $263,779 revenue figure,[45] it explicitly states "this financial performance representation does not reflect other variable or fixed operating expenses, or other costs or expenses that must be deducted from the revenue figures to obtain your net income or profit."[46] In other words, there is no backing in the FDD for the ad's claim that franchisees can "quickly recoup" their investment.
- An ad for moving franchisor Two Men and a Truck states: "New locations are also growing faster than ever, with recently launched locations hitting one **million dollars** of revenue in their first year," and "New franchisees can join the largest local mover in the U.S. and generate on average approximately $450,000 their first year in annual sales. This revenue increases to approximately $900,000 by their fourth year. Plus, the average net profit per franchise unit is 12%."[47] (emphasis in original). Item 19 of the FDD, however, makes no mention of "recently launched locations hitting one million dollars of revenue." Furthermore, while Item 19 reports average first-year sales of $455,797, in line with the ad, it reports average first-year expenses of $418,905, for a net profit of $36,892, or a margin of just over 8 percent,[48] well below the advertised 12 percent margin.
- Driveway maintenance franchisor Jet Black simply claims: "Profits, from day 1."[49] The franchisor's Item 19 disclosure, however, reveals nothing about profits. It includes only gross

[44] FranchiseDirect.com, Chem-Dry Carpet Cleaning web advertisement, http://www.franchisedirect.com/cleaningfranchises/chem-dry-carpet-cleaning-franchise-07022/ (last visited May 7, 2015).
[45] Chem_Dry FDD (2014), Item 19, at 30.
[46] *Id.* at 32.
[47] FranchiseGator.com, Two Men and a Truck web advertisement, http://www.franchisegator.com/two-men-and-a-truck-franchise/ (last visited May 7, 2015).
[48] Two Men and a Truck FDD (2014), Item 19, at 53.
[49] FranchiseGator.com, Jet Black web advertisement, http://www.franchisegator.com/jet-black-franchise/ (last visited May 7, 2015).

> revenues and states, "The figures in the charts above do not reflect the cost of sales, operating expenses, or other costs or expenses that must be deducted from the Gross Revenues to obtain your gross profit, or net income or profit."[50]

In addition to advertising, 68 percent of franchisees in the March 2015 survey reported that before they joined their system a franchisor representative had made financial projections that were not included in the FDD, another clear violation of the Franchise Rule.[51]

An analysis of Small Business Administration data on loans to franchisees indicates that franchisees are put at serious risk by inadequate and misleading financial disclosure. The analysis of 64,191 loans to franchisees made from 1991 to 2010 through the SBA's largest lending vehicle, the 7(a) loan program, found:

- More than one out of every six SBA loans to franchisees made in the 20-year period, or 16.9 percent, had failed,[52] as of October 2014.[53]
- The failure rate has increased over time, from 12.7 percent in the first five-year period analyzed, 1991 to 1995, to 19.3 percent, nearly one failure for every five loans, in the most recent period, 2006 to 2010.[54] This represents a 52 percent increase in the failure rate over the period. Note that to exclude "unseasoned" loans – those made too recently to have failed – the report follows the methodology of the SBA Inspector General and excludes loans that originated after 2010.[55]
- The number of franchise systems with high failure rates – defined as over 20 percent – almost tripled over the 20-year period. For loans with origination dates in the 1991 to 1995 period, only 13.6 percent of systems had failure rates in excess of 20 percent, nearly one in seven systems. For loans originating in the 2006 to 2010 period, 35.9 percent of systems, or more than one in three, exceeded this benchmark.[56]

[50] Jet-Black Int'l FDD (2014), Item 19, at 36.

[51] Appendix 3, *supra* note 5 at 14.

[52] Service Employees International Union, *Risky Business: Franchisees' High and Rising Risk of SBA Loan Failure,* at 3, enclosed as Appendix 2. The report defines the failure rate as the share of loans charged off the SBA's books as a share of all loans made.

[53] *Id.* at 3.

[54] *Id.* at 4.

[55] *Id.* at 1.

[56] *Id.* at 5.

The results of this analysis—significant and worsening franchisee loan failure rates—reveal that franchisees are increasingly facing obstacles to success and that prospective franchisees could avoid bad investments through complete and accurate financial disclosures.

A published study comparing SBA loan data with FDD disclosures found that franchisees whose franchisors did not provide financial performance representations in Item 19 of their FDD were more likely to default on SBA loans than those whose franchisors included financial data in Item 19. Only 23 percent of franchise programs with an SBA franchisee default rate over 35 percent had made financial performance representations in Item 19. By contrast, of franchise programs with a 10 percent or lower franchisee default rate, 67 percent had made Item 19 FPRs.[57] Thus, the poorest-performing franchisors are less likely to provide financial performance data and, by extension, prospective franchisees are more likely to make unwise investment decisions.

In addition to studies cited above, numerous anecdotes demonstrate the disastrous consequences of inadequate financial performance disclosure and misleading advertising:

- Quiznos, a sandwich chain that spent part of 2014 in bankruptcy following several years of poor performance starting in the early 2000s, disclosed sales data in its FDD, but not expenses or profitability figures, and thus masked that most of its franchisees were struggling. In 2003, Quiznos was adding units faster than any other sandwich chain and had gone from #33 to #20 on the Nation's Restaurant News list of the top 100 restaurant chains by unit count in only two years.[58] Nonetheless, about 40 percent of Quiznos stores were not breaking even, according to a memo by a Quiznos attorney,[59] despite average gross sales per store that were near an all-time high. At the same time, Quiznos aggressively recruited new franchisees through Internet advertising, direct mail, radio, television, and in-store marketing.[60] Several franchisees alleged in lawsuits that Quiznos sales representatives made

[57] Marvin E. Rooks, *It is Time for the Federal Trade Commission to Require Financial Performance Representations to Prospective Franchisees*, 11 WAKE FOREST J. BUS. & INTELL. PROP. L. 55, 69 (2010).

[58] Alan J. Liddle, *Cash-Cow Chains Raise Growth Rate Amid Stress of Inflation*, NATION'S RESTAURANT NEWS, June 28, 2004; *Top 100 Chains Ranked by Latest-Year Total Number of U.S. Units*, NATION'S RESTAURANT NEWS, June 30, 2003; *Top 100 Chains Ranked by Latest-Year Total Number U.S. Units*, NATION'S RESTAURANT NEWS, June 28, 2004.

[59] Julie Creswell, *When Disillusion Sets In; Some Quiznos Franchisees Take Chain to Court*, NEW YORK TIMES, Feb. 24, 2007; *see also* Complaint ¶ 315, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).

[60] Complaint ¶¶ 296-307, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).

unsubstantiated claims about outlet costs and profitability, claiming, for example, that franchisees could earn margins ranging from 10 to 25 percent.[61]

- Cold Stone Creamery, an ice cream parlor chain, similarly hid financial distress from prospective franchisees through inadequate financial disclosures. In 2008, a Cold Stone franchisee sued the franchisor after filing for bankruptcy, claiming that Cold Stone had made exaggerated claims of profitability both in the Uniform Franchise Offering Circular and through a Cold Stone representative. The representative touted profit figures representing a margin of 19 to 24 percent, and the UFOC made revenue and profit claims based on data that excluded failed and terminated stores.[62] The franchisee settled the case. Around the same time, another Cold Stone franchisee sued, claiming that Cold Stone had promised a 25 to 30 percent profit margin despite the fact that Cold Stone had one of the highest SBA loan failure rates among all franchise systems.[63] Financial problems for Cold Stone franchisees persist; the failure rate for SBA-guaranteed loans to Cold Stone franchisees is almost 40 percent in the most recent five year period, according to the petitioner's analysis of SBA loan failure data**.**
- Shipping giant UPS bought Mail Boxes, Etc. ("MBE") in 2001, acquiring an instant retail presence at MBE's 4,300 stores across the country.[64] UPS decided to change the chain's model from offering several shipping services to a rebranded UPS Store offering only UPS. In a class-action lawsuit filed in 2003, the franchisees argued that, in order to persuade MBE franchisees to convert to the UPS Store model, UPS representatives promoted a study that purported to show that stores that fully converted to UPS Stores outperformed MBE and jointly-branded stores in revenue and net profit.[65] The franchisees claimed that of 3,500 stores in the MBE network, only 223 were selected to participate in the tests. Of that number,

[61] Second Amended Class Action Complaint ¶¶ 202-213, Siemer v. Quiznos Franchise Co., No.:1:07-cv-02170 (N.D. Ill. Sept. 18, 2009); *see also* Second Amended Complaint ¶ 93, Ballwin v. Quiznos Franchising LLC, No. 10-CV-3711 (Colo. Dist. Ct. Aug. 10, 2011); Complaint ¶ 328, Avengers, Inc. v. QFA Royalties, No. 1:13-cv-00248 (MSK) (D. Colo. Jan. 31, 2013).

[62] Second Amended Complaint ¶¶ 14, 30, Buraye v. Cold Stone Creamery, Inc., No: PC 043 905 (Cal. Sup. Ct. July 1, 2009).

[63] Second Amended Complaint ¶¶ 76-77, Tzamarot v. Cold Stone Creamery, Inc., No.: 09-24277 (RDD) (S.D.N.Y. Aug. 1, 2013).

[64] Amy Doan, *UPS Picks Up Mail Boxes Etc.*, FORBES, March 5, 2001, *available at* http://www.forbes.com/2001/03/05/0305ups.html.

[65] D.T. Woodard, Inc., v. Mail Boxes Etc., B228990, 2012 WL 90084, at *4 (Cal. Ct. App. Jan. 12, 2012) (reversing the trial court's summary judgment in favor of the franchisor).

only 25 percent of the stores submitted *any* type of profit data, and net profits, one of the key elements of the study, were actually not evaluated at all.[66] Nonetheless, UPS promoted the study to MBE franchisees, and 87 percent of them converted to the UPS Store.[67] By converting, the franchisees allege, they lost customers who preferred non-UPS services that MBE had formerly offered and made less per package on UPS shipments because UPS began setting maximum shipping prices.[68]

The evidence detailed above reveals that franchisors are violating the Franchise Rule by making FPRs outside of Item 19. Meaningful financial disclosure in Item 19 would assist prospective franchisees in gauging the financial risks of investing in a franchise and in assessing the accuracy of financial claims made in advertisements or through marketers.

B. Unreasonable Capital Expenditures

Franchisors often require franchisees to fund expensive renovations or equipment during the franchise agreement or as a condition of renewal. The Franchise Rule does not require disclosure of such outlays to prospective franchisees in the FDD. Indeed, of the 14 franchise systems reviewed by the petitioner, all but one of them allow the franchisor to impose capital expenditures on franchisees during the term of the agreement. Only one of these 13 includes any limits on or estimates of the costs of these investments, and that system, Jackson Hewitt, recently doubled the limit.[69]

The March 2015 survey indicates that franchisors do in fact typically keep franchisees in the dark about potential capital investments. Seventy percent of the franchisees said that, prior their purchase of the franchise, the franchisor had not provided a clear estimate of how much they would be required to spend on equipment, remodeling or other capital investments.[70] Fifty-eight percent of franchisees had been required to make major investments in equipment,

[66] Appellant’s Opening Brief at 12-13, D.T. Woodard, Inc., v. Mail Boxes Etc., B228990 (Cal. Ct. App. May 24, 2011).
[67] *Id.* at 7.
[68] *Id.* at 45.
[69] The only system with such limits or estimates is Jackson Hewitt, and it doubled the limit on renovation costs during the franchise term from $12,500 in the 2013 version of its franchise agreement to $25,000 in the 2014 version. *See* Jackson Hewitt Franchise Agreement ¶ 11.2 (2013); Jackson Hewitt Franchise Agreement ¶ 11.2 (2014).
[70] Appendix 3, *supra* note 5, at 14.

renovations, or other capital improvements. Of those, the largest share, 49 percent, did not believe that those required investments had improved their business results.[71]

The generally unlimited ability of franchisors to impose capital expenditure requirements can cost franchisees millions of dollars, as evidenced by recent developments in the fast food sector, where, for example, leading hamburger chains Wendy's, Burger King and McDonald's are all requiring major investments by franchisees:

- Wendy's is suing at least one major franchisee for allegedly flouting the company's requirement to "refurbish a minimum of 60% of their restaurants over the next six years, at a rate of 10% per year."[72] These renovations cost as much as $1.5 million to $1.9 million per store for a "scrape and rebuild," with a less-thorough remodeling option costing $450,000 to $650,000 per outlet.[73] For context, the average sales of a Wendy's restaurant are an estimated $1.4 million a year.[74] The lawsuit alleges that DavCo, a longtime franchisee with over 150 stores in Maryland, Virginia and Washington, D.C,[75] is violating the franchise agreement by refusing to install a point of sale computer platform and to renovate its restaurants on Wendy's time frame.[76] According to DavCo, in the four years since the introduction of Wendy's "Image Activation" remodeling program, there have been nine different design iterations because "the designs have consistently proven to be economically unfeasible."[77]

- Burger King announced its "20/20" design remodels in October 2009.[78] The average cost to "reimage" a restaurant is between $300,000 and $350,000,[79] which amounts to about one-quarter to one-half of a franchisee's estimated annual sales of $1.2 million.[80] The company fines franchisees thousands of dollars if they fail to complete renovations in the required time

[71] *Id.* at 17.

[72] Complaint ¶ 1, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014).

[73] The *Wendy's Company Q1 2014 Earnings Conference Call*, FAIR DISCLOSURE WIRE, May 8, 2014.

[74] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.

[75]Complaint ¶ 22, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014); *see also* Lorraine Mirabella, *Wendy's Sues Franchisee for Md., Va. and D.C.*, BALTIMORE SUN, Jan. 6, 2015.

[76] Complaint ¶¶ 13, 23, Wendy's Int'l v. DavCo Restaurants LLC, No. 14- CV-013382 (Ohio Ct., Franklin Co. Dec. 22, 2014).

[77] Jonathan Maze, *Wendy's Franchisee Files Counterclaim Over Remodels*, NATION'S RESTAURANT NEWS, Feb. 20, 2015, http://nrn.com/corporate-news/wendy-s-franchisee-files-counterclaim-over-remodels.

[78] Ashley M. Heher, *Burger King Revamp Aims for an 'Edgy, Futuristic' Restaurant Look*, USA TODAY, Oct. 7, 2009, http://usatoday30.usatoday.com/money/industries/food/2009-10-06-burger-king-revamp_N.htm.

[79] *Burger King Worldwide Inc. at Barclays Retail and Consumer Discretionary Conference*, FAIR DISCLOSURE WIRE, Apr. 30, 2014.

[80] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.

frame.[81] By December 2013, 30 percent of all U.S. locations had completed the 20/20 remodel.[82] The company aims to reach 40 percent by the end of 2015.[83]

- McDonald's has imposed a remodeling program with estimated costs of $400,000 to $700,000 per store[84] and a "McCafe" combined beverage platform, which has required both equipment purchases and physical alterations to restaurants.[85] In addition, McDonald's has announced the installation of new prep tables[86] and, most recently, plans to roll out a burger customization program in up to 2,000 U.S. stores in 2015[87] that will cost between $100,000 and $150,000 per store.[88] The average McDonald's posts sales of $2.5 million per year.[89]

McDonald's has faced criticism from its franchisees for its onerous renovation requirements. In *Darling v. McDonald's*, a California appeals court affirmed a jury finding that McDonald's management had forced Sandra Darling, the franchisee, to sell her stores by imposing onerous capital expenditure requirements on her, such as requiring $450,000 in unnecessary improvements to one restaurant, and that McDonald's did so in order to gain control of her profitable store and to retaliate against her for her criticism of McDonald's practices.[90] Other McDonald's franchisees have complained anonymously in the past year that McDonald's frequently imposes remodeling costs on franchisees that do not result in greater sales and that ultimately benefit McDonald's, the franchisees' landlord.[91]

[81] Burger King FDD (2014), at 34.

[82] Trefis Team, *Burger King Worldwide New Coverage: $29 Trefis Price Estimate*, FORBES, Apr. 16, 2014, *available at* http://www.forbes.com/sites/greatspeculations/2014/04/16/burger-king-worldwide-new-coverage-29-trefis-price-estimate/.

[83] Wagar Saif, *Will Things Keep Going Burger King's Way*, THE MOTLEY FOOL, May 5, 2014, http://www.fool.com/investing/general/2014/05/05/will-things-keep-going-burger-kings-way.aspx; Alicia Kelso, *Burger King's 'Fewer, More Impactful' Menu Launch Strategy Lifts Sales,* QSR WEB, Aug. 14, 2014, http://www.qsrweb.com/articles/burger-kings-fewer-more-impactful-menu-launch-strategy-lifts-sales/.

[84] Leah Goldman, *A Tour Inside McDonald's Big $550,000-Per-Store Renovations*, BUSINESS INSIDER, May 13, 2011, http://www.businessinsider.com/remodeled-mcdonalds-photos-2011-5; Melissa Harris, *The Man Behind McDonald's New Look,"* CHICAGO TRIBUNE, May 16, 2010.

[85] In an investor call, then-CEO Don Thompson noted that the combined beverage platform required tearing out walls and resetting plumbing. *McDonald's Corp. Investor Meeting Transcript*, FAIR DISCLOSURE WIRE, Dec. 10, 2014.

[86] *McDonald's Corp. Analyst Meeting (Afternoon Session) Transcript*, FAIR DISCLOSURE WIRE, Nov. 14, 2013.

[87] *McDonald's Corp. Earnings Call Transcript*, FAIR DISCLOSURE WIRE, Jan. 23, 2015.

[88] *McDonald's Corp. at UBS Global Consumer Conference*, FAIR DISCLOSURE WIRE, Mar. 5, 2015.

[89] *2014 Top 100: Estimated Sales Per Unit*, NATION'S RESTAURANT NEWS, June 30, 2014.

[90] Darling v. McDonald's Corp., No. B171904, 2006 WL 164986 (Cal. App. 2006).

[91] Mark Kalinowski, MCD: Franchisee Survey Leads to Street-Low June U.S. Comp Estimate, Janney Capital Markets, July 16, 2014, at 5-11 (on file with petitioner).

Expensive capital investment requirements, coupled with broad nonrenewal and termination rights, mean that franchisees feel pressure to expend significant sums on remodeling or equipment just so they can continue to operate their businesses.

C. Retaliation against Members of Franchisee Associations

Independent franchisee associations provide a forum for discussing franchise-related problems, raising them collectively with the franchisor and protecting franchisees from the harmful practices outlined in this complaint. Despite such benefits, only an estimated 7 percent of franchise systems actually have an independent franchisee association, according to a franchisee news website.[92] This low number is unsurprising given the prevalence of franchisor hostility towards associations and franchisor retaliation against franchisees they perceive as challenging their authority. The March 2015 poll of franchisees found that 46 percent of franchisees had experienced at least one of the following: Being told by their franchisor that there could be negative consequences to participating in a franchisee association; being told by the franchisor there could be negative consequences for speaking out about problems within the system; or experiencing increased inspections or evaluations of their business after raising questions or speaking out about problems in the system.[93]

Several franchisees have alleged that they were terminated or not renewed in retaliation for their criticism of the franchisor's practices or their connection with a franchisee association.

- A former 7-Eleven executive attested in several lawsuits that the franchisor terminated "pain in the ass" franchisees and franchisee association leaders, many of whom were critical of the company's practices.[94]
- In 2006, Quiznos terminated eight franchisees active in an independent Quiznos franchisee association after the group posted on its website the suicide letter of a former California Quiznos franchisee who had killed himself after 18 months of litigation with Quiznos.[95]

[92] Don Sniegowski, *Top Winners All Have Independent Franchisee Associations*, BLUE MAU MAU, Jan. 28, 2011, http://www.bluemaumau.org/node/9912/talk#comment-108585.

[93] Appendix 3, *supra* note 5, at 22.

[94] Letter from Gerald A. Marks re Scheduling Order Exhibit 2, ¶¶ 45-47, 7-Eleven, Inc. v. Sodhi, No. 3:13-cv-03715-MAS-JS (D.N.J. May 6, 2014).

[95] Complaint at ¶¶32-33, Bray v. QFA Royalties, No: 1:06-cv-02528-JLK (D. Colo. Dec. 15, 2006).

Quiznos had terminated the California franchisee a month after he formed his own franchisee association.[96]

- McDonald's franchisees have stated that the chain refused to renew their franchises in retaliation for organizing with other franchisees[97] or criticizing the company.[98]

Fear of franchisor reprisal limits the ability of franchisees to build a counterweight to franchisors' power. As one 7-Eleven franchisee leader contends, "If we speak up, we risk retaliation. Right now, there are long-time 7-Eleven franchise owners—some owning stores for more than 40 years—being pushed out of their businesses."[99] A Maine Dunkin' Donuts franchisee concurred in testimony supporting a bill that would have protected franchisee free association rights: "[M]y father is currently the 2nd oldest Dunkin' Donut Franchisee in the system. He is very unsure about me coming here today. He is very concerned that if this bill does not pass we are all in jeopardy, and could face reprisals from our franchisor for speaking out. . . . We find it very disturbing at how easily our business can be taken away from us after more than 35 years of hard work and loyalty."[100]

D. Unfair Terminations

The terms of most franchise agreements allow unilateral terminations by the franchisor, and the effects of termination can be devastating for franchisees. According to the March 2015 survey, 76 percent of franchisees polled pledged their home, retirement savings or other personal assets as collateral for the loans they took out to buy their franchise.[101] Upon termination, franchisees may be able to sell certain tangible assets of the franchise back to the franchisor, but typically, franchisees lose the bulk of the value of their investment and may default on debt taken on to finance the business.

[96] Timothy Noah, *Disenfranchised: Why Are Americans Still Buying Into the Franchise Dream*?, PACIFIC STANDARD, Mar. 4, 2014, *available at* http://www.psmag.com/navigation/business-economics/disenfranchised-fast-food-workers-quiznos-73967/.

[97] Kathryn Carter, *Leveling the Playing Field With the Likes of McDonald's*, THE LEFT HOOK, July 11, 2014. http://thelefthook.com/2014/07/11/leveling-the-playing-field-with-the-likes-of-mcdonalds/.

[98] First Amended Complaint ¶¶14, 28, Garrett v. McDonald's Corp., No. 4:05-cv-4 (FRZ) (D. Ariz. May 10, 2006).

[99] Jaspreet Dhillon, *Changes Urged in the Franchise System,* CAPITOL WEEKLY, July 17, 2014, http://capitolweekly.net/franchise-owners-rights-sb610/.

[100] Normand Boulay, Jr., Testimony before the Labor, Commerce, Research and Economic Development Committee of the Maine State Legislature, May 8, 2013 (on file with petitioner).

[101] Appendix 3, *supra* note 5, at 16.

All 14 franchise agreements in the petitioner's contract analysis contain a group of provisions that taken together allow the franchisor to terminate franchisees virtually at will. Specifically, all 14 contracts contain a catchall provision that essentially allows the franchisor to terminate the franchisee for any violation of the franchise agreement,[102] as well as a provision requiring compliance with operating manuals, policies and procedures that franchisees may have not seen prior to investing and that franchisors may modify, update or change unilaterally during the term of the agreement.[103] These rights, combined with the unrestricted right to inspect franchisee premises – usually unannounced[104] – effectively allow all 14 franchisors to terminate franchisees at will.

In addition to this set of "termination at will" provisions, franchisors in the set of 14 commonly enumerate other causes of termination that are broad. For example, all the systems except Burger King include language barring disparagement of the franchisor or franchisee conduct that reflects badly on the franchisor and the franchisor's brand.[105] Jackson Hewitt, for example, can terminate franchisees who "commit any act within or without the Franchised Business that would tend, in our judgment to reflect poorly on the goodwill of our name or any

[102] *See* Appendix 1, Part A. Although most of the agreements require notice before termination, some of the agreements require only one breach and failure to cure before the franchisor can terminate. For example, Dunkin' Donuts franchise agreement simply states "if you fail to timely cure any default that may be cured, we may terminate this Agreement." Dunkin' Donuts Franchise Agreement ¶14.6 (2014). Similarly, Fitness franchisor Jazzercise specifies that it may terminate franchisees if they fail to cure "noncompliance with any requirement in this Agreement not listed in Subsection B above within thirty (30) days after notice thereof is delivered to Franchisee." Jazzercise Class Owner Franchise Agreement ¶13.C (1) (2014). Taco Bell's franchise agreement allows it to terminate "at any time" not only the franchise for the location that it finds in default but "any other such franchise agreement" in cases of default that continue for 30 days after written notice from the franchisor. Taco Bell Franchise Agreement ¶15.0 (2014).

[103] McDonald's, for example, requires franchisees "to promptly adopt and use exclusively the formulas, methods, and policies contained in the business manuals, now and as they may be modified from time to time" and specifies that, "[s]uch manuals, as modified from time to time, and the policies contained therein, are incorporated in this Franchise by reference." McDonald's Franchise Agreement ¶4 (2014).

[104] Nine of the 14 systems explicitly state that inspections may be unannounced/without notice – Ameriprise, Applebee's, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt, Jazzercise, Taco Bell and Subway**.** *See* Appendix 1, Part A, Section 4. For example, Burger King "shall have the unrestricted right to enter the Franchised Restaurant to conduct such activities as it deems necessary to ascertain Franchisee's compliance with this Agreement. The inspections may be conducted without prior notice at any time when Franchisee or one of his employees is at the Franchised Restaurant." Burger King Individual Owner/Operator Franchise Agreement ¶5(J) (2014). Four of the remaining five systems – Holiday Inn, McDonald's, Comfort Inn and Pizza Hut – require franchisees to give access to their premises at any time or any reasonable time but do not explicitly specify that the access may be without notice. One system, 7-Eleven, states that inspections will be on 72 hours notice. *See* Appendix 1, Part A, Section 4.

[105] *See* Appendix 1 Part A, Section 5.

of our Marks, Operating System, or the Network, and you fail to cease this activity or cure this breach within five (5) days after delivery of notice."[106]

The International Franchise Association enshrines as a guiding principle that franchisees "should have the opportunity to monetize any equity they may have developed in their business prior to the expiration or termination of the franchise agreement."[107] Nonetheless, franchisees can seldom count on realizing much value from their business if their franchise is terminated. For example, the McDonald's and Burger King franchise agreements give the franchisor the option to purchase various assets, but neither agreement *requires* the franchisor to purchase assets, and the McDonald's agreement specifically states that "there shall be no payment by McDonald's for intangible assets of Franchisee,"[108] for example, goodwill built up over years of serving customers. The Choice Hotels franchise agreement lists four sets of obligations for the terminated franchisee upon termination, and no obligation of the franchisor toward the franchisee.[109] Because the consequences of termination are so dire, the threat of termination is the stick franchisors use to impose onerous operating and expenditure requirements on franchisees and eliminate criticism of the franchisor's practices.

The March 2015 survey of franchisees found that franchisors often use termination threats:

- 80 percent of franchisees reported that their franchisor told them they could face termination or nonrenewal based on violations identified during inspections, which, as noted above, can typically happen at any time without notice.[110]
- 38 percent of franchisees reported that their franchisor had told them they might be terminated because of actions they thought were appropriate for the operation of their business.[111]

Franchisees have alleged in litigation, legislative hearings and in the media that franchisors have used their virtually unfettered termination power to generate profit by reselling

[106] Jackson Hewitt Franchise Agreement ¶19.2(t) (2014).
[107] Int'l Franchise Assoc., *Statement of Guiding Principles*, http://www.franchise.org/statement-of-guiding-principles (last visited May 4, 2015).
[108] McDonald's Franchise Agreement ¶20 (b) (2014).
[109] Choice Hotel Int'l Franchise Agreement ¶11 (2014).
[110] Appendix 3, *supra* note 5, at 22.
[111] *Id.* at 23.

franchise units, to chill franchisee dissent and organizing efforts, and for other reasons wholly unrelated to their performance:

- 7-Eleven has terminated franchisees to "seize the stores of profitable franchisees without providing them fair compensation" and refranchise them at higher prices or to retaliate against franchisees critical of 7-Eleven's practices, according to an affidavit submitted by a former 7-Eleven loss prevention officer in several franchisee lawsuits.[112] The former loss-prevention officer attested that 7-Eleven targeted for termination stores run by "pain in the ass" franchisees and independent franchisee association leaders. [113] One couple charged that 7-Eleven representatives forced them to give up their store by threatening them with a lawsuit and interrogating them for hours about alleged coupon fraud without allowing them to see the evidence against them or present evidence that they had redeemed the coupons correctly.[114]

- Former Dunkin' Donuts franchisee Stanley Furash told Massachusetts legislators in 2011 that after he had improved the performance of his two stores, Dunkin' terminated him on a pretext in order to resell the stores.[115] Other critics support Furash's interpretation, asserting that after three private-equity firms bought Dunkin' Donuts in 2006, the debt-laden company pressured franchisees to pay penalties and sell their stores or face termination.[116]

- In 2006, Quiznos terminated eight franchisees active in an independent Quiznos franchisee association after the group posted on its website the suicide letter of a former California Quiznos franchisee who had killed himself after 18 months of litigation with Quiznos.[117]

[112] Letter from Gerald A. Marks re Scheduling Order at 10, 7-Eleven, Inc. v. Sodhi, No. 3:13-cv-03715-MAS-JS (D.N.J. May 6, 2014).

[113] *Id.* at 15-16.

[114] Tiffany Hsu, *Franchisees Allege Hardball Tactics, Store Seizures by 7-Eleven*, LOS ANGELES TIMES, June 4, 2014, *available at* http://www.latimes.com/business/la-fi-7-eleven-lawsuits-20140605-story.html#page=2; Amended Complaint at 7-12, Patel v. 7-Eleven, Inc., No. 5:14-cv-00519 (PSG) (C.D. Ca. June 3, 2014).

[115] Blue Mau Mau, Franchisees Paint Grim Scenes of Dunkin', July 13, 2011, http://www.bluemaumau.org/10538/franchisees_paint_grim_scene_dunkin. Furash reported that the franchisor's reason for termination was the fact that he lived in a different state from his stores, even though, he testified, the contract did not prohibit living in a different state and he actually worked in the stores.

[116] Holly Sanders Ware, *Flunkin' Donuts*, NEW YORK POST, Sept. 3, 2009, *available at* http://nypost.com/2009/09/03/flunkin-donuts/.

[117] Complaint at ¶¶32-33, Bray v. QFA Royalties, No: 1:06-cv-02528-JLK (D. Colo. Dec. 15, 2006).

Quiznos had terminated the California franchisee a month after he formed his own franchisee association.[118]

- In the early 2000s, franchisees of car rental franchise Rent-A-Wreck claimed that the company, which was struggling financially, used audits to drive franchisees out of business and enable the company to resell the franchises.[119]
- In the 2010 *Trocki v. Choice Hotels* case, the franchisees contended that the franchisor's termination notices came after the franchisee had used the franchisor's official internal process to object to an application to rebrand the hotel next door as a Choice hotel.[120] The franchisees claimed that after Choice forced them out, they had to reflag their hotel with a less prominent brand, which drew fewer customers, and their formerly profitable hotel began operating at a loss.[121]
- In a complaint to the FTC dated July 7, 2014 ("McDonald's FTC Complaint"), franchisees of 27 McDonald's restaurants in Puerto Rico alleged that McDonald's violated the Franchise Rule by unilaterally imposing a sub-franchisor for all franchisees in Puerto Rico. According to the complaint, the sub-franchisor instituted an advertising campaign and barred sub-franchisees who did not contribute financially to the campaign from selling products promoted in the campaign. After certain sub-franchisees voluntarily honored customers' requests for products advertised through the campaign, those sub-franchisees were threatened with termination for selling unauthorized products.[122]

The options for franchisees facing termination are bleak: costly litigation or arbitration; selling the franchise to a franchisor-approved buyer (often at fire sale prices); or the loss of their financial investment and years of sweat equity.

E. Unfair Nonrenewals

[118] Timothy Noah, *Disenfranchised: Why Are Americans Still Buying Into the Franchise Dream*?, PACIFIC STANDARD, Mar. 4, 2014, *available at* http://www.psmag.com/navigation/business-economics/disenfranchised-fast-food-workers-quiznos-73967/.

[119] Robyn Lamb, *Rent-A-Wreck, Family Owners Struggle Through Legal Disputes*, THE DAILY RECORD (Baltimore), Sept 3, 2004.

[120] Notice of Removal Exhibit 1 ¶¶13-2, Trocki Hotels v. Choice Hotels Int'l, No. 1:10-cv-5177 (RMB) (D.N.J. Oct. 7, 2010).

[121] *Id.* ¶ 27.

[122] Complaint by 78% of Puerto Rico Franchisees Against McDonald's Corporation and Others in Concert Therewith Pursuant to FTC Act Section 5 and the Franchise Rule, July 4, 2014, at 15 (on file with requesters).

Franchise agreements often grant franchisors complete discretion in deciding whether to renew a franchise. A franchise nonrenewal is not merely the end of a contract; it is the loss of a franchisee's decades-long business, livelihood, and sweat equity. And, unlike a normal contract, franchisees typically cannot find another party to contract with. The tangible assets and know-how they have acquired cannot be used to contract with a different franchisor because of the prevalence of noncompetition clauses. Of the 14 franchise agreements reviewed, 11 include some restrictions on the ability of terminated or nonrenewed franchisees to compete with their former franchisors. Nine bar former franchisees from competing in the same line of business or in the same physical location as their former unit for some period of time, ranging from one to three years, after the franchise agreement expires or is terminated.[123] Two have other restrictions on competitive activity for former franchisees.[124] Even in the lodging industry, where franchisees typically own a hotel that they may rebrand if their franchisor does not renew, such moves often result in losses for the franchisee, as in the *Trocki* case discussed above and in the case of California hotelier Vipul Dayal, who stated,

> InterContinental Hotels Group revoked one of my families' franchises—even though this property had been a Holiday Inn Express for years and met all of the corporation's standards. We had no say in this decision, but felt the impact of it. It took years to rebuild the client base for this hotel, and in the first year after the change, its occupancy rate was cut nearly in half.[125]

In sum, franchisees often can only realize a reasonable value for their investment by contracting and renewing with the franchisor, which makes nonrenewals unrelated to performance particularly unfair and financially devastating for franchisees.

All of the 14 franchise agreements in the petitioner's contract analysis provide no renewal rights or significantly limit franchisees' renewal rights. Five of the 14 systems – McDonald's, Pizza Hut, Taco Bell, Holiday Inn and Comfort Inn – specify that franchisees have no renewal rights at all.[126] All of the remaining nine systems indicate that any renewal may be on

[123] The nine are 7-Eleven, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise, McDonald's, Pizza Hut and Subway. *See* Appendix 1, Part C, Section 1.

[124] The two are Ameriprise, which bars former franchisees from seeking to serve their former Ameriprise clients for one year after termination of the agreement, and Taco Bell, which imposes competition restrictions on former franchisees terminated for cause for one year after termination of the agreement. *See* Appendix 1, Part C, Section 2.

[125] Service Employees International Union, Restore Fairness for California Franchise Owners, 2014 (on file with petitioner).

[126] The five are Comfort Inn, Holiday Inn, McDonald's, Pizza Hut and Taco Bell. *See* Appendix 1, Part B, Section 1.

materially different terms than the franchisee's current contract.[127] This could mean higher royalties, a mandate for expensive renovations or equipment purchases or other unwelcome changes. Six of the nine systems that allow renewals require renewing franchisees to release the franchisor from any claims arising from the prior franchise agreement.[128] In other words, if franchisees want to stay in business, they have to give up the right to sue for any contract violations the franchisor may have committed during the previous term of the franchise contract.

As a Dunkin' Donuts franchisee wrote in a letter supporting a Maine franchisee rights bill:

> Presently Franchise Owners who adhere to brand standards and honor their obligations can only watch their equity evaporate as the end of their franchise term nears. Without reasonable assurances of renewal our family businesses essentially become rent-a-businesses and are worthless to anyone except the Franchisor. Franchise Owners are often presented with one of two options; Sign a more draconian new form franchise agreement or walk away from their life's work and family's business equity.[129]

Because franchise contracts typically have little or no protection of franchisees' renewal rights, franchisors may force franchisees to give up their businesses at the end of the franchise term for reasons unrelated to their performance. To cite some examples:

- A longtime McDonald's franchisee alleged publicly that the franchisor had not renewed the franchise on one of her stores in retaliation for her advocacy of franchisee rights legislation in California.[130] Similarly, in 2006, an Arizona couple who owned McDonald's restaurants in Tucson claimed in a lawsuit that McDonald's had a plan to remove franchisees who were either the most profitable or the most vocal in opposition to McDonald's management or policies. They alleged that they fell victim to this plan when McDonald's refused to renew their franchise after they became outspoken about the chain's unfair treatment of them.[131]

- In June 2010, one month after its franchisee filed an arbitration challenging the company's requirement to use its tax preparation software, H&R Block notified the franchisee of its

[127] The nine are: 7-Eleven, Ameriprise Financial Services, Applebee's Neighborhood Grill & Bar, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise and Subway. *See* Appendix 1, Part B, Section 2.

[128] The six are 7-Eleven, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service and Jazzercise. *See* Appendix 1, Part B, Section 3.

[129] Maine Franchise Owners Assoc., Letter from Maine Franchise Owners Chairman Ed Wolak, Feb. 21, 2014. http://www.mainefranchiseowners.org/letter-from-maine-franchise-owners-chairman-ed-wolak/ (last visited May 5, 2015).

[130] Carter, *supra* note 97.

[131] First Amended Complaint ¶¶14, 28, Garrett v. McDonald's Corp., No. 4:05-cv-4 (FRZ) (D. Ariz. May 10, 2006).

intent not to renew two franchise agreements when they expired at the end of the year.[132] In 2012, a federal appeals court ruled that H&R Block had the right to deny the franchise renewals, despite the fact that the franchise agreements stated that they "shall automatically renew" for five-year terms, because this language did not indicate an unequivocal intention by the parties that the contract continue in perpetuity.[133]

The arbitrary and retaliatory nonrenewal of franchise agreements harms franchisees and chills critical speech and collective action by franchisees.

F. Interference with Transfer or Sale

Franchisees may want to transfer their franchise to a family member or to another qualified buyer during the term of the agreement, often so that they can retire and realize the value of decades of investment. Franchise agreements, however, typically grant franchisors broad discretion to approve or deny transfers, which mean the process is vulnerable to franchisor abuse. Franchisors often have the right to deny a transfer for any reason or can require a franchisee to sell to the franchisor's preferred buyer at a lower price. While it is reasonable for a franchisor to require approval of transfers to ensure that only individuals meeting its qualifications enter the business, it is unreasonable when franchisors adopt no clear standards for their transfer process or enforce standards in an arbitrary way, thereby allowing them to behave opportunistically, often to the franchisee's detriment. A franchisee of nine Burger King restaurants in Maine explained to legislators the importance of transfer rights: "As part of a family business it has always been a dream of mine to start a business that can be passed down from generation to generation." Protecting transfer rights "goes a long way to making that dream a reality by ensuring that I remain in control of the transfer process and limiting the power the franchisor has to move this business as they see fit."[134]

Eight of the 14 franchise agreements reviewed allow the franchisor broad discretion to approve or reject franchisees' proposed sales or transfers of their units.[135] For example,

[132] H&R Block FDD (2012), at 16; Complaint ¶ 19, H&R Block Tax Services LLC v. Franklin, 4:10-cv-1165 (DW) (W.D. Mo. Nov. 23, 2010).
[133] H&R Block Tax Services LLC v. Franklin, 691 F.3d 941, 945 (8th Cir. 2012).
[134] Testimony of Larry & Brek Kohler in Support of LD 1458, an Act to Enact the Maine Small Business Investment Protection Act, May 8, 2013 (on file with petitioner).
[135] The eight are 7-Eleven, Ameriprise Financial Services, Applebee's, Burger King, Holiday Inn, Jazzercise, McDonald's and Pizza Hut. *See* Appendix 1, Part D, Section 1.

Applebee's states "nothing in this Appendix B shall limit Franchisor's discretion in granting or withholding consent to a Transfer or to require the applicable parties to agree to certain terms as a condition to obtaining consent to a Transfer."[136] In addition to this broad discretion, franchise agreements commonly include various restrictions on transfers, including a required general release of claims on the franchisor before approving a transfer (11 systems)[137] and a provision allowing the franchisor to block a sale based on contract violations by the transferring franchisee (10 systems).[138] Three systems allow the franchisor to require that the transferring franchisee refurbish their facility (Great Clips) or bring it up to current standards of appearance (Jazzercise and Taco Bell).[139] This can force franchisees who want to leave the system because they are in difficult financial straits to make a further, often costly, investment in a system they are trying to exit. Two systems, McDonald's and Burger King,[140] require franchisees who sell their stores to retain liability for the buyer's royalties for some period. McDonald's franchise agreement allows it to hold former franchisees liable for "all affirmative obligations, covenants, and agreements" for the full term of the selling franchisee's original agreement, even after the franchise has been transferred, with McDonald's approval, to a new owner.[141]

In addition to arbitrary denials of transfers, many franchisees report malicious interference by franchisors in their efforts to find a purchaser for a franchise:

- A former McDonald's franchisee alleged in a 2012 bankruptcy filing that McDonald's repeatedly interfered with offers to buy its stores with the intent that the franchisee sell the stores to McDonald's preferred buyer at a significantly reduced price.[142]
- In a lawsuit filed in 2011, AM/PM gas station/convenience store franchisees alleged that their franchisor, BP, had "a history of giving unreasonable and untimely approvals or denials when franchisees wish to sell their franchises" and of placing unreasonable restrictions on

[136] Applebee's Franchise Agreement, Appendix B (2014).
[137] The 11 are 7-Eleven, Ameriprise Financial Services, Applebee's, Burger King, Dunkin' Donuts, Great Clips, Jackson Hewitt Tax Service, Jazzercise, Pizza Hut, Subway and Taco Bell. *See* Appendix 1, Part D, Section 2.
[138] The 10 are 7-Eleven, Ameriprise Financial Services, Dunkin' Donuts, Holiday Inn, Jackson Hewitt Tax Service. Jazzercise, McDonald's, Pizza Hut, Subway and Taco Bell. *See* Appendix 1, Part D, Section 3.
[139]*See* Appendix 1, Part D, Section 4.
[140] *See* Appendix 1, Part D, Section 5.
[141] McDonald's Franchise Agreement, ¶15(d) (2014).
[142] Debtors' Omnibus Response to Objections of McDonald's and Lake Forest Bank ¶¶ 5-9, 18-25, 37, In re Azuka Foods, Inc., No. 11-40934 (ESS) (E.D.N.Y. Sept. 5, 2012).

lenders in ways that restricted franchisees' ability to sell their units and lowered the value of the franchises.[143]

- In 2006, a Cold Stone Creamery franchisee sued the ice cream franchisor, alleging that the company had blocked his attempts to sell his stores by telling potential buyers they could buy franchises directly from Cold Stone for less money.[144] The parties settled the case in 2008 after the franchisee filed for bankruptcy.[145]

- In a currently pending case, an Oregon-based franchisee of Jackson Hewitt alleges that the franchisor interfered in its efforts to get the best price for six Idaho tax preparation franchises it was selling in 2010. According to the lawsuit filed in May 2013, Jackson Hewitt imposed an unrealistic two-week time frame for finding prospective buyers for the Idaho franchises and then rejected a suitable buyer.[146]

- According to the McDonald's FTC Complaint, McDonald's franchisees in Puerto Rico have been forced to accept a new sub-franchisor "that unfairly competes with them, radically changes their franchise, and intentionally impacts sales in their restaurants." They "have been given only one alternative to resolve the current situation - jointly to sell all of their restaurants to the sub-franchisor at a discounted value."[147]

The breadth of franchisors' discretion to deny transfer or assignment of a franchise enables abusive and harmful practices by franchisors.

IV. Petition for Investigation

The FTC has authority to undertake investigations into specific wrongdoing as well as general industry practices pursuant to Sections 6, 9, 20, and 21 of the FTC Act. These provisions give the Commission a variety of methods of obtaining information, including the power to issue civil investigative demands. Section 6(b) grants the Commission the power:

> [t]o require, by general or special orders, persons, partnerships, and corporations, engaged in or whose business affects commerce . . . or any class of them, or any

[143] Class Action Complaint ¶ 59, Green Desert Oil Group Inc. v. BP West Coast Products LLC, 3:11-CV-2087 (CRB) (N.D. Ca. Apr. 28, 2011).

[144] Amended Complaint ¶ 65, Prasad v. Cold Stone Creamery, Inc., No. 3:06-cv-00648 (MLC) (D.N.J. Feb. 1, 2007).

[145] Cold Stone Creamery FDD (2014), at 27-28.

[146] Amended Complaint ¶¶ 101-18, FasTax Inc. v. Jackson Hewitt, Inc.., No: 2:13-cv-03078 (WJM) (D.N.J. July 15, 2014).

[147] Complaint by 78% of Puerto Rico Franchisees against McDonald's Corp., *supra* note 122, at 20.

> of them, respectively, to file with the Commission in such form as the Commission may prescribe annual or special, or both annual and special, reports or answers in writing to specific questions, furnishing to the Commission such information as it may require as to the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals of the respective persons, partnerships, and corporations filing such reports or answers in writing.[148]

Given the substantial evidence of pervasive abuses in the franchise industry, the FTC should compel the provision of information from no fewer than nine leading franchise companies concerning their relationships with and conduct towards their franchisees. In particular, the FTC should compel the provision of information concerning:

(1) each franchisee terminated in the last 10 years and the reasons for termination;

(3) the franchisor’s policies on franchise termination;

(4) each franchisee who was not renewed in the last 10 years and the reasons for nonrenewal;

(5) the franchisor’s policies on franchise renewal;

(6) each franchisee who requested the transfer or sale of one or more franchise units in the past 10 years and the handling and disposition of each proposed transfer or sale, including the date on which the transfer or sale was requested, the date on which the transfer or sale was approved or rejected by the franchisor, the reason for the approval or rejection, the price received by the transferring franchisee for each franchise unit sold, and the name and contact information for the recipient of the transfer;

(7) the franchisor’s policies on transfer and sale of franchises;

(8) each capital expenditure program with an average cost per franchised unit of $10,000 or more required or initiated by the franchisor in the last 10 years and the mean and median cost to franchisees of each expenditure;

(9) the franchisor’s policies on capital expenditures by franchisees;

(10) each financial performance representation made by franchise representatives, in advertisements or in other marketing materials in the last 10 years;

(11) the income and expenses of each franchised unit, organized by number of years in the franchise system;

[148] 15 U.S.C. § 46(b).

(12) all financial performance information provided to potential franchisee lenders, including the SBA, in the last 10 years;
(14) whether the franchisor participates in the FranDATA "Bank Credit Report" program;
(11) all documents, policies, procedures and manuals incorporated by reference into the franchise agreement;
(12) for each document identified in item 11, state the number of pages in the document and identify each change to the document made in the last 10 years;
(13) the number and date of each type of inspection or audit conducted on each franchise outlet in the last 10 years; and
(14) the contact information for all franchisees who exited the system in the last 10 years.

The evidence summarized in this petition shines a light on the power imbalance in the franchise relationship that results in serious financial harm to franchisees. Franchisees often enter into the relationship on the basis of inadequate or misleading financial performance information. Once they sign the agreement, they may be subject to the franchisor's changing operating requirements and unreasonable capital expenditure demands, and they can lose their investment and their financial security if they challenge rather than accede to these demands. For these reasons, the petitioner asks the FTC to order franchise companies selected for this investigation to provide the information listed above so that the FTC can investigate the existence and extent of the harmful practices described in this request and issue a report with the agency's finding and recommendations.

Appendices:

1. Analysis of contract terms of 14 leading franchise systems
2. Risky Business: Franchisees’ High and Rising Risk of SBA Loan Failure
3. FranchiseGrade.com, Inc., *National Survey of Franchisees 2015*