



FROM THE OFFICE OF SENATOR CORTEZ MASTO  
**STRATEGIES TO IMPROVE THE FRANCHISE MODEL:**  
PREVENTING UNFAIR AND DECEPTIVE FRANCHISE PRACTICES

APRIL 2021 | REPORT

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## I. Executive Summary

In 2019, the Economic Policy Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held a hearing on economic mobility and heard from a witness who described troubling practices affecting businesses operated as franchises.<sup>1</sup> This information was consistent with complaints Senator Cortez Masto had heard from press reports and constituents in Nevada. Following that hearing, the Senator, then-ranking Democrat on the Subcommittee in the 116<sup>th</sup> Congress, directed her personal office staff to analyze franchise business practices and explore any need for legislative and other reforms, leading to this report. This report suggests a menu of legislative, regulatory, and business reforms pursuant to Congress's jurisdiction over issues related to economic growth, employment, small business lending, and economic stabilization.

Nationwide, we hear stories of entrepreneurs who faced financial ruin because they purchased a franchise.<sup>2</sup> In the past decade, more than 4,000 Quiznos franchise locations closed, and the company declared bankruptcy.<sup>3</sup> Dozens of entrepreneurs buying Huntington Learning Center franchises were provided false revenue estimates.<sup>4</sup> The franchise owners, also known as franchisees, of Curves twice sued the company after being forced to make decisions that lost them revenue and threatened their viability.<sup>5</sup> Burgerim franchisees allege the company sold 1,200 franchises in 39 states and DC with no viable business model.<sup>6</sup>

Difficulties facing the franchise industry should concern the nation: In February 2020, 8.67 million people are expected to work for as many as 785,316 franchises.<sup>7</sup> Franchises employ more people than those who work in construction and a roughly equal number to those employed in financial activities.<sup>8</sup> Leaders in the franchise sector have dismissed or ignored aggressive sales practices and one-sided contracts that have damaged too many lives. The industry is too often measured by franchises sold; franchise corporations benefit from the sale of a franchise, but are not held accountable for franchise success or failure.

In response to the COVID-19 pandemic, sales of many restaurant franchise businesses continue to boom.<sup>9</sup> Unemployed restaurant workers may decide to run their own business instead of looking for another job. Some franchise sales pitches recommend investors move their funds out of a volatile stock market and buy a franchise.<sup>10</sup> Some franchise owners will receive suggestions to fund the new franchise using the Rollover for Business Startups (ROBS), putting their retirement funds at risk. As restaurants and other businesses close due to the economic collapse from the COVID-19 pandemic, some franchise brands, also known as franchisors, will be marketed at “a discount” to new investors.

However, some closed franchises are not shuttering solely due to the pandemic; a brand may have been troubled long before due to a franchise corporation's problematic and unfair practices.<sup>11</sup> In response to the pandemic, franchisors should work with their brand's franchisees to survive; some franchise corporations are allowing more flexibility in the franchise agreement – for example, reducing, abating, or deferring rents, royalties and marketing fees. However, some franchise corporations demand that franchise owners

agree to new contract terms to realize the benefits from those accommodations. For example, franchise owners, who may only be open fewer hours than required by their initial contract, report being forced to sign new contracts that are disadvantageous to them.<sup>12</sup> These new terms often release the franchise corporation from any legal liability.

There are good franchise corporations out there that provide profits to investors, living-wage jobs, and support for the community. But for too many and for too long, some franchise corporations and lenders have treated entrepreneurs unfairly, which cascades into low-wage employment and stores closing. Overly optimistic revenue projections are given outside the legal disclosure process; contracts are written by the franchisor and in the franchisor's favor; pre-dispute mandatory arbitration clauses block franchise owners' access to the courts; and contractual provisions allow franchisors to overcharge for licensing and marketing fees, demand kickbacks from vendors, or limit a franchise owner's right to free speech.<sup>13</sup> These are the hallmarks of a franchise model that operates to strip small business owners of their wealth.

No small business is without risk, but franchises are marketed as safer investments because they are supposed to be proven business models.<sup>14</sup> But when franchise corporations engage in deceptive practices or enforce unfair rules, such as demanding payments for inadequate training or requiring unfair contracts, while also using government resources and requirements to appear as a regulated investment or aid in financing, the government inadvertently condones franchises' misrepresentation.<sup>15</sup> When franchise owners cannot financially survive, they struggle to pay their workers a living wage.

This paper details the problems reported by franchise owners of ten franchise brands – Burgerim, Complete Nutrition, Dickey's Barbecue Pit, Experimac, Subway, Quiznos, Curves, 7-Eleven, Huntington Learning Centers, and Massage Envy – although similar problems also affect additional franchises.

This report highlights four areas where franchise complaints are most problematic, including unfair and deceptive contracts that give nearly all control to the franchise corporation, a lack of honesty and transparency in the financial disclosure documents, costly kickbacks and overpriced goods, and fees charged for limited or no actual benefit.

This report recommends the following actions from Congress, agencies, state governments, and franchise corporations themselves:

- **Congress:** While federal agencies have the authority to protect franchise owners with existing rules, Congress can provide for a private right of action for franchise owners and require fair contracts. Congress can also increase funding for the Federal Trade Commission so it can enforce fair contracts and require the SBA to mandate the timely disclosure of financial performance information by franchise brand for all SBA-guaranteed loans.
- **Federal Trade Commission (FTC):** The FTC should revise its Franchise Rule to provide more investor protection by recognizing that voluntary financial

performance disclosure has failed to provide accurate information to investors. The FTC should prohibit franchise contracts that require pre-dispute mandatory arbitration. Contracts should not include non-disparagement and non-disclosure requirements; they prevent franchise owners from being honest with future investors doing their due diligence. The FTC should take enforcement action against duplicitous or unfair franchise corporations and seek penalties.

- **Small Business Administration (SBA):** Prior to providing a government guarantee of a loan to a franchise, the SBA should require franchise companies to provide actual historic revenue data and store closing information to franchise owners who are liable to repay the loan. The SBA should publish loan performance information by franchise brand and refuse to guarantee any loan to a franchise if the underlying franchise agreement includes terms such as mandatory arbitration, non-disparagement and non-disclosure clauses, or prohibitions against associations. Franchise brands with high levels of default should lose access to government-guaranteed loans.
- **State Governments:** California, Washington, and Minnesota have some of the strongest state statutes regulating franchise businesses. States should enact legal protections for franchise investors and owners and provide resources for enforcement of fair practices.
- **Franchise Sector:** The franchise sector and its trade association must set standards for franchise brands that require fair treatment for franchise owners. Business development agents and consultants should be required to register, receive annual education and have a fiduciary duty to the franchisee clients. They should also establish and provide assistance when a franchise mistreats its franchise owners.

The franchise industry needs to ensure that franchise owners are sold viable businesses with fair contract provisions, with a reasonable expectation of success. Federal and state governments must address this massive part of our economy; they must enforce their regulations against unfair, abusive and deceptive trade

practices and, where current rules and laws that prohibit unfair and deceptive practices fall short, they must strengthen them. Without adequate investor disclosure, some entrepreneurs may invest in a franchise brand that will strip their wealth, leaving them facing eviction, foreclosure, and bankruptcy.<sup>16</sup> These franchise owners will be unable to

The franchise industry is large, and, over time has allowed many to realize their American Dream. There are many examples of great brands that have provided these opportunities...[H]owever, because of little transparency and oversight, it is also an industry with far too many examples of predatory franchise companies that take advantage of prospective entrepreneurs and leave them overworked, despondent and broke. We hear the lure of the industry as it advertises to be your own boss, with proven business models, and no experience necessary.  
**Keith Miller, Subway Owner.**

experience the goal they had for themselves – a financially self-reliant business that provides services and good jobs in their communities. This report provides a road map to improving the franchise model which will serve our nation’s entrepreneurs, workers and communities.

## II. Overview of the Franchise Sector

Franchise businesses provide business ownership opportunities to hundreds of thousands of entrepreneurs. The business model involves an owner licensing trademarks, methods, and other products to an independent entrepreneur. Franchise businesses provide a variety of services to people and communities, including restaurants, hotels, technical services, senior care, healthcare, and recreational activities.<sup>17</sup>

Typically, an investor (the franchise owner or the franchisee) pays a fee and in turn receives a format or system developed by the company (the franchisor). The franchise owner will often be expected to pay to the franchisor a percentage of their sales; royalty and advertising fees; and other associated costs for a small business, such as renting a location, paying fees to construct and equip the store, purchasing operating licenses, buying insurance, and stocking inventory. The franchisor can assist the franchise owner with finding a location, training materials for franchisees and employees, providing operational systems (such as establishing a point-of-sale system), receiving management assistance, offering marketing and a website, providing workshops and seminars, and setting up a telephone number or website for promotions, questions or concerns.<sup>18</sup>

Franchise owners come from all walks of life. One in seven franchises is owned by veterans, who are frequently encouraged to buy franchises through Transition Assistance Programs offered to service members separating from the service or through veteran franchise sales programs.<sup>19</sup> About 30 percent of franchises are owned by Black Americans, Latinos, or Asian Pacific Americans.<sup>20</sup> Many immigrants choose to invest in franchises because of the perceived reliability of the brand backing the individual store.<sup>21</sup>

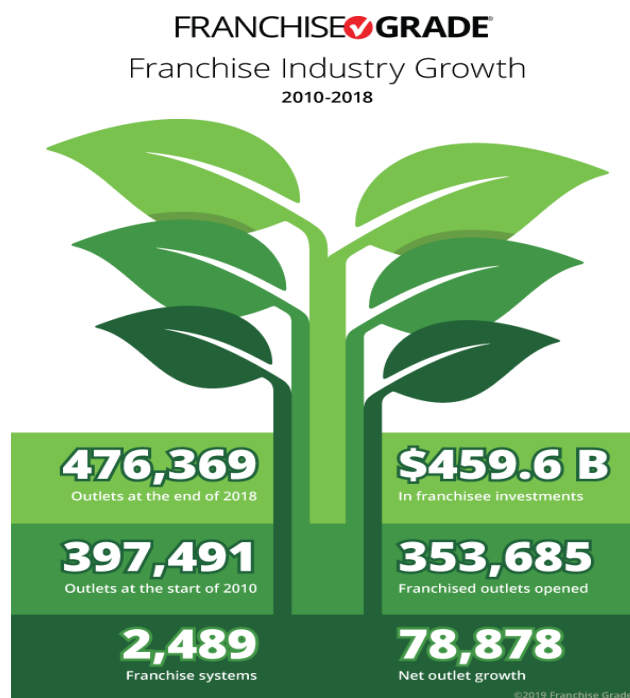
Franchises contribute millions of dollars to state and local economies. The trade association for franchise corporations and some franchise owners, the International Franchise Association (IFA), estimates that in February 2020, 8.67 million people are expected to work for as many as 785,316 franchises.<sup>22</sup> Franchises employ more people than those who work in construction and a roughly equal number to those employed in financial activities.<sup>23</sup> About one-third of franchise businesses offer fast food;<sup>24</sup> on any given day, an estimated one-third of all American adults purchases food at a fast-food restaurant, many of which are franchises.<sup>25</sup>

Franchise corporations promise business owners the dream of opening their very own small business. Some franchises market to people without experience, promising that the “will to succeed” is adequate as long as the franchise owner follows the rules laid out by the brand.<sup>26</sup>

While franchises can be a prosperous and successful endeavor, some franchise companies are more interested in selling franchises than enabling franchise owners' long-term success.<sup>27</sup> The Office of Senator Catherine Cortez Masto received dozens of complaints from franchise owners – both from Nevada and across the country – about franchise contracts and unscrupulous franchisor practices that make owning a franchise a financially devastating decision. Franchise owners report receiving inaccurate information about profitability prior to investing in a franchise, being forced to buy overpriced goods and services, and having to comply with constantly changing and expensive requirements.<sup>28</sup> Sometimes, regional supervisors find fault with a store's management and operation so that the supervisor can report the store for noncompliance.<sup>29</sup> Overly aggressive or unfair compliance reporting can allow the regional supervisor to buy noncompliant stores at a discount rate, thus providing new fees from sales.<sup>30</sup> In Marcia Chatelain's 2020 book, *Franchise: The Golden Arches in Black America*, she states, "the relationship between franchisor and franchisee is like a distorted parent and child bond, in which the parent sets the rules and the child pays all the household bills...franchisees can make good money, but the franchising system requires skill at navigating an unequal power relationship."<sup>31</sup>

Franchises are sold as a proven – and profitable – business model. But when the actual numbers are revealed, what looks like growth may just be a lot of openings without consideration of store closures.<sup>32</sup> From 2010 to 2018, franchise owners opened 353,685 outlets, yet the total number of franchises only grew by 78,878, an increase of only 20%.<sup>33</sup> Franchise corporations may blame the franchise owners for store failures, citing poor management or an inferior location, but the franchise owners are not necessarily at fault. Franchise store failure in the first year or two may be due to an unsustainable business model with poor unit economics, insufficient support or inadequate working capital to survive the startup growth period. A previously successful franchise may fail because of franchisor demands or encroachment from new, competing outlets into a territory.<sup>34</sup>

Chart 1: Net Growth in the Franchise Industry Is Small<sup>35</sup>



The franchise industry also tends to gauge success by whether a franchise outlet remains open. However, this measure of success may not account for profits gained from fees generated by a single store cycling through numerous owners in a short period of time. Franchise owners and regulators should be concerned about “churn” or “disorderly attrition” in certain brands; high levels of transfers, terminations, acquisitions by the franchisor, and ceased operations can be signs of an unsustainable business model that could have been financially unsustainable for previous owners.

### **What Are the Risks in Franchise Ownership?**

Franchises are not ordinary investments. If someone invests \$100,000 in a stock, the stock could fail, and the investor could lose the entire \$100,000. If an entrepreneur invests the same \$100,000 to buy a franchise, the franchise owner risks considerably more than the \$100,000.<sup>36</sup> Franchise contracts can last for decades and require continuous payments of royalties, marketing, and other fees, as well as a share of the profits. Franchise contracts most often require personal guarantees from the franchise owner. Contracts may demand the owner upgrade the store, purchase goods and services from a specific vendor, or sell new products. Many franchise owners borrow from a lender to pay for the initial franchise fee, store renovation, and start-up costs. Most times, those loans are obtained by a borrower’s personal guarantee to repay with the borrower’s personal assets – such as a home, savings, retirement accounts, or land – as collateral. Assets can also come from the immediate family of the borrower. When a franchise is not profitable, franchise owners and their co-investors can lose these assets.

In addition to the personal loss to the franchise owner, failing franchise owners cannot pay living wages.<sup>37</sup> When franchise owners run deficits, they may struggle to pay wages and payroll taxes. When franchise owners fail to fulfill wage and tax obligations, they can end up in trouble with the government. Some franchises have nearly no employees – the franchise owners and family members work non-stop to keep these businesses afloat.<sup>38</sup>

### **III. Government Oversight of Franchises Is Inadequate**

Most people, especially prospective franchise owners, believe franchises are heavily regulated. Franchise corporations encourage this belief by promoting the different ways governments regulate and support franchises. The Federal Trade Commission (FTC) is widely recognized as overseeing franchise businesses. The Small Business Administration (SBA) publishes a Franchise Registry and provides loan guarantees through the 7(a) and 504 loan programs. The Department of Veterans Affairs (VA) promotes the franchise model to service members through its Transition Assistance Program. In addition, nineteen states have some oversight over franchise corporations.<sup>39</sup> However, government oversight is quite weak, which leaves franchise owners vulnerable to unfair practices by some franchise corporations.

## The Role of the Federal Trade Commission

The Federal Trade Commission (FTC) regulates presale disclosure of franchises through its Franchise Rule.<sup>40</sup> The Franchise Rule is meant to ensure that entrepreneurs have access to information that can help them decide whether to invest in a franchise. It also requires franchisors to furnish a Franchise Disclosure Document (FDD) that includes specified information about the franchisor, the franchise business, and the terms of the franchise agreement. The FDD is meant to provide a plethora of information on the company, including information about the business and its executives; any litigation and bankruptcy history; costs and restrictions with suppliers, territory, and customers; advertising and training programs; financial performance; and financial statements.<sup>41</sup> The Rule also prohibits franchisor misrepresentation.

The FTC is also responsible for investigating unfair, deceptive or abusive practices by franchises, and educating business owners about their respective responsibilities. This authority goes beyond the Franchise Rule; the FTC can prosecute franchise corporations engaged in unfair or deceptive conduct throughout the course of a franchise relationship. The FTC has not taken an enforcement action on a franchise matter since 2007.<sup>42</sup>

In his Congressional testimony, franchise owner and advocate Keith Miller said, “on the first page of all FDDs, it specifically states in bold print, ‘Note, however, that no governmental agency has verified the information contained in this document.’”<sup>43</sup> The FTC does not collect the FDDs; instead, it relies on potential franchise owners to do their own due diligence about the viability of the businesses with the information disclosed.<sup>44</sup>

The FTC’s approach relies on the franchise corporation disclosing accurate and complete information to the potential franchise owner who can choose whether to invest or not. A key element of disclosure is the financial performance representation made by the franchisor, yet this disclosure is voluntary. The FDDs should include break-even analysis, annual financial data and skills, knowledge and ability to run the business. In addition, financial performance representations should be presented in the same format by sector, such as hotels or restaurants. The FTC should also collect and post all FDDs so prospective investors can search by sector.

Even if information is disclosed, it may not be clear to a franchise investor reviewing hundreds of pages of a contract that the government does not approve – or even regulate – the investment.<sup>45</sup> Contracts can deny franchise owners the right to buy goods from a lower-cost source, prohibit franchise owners from organizing into an association, and even ban them from sharing their experience with current and future franchise owners. Some franchises refuse to provide the FDD until the potential owner pays an application fee, which generates additional profits for the franchisor. Some FDDs include disclaimers that protect franchisors from future allegations of unfair treatment. The FTC does little to take action against franchise corporations that provide inaccurate information or demonstrate deceptive practices. The FTC has taken no action to stop franchisors from providing inaccurate financial information outside of the FDD, either through third-party brokers and consultants or directly to the investor.

Not only is there no private right of action in the Franchise Rule which would enable franchise owners to sue franchise corporations, but the FTC permits contracts that require mandatory arbitration, prohibit disclosure and disparagement, and include language that allows the franchisor to change the terms of the contract without agreement from the franchisees. Additionally, franchise owners rarely have the cash to hire an attorney after putting all their resources into opening and operating the business. Since franchisors have deeper pockets, they can choose to extend litigation beyond what some franchisees can afford. Some franchise owners argue that the Franchise Rule is rigged in favor of the franchise corporations and against the franchisees.

### **The Federal Trade Commission's Franchise Rule**

The current Franchise Rule requires franchisors to provide prospective franchise owners with their FDD at least 14 calendar days before franchisees make any payment or sign a binding agreement in connection with a proposed franchise sale. The FDD provides prospective franchise purchasers with 23 items of information pertinent to their investment decisions.<sup>46</sup> In practice, the Franchise Rule gives franchise owners the false belief that the FTC “approves” franchises and endorses them as viable investments. The franchise representative or a sales representative “may tell a prospective franchise directly and through subtle means that the FDD has been reviewed and approved by the government and it’s a safe investment.”<sup>47</sup> FTC’s regulation of FDDs contribute to this problem. For example, the FTC allows – but does not require – franchisors to include financial information in Item 19 of the FDD. Franchisors are also permitted to include in Item 19 a disclaimer to the effect that any other financial information provided outside Item 19 is illegal and should not be relied upon as factual.<sup>48</sup> In practice, this is a problematic provision; it allows franchisors to connect investors with buyer development agents or brokers, franchise owners, newsletters, or other projections or data without the requirement of accuracy as franchise investors do not understand that financial material provided outside the FDD may not be reliable.

The FTC has rarely taken action against a franchise corporation for any reason, including deceptive financial documents. The FTC will argue that few complaints are filed, which until recently was true, in part because it is technically difficult to figure out how to file a complaint to the FTC. In addition, franchise owners who file complaints may face retaliation from the franchise company.<sup>49</sup> A common practice is for a franchise corporation to release a franchise owner with a failing business from the contract while prohibiting the franchise owner from making any disparaging comments or sharing complaints. These non-disclosure agreements in exchange for absolution of the remaining contract can lead to a cycle of failed franchise loans even though the FTC has stated that requiring consumers sign gag clauses is an unfair practice.<sup>50</sup> In addition, the FTC has traditionally preferred cases with many complaints, such as when 10,000 customers are overcharged \$20 on a transaction, instead of a few dozen or a hundred entrepreneurs who may have been misled into investing \$500,000 in a failed franchise. The FTC should not wait for franchise owners to file complaints; it can also consider evidence of problems noted by the Office of Inspector General’s office at the Small Business Administration.

## **The Federal Trade Commission's Comment Periods on the Franchise Rule**

In May 2019 and September 2020, the FTC solicited comments regarding the Franchise Rule.<sup>51</sup> The FTC asked whether prospective franchise owners have benefitted from the Rule, what the costs of compliance are, and whether the Rule should be amended, especially to account for technological or economic changes. The Franchise Rule was last updated in 2007. In 2019, the FTC received 46 comments. Commenters representing the franchise owners generally wanted a more robust Rule that included financial performance representations, including “break-even” data and increased transparency around costs. Commenters representing franchisors argued the Rule should not be changed. In the Fall of 2020, the FTC sought additional comments on the Franchise Rule; by the December 17, 2020 deadline 239 comments were submitted, the vast majority from franchise owners requesting protection from franchise practices related to the FDDs and other practices which they allege are unfair.<sup>52</sup>

## **The Role of the Small Business Administration**

Prospective franchise owners can receive guaranteed loans from the Small Business Administration (SBA) through the 7(a) or 504 loan programs.<sup>53</sup> The SBA maintains a Directory of all franchise brands that meet the SBA's criteria. Only franchise brands listed in the Directory, which is managed by an outside vendor, may receive SBA-guaranteed loans. Eligible franchise brands must meet the SBA's affiliation rules regarding ownership, management, license, and other eligibility criteria.<sup>54</sup> For example, 7-Eleven franchise owners are not eligible for SBA-guaranteed financing as their corporate office retains significant control over day-to-day operations. For some franchise owners, seeing a brand listed in the Franchise Directory provides a sense of legitimacy, which can lead to undue belief in the viability of the brand.

SBA-affiliated lenders (SBA-AL) determine if the brand and a loan applicant are creditworthy and low risk. According to SBA's Standard Operating procedure, the franchise owner must be able to repay the loan through profits from the business, not from the owner's personal wealth. SBA's Office of Credit Risk Management is responsible for analyzing the loan portfolio and reviewing lender performance. However, the SBA-AL is the entity responsible for identifying and avoiding poorly performing loans and avoiding fraud.<sup>55</sup>

There is a lack of clear data reporting on the performance of SBA loan guarantees provided to SBA-ALs for various franchise brands. The data and charts in the following pages are provided by public sources, supplied by the SBA, or based on research by Senator Cortez Masto's office from publicly-available SBA data. The Senator's staff requested technical comments from the SBA staff to confirm or correct the analysis, but the SBA staff declined, citing their practice of “not publicly releasing information that could be competitively harmful to both franchisors and franchisees.”<sup>56</sup> SBA staff wrote in an email that, “since the charts and graphs are limited to the Agency's experience with franchise loans they may not portray an accurate picture of the Franchise Groups' overall default and charge-off rate or financial health.”<sup>57</sup> This report provides this data to better inform readers of the large number and large financing amounts of SBA guaranteed loans to

franchises and the high levels of default with SBA loans to some franchise brands. All of these figures are prior to the COVID-19 pandemic.

According to the data from the Small Business Administration – and as shown in Chart 2 – franchise loans make up 13% of the SBA’s total loan portfolio.<sup>58</sup> Lending to franchises has increased over time; SBA-guaranteed loans to franchises have increased more than 20% in number of total loans and in amounts guaranteed since 2017. Loans to franchises are made through two SBA programs:

- **7(a).** In 2019, SBA’s 7(a) program guaranteed 51,907 business loans, of which 6,874 loans went to franchise businesses; franchise businesses received 13% of the total loans. The 7(a) program guaranteed \$17 billion in loans, of which franchise loans were \$3.7 billion (22% of funds guaranteed).<sup>59</sup>
- **504.** In 2019, SBA’s 504 program guaranteed 6,099 business loans, of which 621 loans were to franchise businesses, approximately 10% of the loans. The 504 program guaranteed loans worth nearly \$5 billion, of which franchise loans make up \$851 million (17% of funds guaranteed).<sup>60</sup>

Chart 2: Proportion of 7(a) and 504 Loans Made to Franchises by Fiscal Year<sup>61</sup>

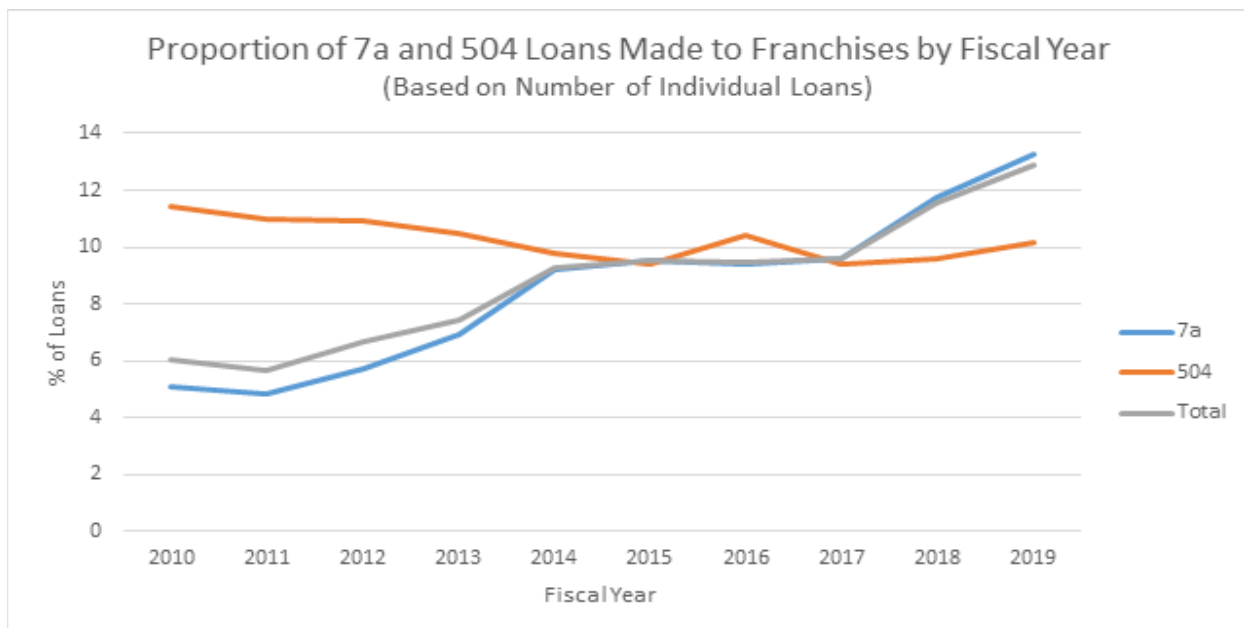
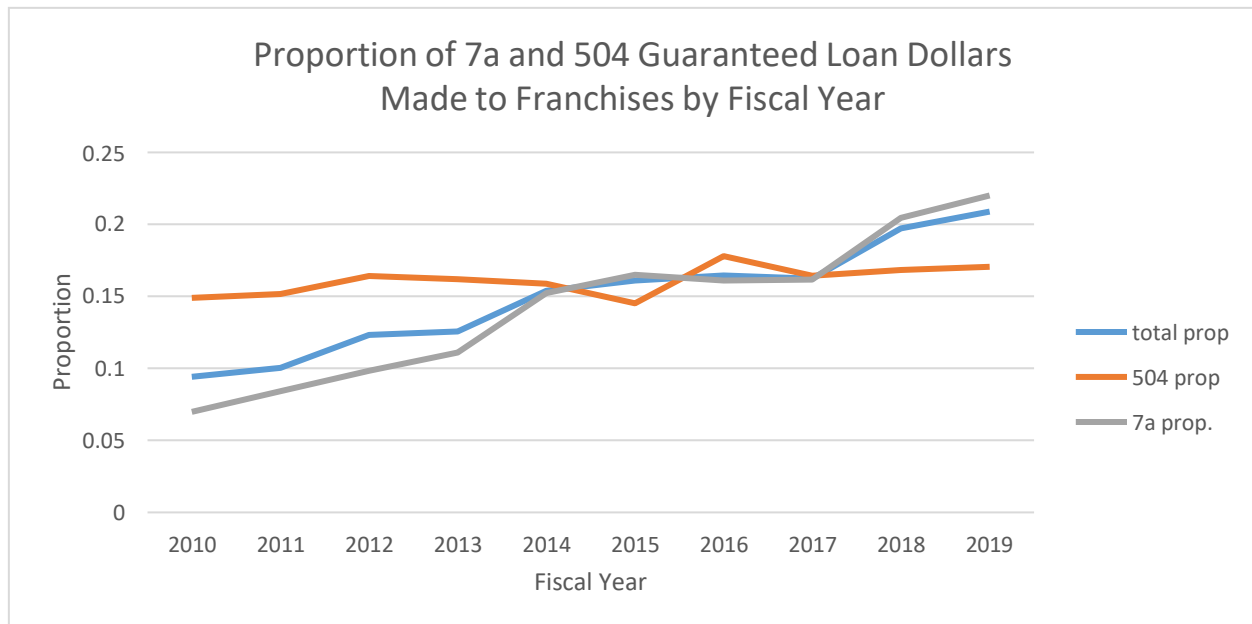


Chart 3: Proportion of 7(a) and 504 Guaranteed Loan Funds Made to Franchises by Fiscal Year<sup>62</sup>

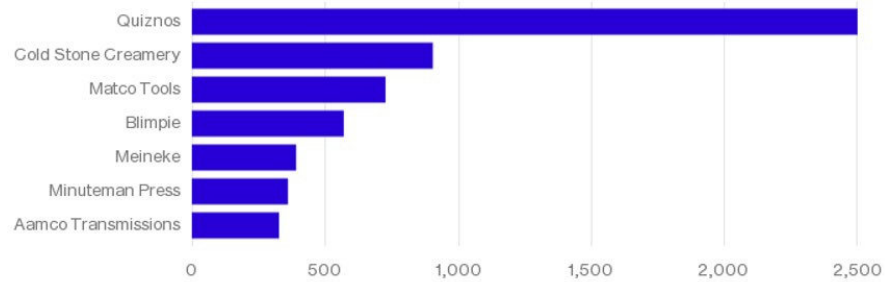


For decades, advocates and some franchise owners asserted that poor oversight of the SBA loan guarantee programs enabled failure and deceptive practices.<sup>63</sup> From 2003 to 2012, more than one in four loans – 28% – to franchises guaranteed by the 7(a) program defaulted,<sup>64</sup> which required that the SBA compensate lenders with \$1.5 billion for failed loans.<sup>65</sup> Failed loans occur after the lender liquidates collateral, seizing the borrower's assets, home, land, and retirement accounts.<sup>66</sup> Charts 4 and 5 are *Bloomberg* and *Wall Street Journal* analyses finding high failure rates for well-known franchise brands.<sup>67</sup>

Chart 4: Some Franchise Brands Experience High Defaults. 1991-2010 (Bloomberg Analysis)<sup>68</sup>

### Franchise Loans

Loans made to franchises with charges-off rates of greater than 20 percent, 1991-2010



Source: SEIU

Bloomberg

Chart 5: Top Franchise Defaulters Fiscal Years 2004-2013 (Wall Street Journal Analysis)<sup>69</sup>

### Top Franchise Defaulters

Chains whose franchisees had the highest failure rates on SBA loans from 2004 through 2013\*

Company	Default rate	Amount (millions)
Planet Beach	41.1%	\$10.8
Huntington Learning Centers	31.1%	\$7.8
Quiznos	29.6%	\$38.4
Cold Stone Creamery	29.4%	\$34.1
Aamco Transmissions	26.4%	\$6.3
Curves International	25.1%	\$6.7
Cici's Pizza	20.9%	\$7.3
Minuteman Press	20.3%	\$2.6
Sylvan Learning	20.2%	\$4.6
Cartridge World	17.5%	\$2.2

\*Limited to chains whose franchisees took out a total of 100 or more loans

Source: An analysis of U.S. Small Business Administration data. The Wall Street Journal reviewed all SBA 7(a) loans to franchisees issued from January 2004 through December 2013.

Chart 6: Loans Issued to Selected Franchises (Cortez Masto Staff Analysis, February 2020)<sup>70</sup>

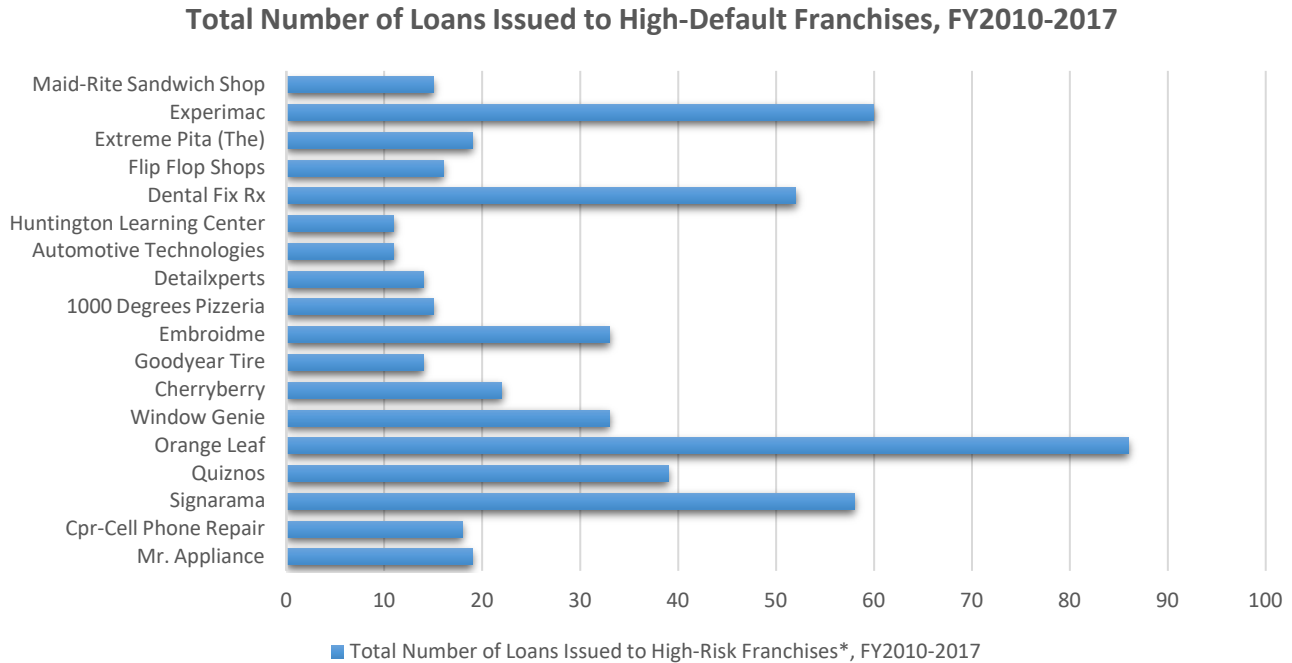


Chart 7: Dollars Charged off by Selected Franchises (Cortez Masto Staff Analysis)<sup>71</sup>

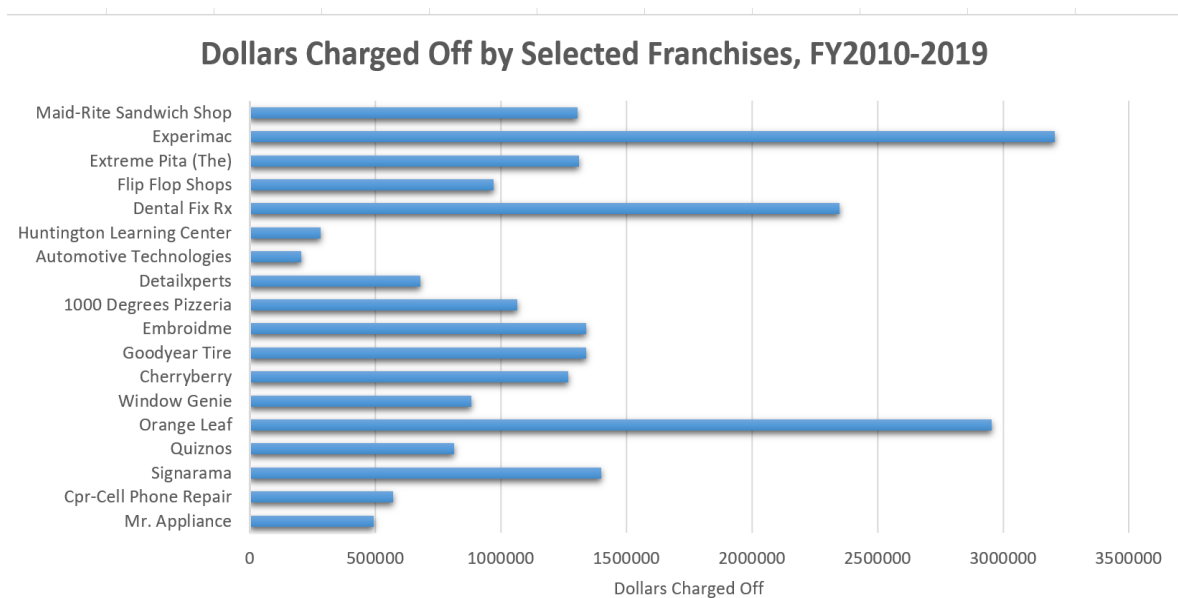


Chart 8: Charge-off Rates of Selected Franchises (Cortez Masto Staff Analysis)

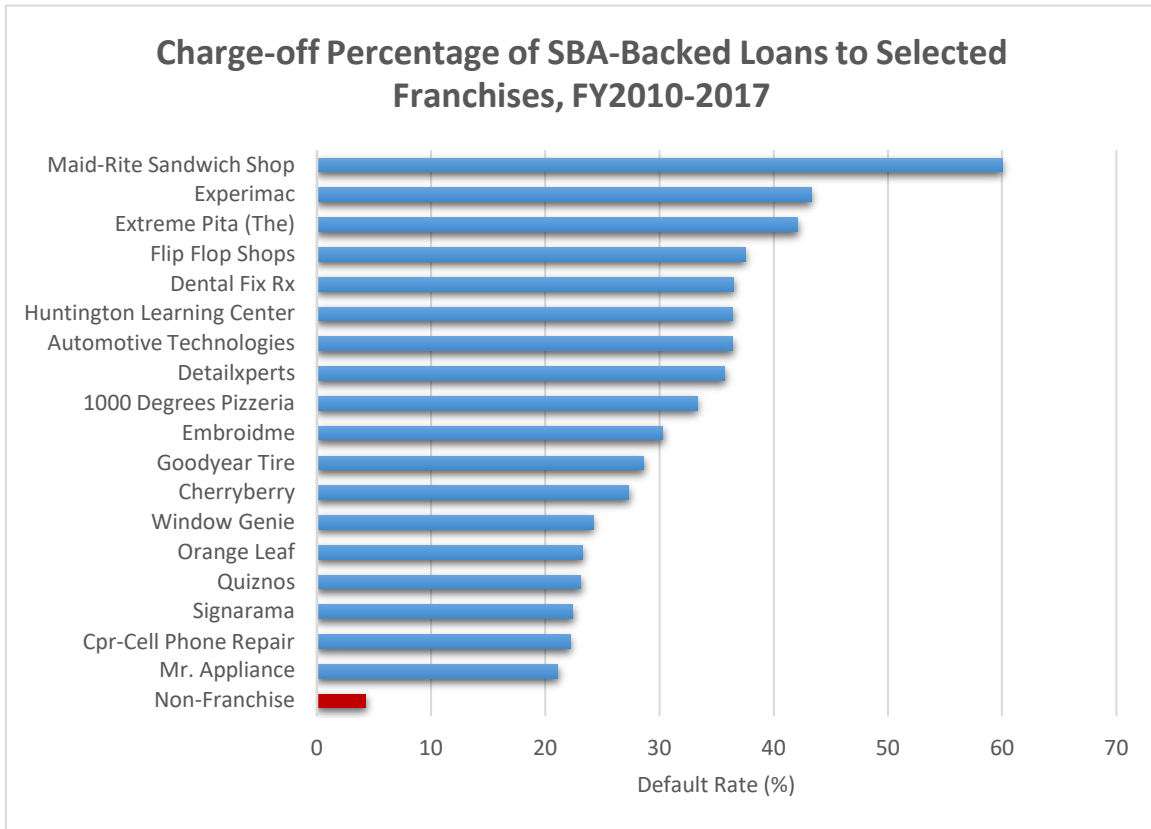


Chart 9: Data on SBA Loans to Selected Franchises – FY 2000-2020 (Cortez Masto Staff Analysis, February 2021)

Source: Analysis of SBA Loan Data made public by the FOIA (<https://www.sba.gov/about-sba/open-government/foia#section-header-32>)

Franchise	Loans Guaranteed	Loans Charged Off	% Charged Off	Amount Guaranteed (millions of dollars)	Amount charged off (millions of dollars)	% Charged Off
Complete Nutrition	63	9	14%	\$5.22	\$3	57%
Dickey's Barbecue Pit	269	55	20%	\$45.91	\$14.99	32%
Experimac/ Experimax*	74	35	47%	\$7.47	\$4.94	66%
Quiznos	2133	637	30%	\$248.01	\$64.47	26%
Curves	409	82	20%	\$29.88	\$9.79	33%
Huntington Learning Center	177	64	36%	\$26.96	\$12.10	45%
Meineke	356	102	28%	\$65.24	\$20.93	32%

\*Experimac does not pre-date 2016

## The Small Business Administration Received Decades of Warnings

For decades, the SBA's Office of Inspector General (SBA OIG), the Government Accounting Office (GAO), and independent researchers published reports raising concerns about SBA guarantees of loans to poorly performing franchise owners. Below are some notable reports:

- The SBA OIG noted difficulties with franchise lending in its *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2020*.<sup>72</sup> The SBA OIG wrote, "SBA continued to guarantee loans to high-risk franchises and industries without monitoring risks, and where necessary, implementing controls to mitigate those risks."<sup>73</sup> It also identified lender noncompliance, and found that lenders had failed to provide documentation to support requirements that borrowers had met requirements related to eligibility, repayment ability, size standards, franchise agreements, business valuations, appraisals, equity injection, and debt refinance.<sup>74</sup>
- In 2013, the Government Accountability Office released a report (GAO-13-759) that showed during the previous 10 years, "SBA guaranteed franchise loans under its 7(a) program totaling around \$10.6 billion. SBA made guaranteed payments on

approximately 28 percent of these franchise loans, representing about \$1.5 billion.”<sup>75</sup> Lenders receive government payment after the borrower’s collateral is seized. Four lenders originated most of the failing loans. The GAO report found that, over a dozen years, more than 40% of buyers of a single franchise defaulted on the loans that the SBA guaranteed, costing \$11 million in guarantees.<sup>76</sup>

- A 2013 SBA OIG report reviewed loans for the franchises Planet Beach, Petland, and Cold Stone Creamery and found default rates above 46%, resulting in \$39 million in guarantees paid.<sup>77</sup>
- In 2011, the SBA OIG published a report finding inflated gross revenue projections in loans made to Huntington Learning Center franchise owners.<sup>78</sup> The OIG found that the lender used inflated numbers to get the SBA guarantee for the bank. The OIG recommended the SBA seek recovery of the loan guarantees, less any recoveries, paid in connection with the 10 defaulted loans that cost the SBA more than \$2 million.<sup>79</sup>
- A 2013 GAO report found borrowers in the Patriot Express program, an SBA program meant to facilitate loans to veteran-owned businesses, had high failure rates.<sup>80</sup> Defaults cost \$31 million in total, with a default rate consistently exceeding other SBA programs.<sup>81</sup> Default rates were so high that SBA did not renew the program when it expired in December 2013.

#### IV. Case Studies

This section considers franchise models that work for franchise owners as well as those that are problematic.<sup>82</sup>

##### Franchise Models That Work

The restaurant industry is generally riskier than others. When operated from the top with the franchisee’s best interest in mind, the franchise model can successfully mitigate that risk for a small business owner. Popeye’s is a positive example of how a franchising corporation can be successful both for the franchisees and for the shareholders. In 2007, the company had a leadership change following a series of struggles. The former CEO, Cheryl Bachelder, brought a values overhaul to the company.<sup>83</sup> Her methods focused on putting the franchisees’ interests first and including them in discussions regarding advertising and fees. The company’s corporate management tracked restaurant-level productivity closely, and bottom-up growth followed. A *Harvard Business Review* article reports a growth in revenues from \$154 million to \$259 million in the four years from 2011 to 2015.<sup>84</sup> That growth included an increase from \$24 to \$44 million in net profits to the corporation, while the rest of the growth went to franchisees.<sup>85</sup> Evidence for Popeye’s recent success can be found in the results of the 7(a) and 504 loans the company’s franchises have received. Since Fiscal Year 2010, Popeye’s franchisees have received seventy 7(a) loans and forty 504 loans. As of the end of the 2019 fiscal year, sixty loans had been paid back in full, and zero have defaulted.<sup>86</sup>

Dunkin' is another example of a business model that successfully mitigates the franchisee's risk. Dunkin's franchisees have received 147 SBA-backed loans since Fiscal Year 2010, and not one has defaulted.<sup>87</sup> *Entrepreneur* ranked the company number one on its 2020 Franchise 500 list, a spot it earned based on its national brand name recognition, effective marketing, high expected earnings, reasonable fees, and the wide array of support offered by the franchisor.<sup>88</sup> The company has demonstrated remarkably fast growth over the past ten years and, unlike other franchises, all of its locations are owned by franchisees.<sup>89</sup>

Outside of the restaurant business, FASTSIGNS has gained a notable reputation as a supportive and highly successful franchisor. Of the 167 SBA loans its franchisees have received since Fiscal Year 2010, only one has defaulted; 35 have been paid back in full.<sup>90</sup> In fact, *Franchise Business Review* has listed FASTSIGNS as a top 200 franchise every year since 2006.<sup>91</sup> In addition, *Entrepreneur* ranks FASTSIGNS number one in the world in its category and 55<sup>th</sup> overall.<sup>92</sup> FASTSIGNS' success is partially because the company allows individual owners to make decisions about their own business. For example, franchisees have the freedom to set their businesses' hours, and they face very low minimum staffing and inventory requirements.<sup>93</sup> FASTSIGNS CEO, Catherine Monson, is well known for measuring the importance of franchisee profitability as the long-term key to growth in the company.

## Franchise Models with a History of Owner Complaints

### *Burgerim*

Burgerim is a fast casual restaurant that has grown quickly in a few years, from only one franchised location in 2016 to at least 1,550 licenses sold by the end of 2019.<sup>94</sup> Over that period, Burgerim raised at least \$57.7 million in franchise fees.<sup>95</sup> Yet, as reported in *Restaurant Business*, many Burgerim franchisees are already facing financial ruin.<sup>96</sup> In 2019, Burgerim announced that it was considering bankruptcy and had hired a new CEO, a chief restructuring officer, and a bankruptcy lawyer. The founding CEO fled the country.<sup>97</sup>

The Maryland Attorney General and Securities Commissioner issued a Stop Order against Burgerim and suspended franchise registration in Maryland on the grounds that the FDD failed to disclose the company was going through bankruptcy.<sup>98</sup> Within a month, the state of Washington also revoked Burgerim's right to sell franchises.<sup>99</sup> The company's franchise registrations expired in Virginia and Maryland and were not renewed.<sup>100</sup> In February 2021, the state of California fined Burgerim executives nearly \$4 million dollars for concealing the number of cancellations and refunds, mismanaging franchisees' initial franchise fees, bouncing refund checks, and abandoning its franchise obligations.<sup>101</sup> The SBA guaranteed \$38 million loans to 119 Burgerim franchise owners.<sup>102</sup>

**Jay Hackstaff, Reno, Nevada:** *"I've been in the restaurant business for 21 years. I've never seen a business so unorganized...what you are seeing in the news, it's 1,000 times worse. There are all these things Burgerim is supposed to do that are clearly stated in the franchise agreement but they are not doing them."*<sup>103</sup>

## *Complete Nutrition*

In March 2019, Complete Nutrition, a franchise that provides nutrition and health supplements and other related products, told its franchise owners it would no longer provide any franchise services.<sup>104</sup> Individual stores had the option to become independent, but they were required to pay as much as \$10,000 to do so. Alternatively, the stores could remain part of the franchise and follow all previous franchisee requirements, including paying monthly royalties based on gross sales, and meeting certain higher sales quotas of specific Complete Nutrition products while competing with Complete Nutrition Corporate's online sales.<sup>105</sup>

Prior to that decision, Complete Nutrition had made major changes to its franchise model that franchise owners said were harmful.<sup>106</sup> According to the franchise owners, Complete Nutrition lowered pricing across all products, which reduced franchisees' profit margins by 30%.<sup>107</sup> The franchise also required franchise owners to pay high fees if they did not make impossible targets, such as selling certain types of products that were not readily available. Through the shared point-of-sale system, Complete Nutrition obtained email contact information for the customers of its franchise owners and began marketing to all customers, sending them special discount offers coupled with free mail delivery. Stores were unable to compete with Complete Nutrition's online business, because the online offers were lower than what the franchise owners paid wholesale and thus price matching would cause franchise owners to lose money. In the end, these promotions reduced income to the franchise owners who operated the store locations.

In April 2019, Complete Nutrition franchise owners allege, the corporation eliminated franchise owners' access to the point-of-sale system, removed franchise owners' locations from its website, and sent an email to the customers telling them that their retail locations had been sold and that customers should order online. A few days later, Complete Nutrition sent an apology email to all the customers of its stores saying the email was sent in error, but damage to the franchised stores had been done.<sup>108</sup>

According to data provided by the Small Business Administration, the agency guaranteed more than \$17 million in loans to 67 Complete Nutrition franchise owners. At least 12% percent of the loans have been charged off, which cost SBA \$574,657.<sup>109</sup> The most recent data from SBA on late payments (as of March 31, 2019) reports that 45% of Complete Nutrition loans are not current.<sup>110</sup> And this was before they cut off franchise services.

**Michael Hataway, Reno, Nevada:** *"They canceled our membership loyalty program (replacing it with a FREE program) which was an average of \$3,500 per month in sales for my store, that's \$40,000 per year...I'm shutting my store down at the end of this month. It's just not worth the fight anymore and I've lost so much money".<sup>111</sup>*

### *Dickey's Barbecue Pit*

*Restaurant Business* reports that Dickey's Barbecue Pit franchises are closing at an alarming rate.<sup>112</sup> According to the Dickey's Barbecue Pit Franchise Disclosure Document (FDD) dated September 4, 2018, for the fiscal year ending May 31, 2018, the brand opened 72 new franchised units, but had 89 terminations and 24 ceased operations, for a net store loss of 41 units. An additional 44 units transferred to new owners.<sup>113</sup> Dickey's ended the fiscal year with 521 units. In comparison, the previous fiscal year showed 88 units opened, 70 ceased operations, and 67 transferred.<sup>114</sup> Dickey's store performance has only gotten worse; in fiscal years 2019 and 2020, Dickey's opened 60 and 30 stores respectively, but ended May 31, 2020 with only 466 units.<sup>115</sup>

Some franchise owners allege that some of the loan failures may be due to Dickey's Barbecue Pit leadership providing misleading and inaccurate information to potential franchise owners, resulting in failed businesses and bankruptcy.<sup>116</sup> Some franchise owners allege that Dickey's Barbecue was telling franchise owners to expect revenue of up to \$80,000 per month, but most stores earned much less.<sup>117</sup> In addition, new menu boards, errors with gift cards, and costly promotions decreased profitability for franchise owners. Franchise owners contend that Dickey's leadership lied about reasons that stores are available for sale.<sup>118</sup>

The 2019 Pit Owners' Association Franchisee Satisfaction Survey reported that 75% of current Dickey's franchise owners say the franchise agreement they signed is not fair, 85% said they would not invest in a Dickey's again, and 61% are considering closing their store.<sup>119</sup> At the end of 2019, the SBA guaranteed 255 loans to Dickey's Barbecue franchise owners for more than \$72 million, of which 41 (nearly \$11 million) were charged off. The most recent data from SBA on late payments (as of March 31, 2019) finds that 28% of Dickey's Barbecue Pit loans are not current.<sup>120</sup>

**Amin Abdelkarim, Dickey's BBQ, Texas:** *Amin is an immigrant from Egypt who worked double shifts at the Dallas Fort Worth International Airport and saved enough money to invest in a business. He purchased a Dickey's Barbecue Pit franchise. He was given the FDD, as well as a spreadsheet showing*

*estimated startup costs, and was provided assistance with applying for an SBA 7(a) loan. He alleges that the estimates given were grossly incorrect, and all his startup capital was spent getting the business open. He opened his business in August 2018, but one month after opening, he had no money. He could not pay his SBA loan, and feared he would lose his home, rendering*

*his family homeless. Dickey's reminded him of the 60-month liquidated damages clause in his contract. His other option was to sell his business to a buyer Dickey's found, for pennies on the dollar. Either way, he knew his SBA loan was going in default, and he was*

**“In a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money.”**

*going to lose all his assets. At one point he said, "In a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money."*<sup>121</sup>

**Anonymous Dickey's BBQ owner, Southwest United States:** *"I feel Dickey's is using franchise owners and their money to sell direct to supermarkets and develop a software company. Their recent actions show no care for owners' income, just increasing the corporation's share of revenue by auto shipping and billing for products they know won't sell and also charging owners above retail price and receiving the rebates on owners' forced purchases. Dickey's has already placed product for sale direct to consumer in Walmarts across the country directly competing with the local restaurant and selling direct at less than what they charge owners."*<sup>122</sup>

### *Experimac/Experimax*

Experimax sells and repairs previously used Apple brand computers, tablets, and phones. In response to a lawsuit from Apple, Experimax legally changed its name to Experimax due to a legal complaint with Apple that some franchise owners say was not disclosed.<sup>123</sup> A number of these franchise owners – including six who filed complaints with the Federal Trade Commission – state that the estimated revenue projections provided by Experimax specifically to obtain SBA loans were inflated and that they never earned the revenue reported as typical.<sup>124</sup> Some franchise owners say they were coached on how to "fudge numbers" to obtain an SBA guaranteed loan. They also contend they were not provided the training, services, and supply chain of quality goods promised and for which they paid. Experimax required unusually high initial payments of \$49,500 per franchise owner.<sup>125</sup> Experimax franchisees allege that the company also required franchise owners to spend \$130,000 to design the store and buy supplies at inflated prices.<sup>126</sup>

Between January 2016 and December 2019, SBA guaranteed 80 loans to Experimax franchise owners. Most of the loans – 86% – were made by one bank. At the end of 2019, 26 of the 80 loans (33%) had been charged off. In addition, 8 loans were not current but not yet charged off.<sup>127</sup> Despite these high default rates, the franchisor was still falsely promising potential franchise owners that there were "locations in our Million Dollar Club".<sup>128</sup> Experimax's current FDD shows the highest volume franchised location with revenue of \$822,375, with an average unit doing \$410,639.<sup>129</sup>

**Jeff and Gina Siepierski, New York:** *"We have sacrificed our careers in order to invest into the Experimax/x brand. In addition, we have invested every cent of our \$103,000 savings of stocks, have taken on an additional \$90,000 in personal credit card debt, signed as personal guarantors to over \$300,000 in business. Now in year 5, when compared to the inflated projections provided to secure our SBA loan, our Experimax/x store has a (\$1,145,000) shortfall [30%] at the end of 2020 despite being one of the top 3 stores in the company."*<sup>130</sup>

**Mark Shor, Henderson, Nevada:** *He retired from his IT job at a New York State university and bought an Experimac franchise outside of Las Vegas in order to be closer to his brother. He was hopeful that it would be an enjoyable job for his retirement and allow his son to take over the business. “The franchisor directed me to a loan broker that helped me apply for and obtain an SBA 7(a) loan. The loan broker provided a projection spreadsheet that showed nearly \$700,000 in revenue for the first year, \$995,400 the second year,” he said. Shor never earned anywhere close to such projected revenue. He plans to close his store soon. He and his son were the only employees, and they may end up defaulting on the loan greatly reducing the funds he set aside for his retirement.*<sup>131</sup>

### *Subway*

Numerous journalists have reported that Subway sandwich shop franchise owners across the nation are struggling to survive, with what franchise owners say are heavily discounted promotional offers and corporate decisions that undermine the franchise owners’ survival.<sup>132</sup> Some franchise owners allege that franchisees have little say in the vendors that are chosen or the way prices of goods are set, nor can the franchise owner use its leased premises for another purpose.<sup>133</sup> Franchise owners have accused Subway of using minor infractions to “steal” the stores from franchisees through a rigged inspection and arbitration system.<sup>134</sup> Franchise owners also allege Subway allowed stores to open within blocks of existing locations or forced franchise owners to open additional stores nearby, a practice *Business Insider* referred to as “cannibalizing businesses.”<sup>135</sup> More than 75 Subway franchise owners submitted comments to the FTC raising a variety of business practices they consider unfair, such as demand for renovations and new programs, costly rebates, and changes to the operations manual.<sup>136</sup>

Subway franchise owners also allege that a Business Development Agent (BDA) in the western region misused his power to force and deny store sales.<sup>137</sup> Usually the BDA’s duties include franchise sales, site location assistance, training, and operational assistance. However, as reported in the *New York Times* and in litigation, the BDA earns more money – a 2.5% increase in the franchisee’s monthly fee – and can take non-performing stores for infractions such as choppy vegetables, “dirty mop sink”, “card reader not fastened to the counter”, being “out of product” when Subway controls product delivery, or other violations found by “hit men” inspectors.<sup>138</sup> One Nevada franchise owner alleges that such an inspector “sabotaged a bag of meatballs by puncturing the storage bag with a thermometer and then waiting until the temperature went up to record the temperature of the meatballs.”<sup>139</sup> Others report similar “hit jobs” designed to report the franchise owner as non-compliant. Franchise owners report being forced into long arbitration processes where they are unable to win.

Over the years, the SBA has guaranteed loans to 1,669 Subway franchise owners worth \$417 million. Of those, 191 loans for more than \$16 million were charged off – at a cost of more than \$12 million to the SBA. In addition, 11% of SBA loans to Subway franchise owners have defaulted; 76 loans are not current but have not yet defaulted.<sup>140</sup>

**An anonymous Subway franchise owner for more than 20 years:** *"The \$5 foot-long sandwich promotion which runs for three months out of the year for many years is a major financial burden for franchise owners. Recently Subway had a \$2 meatball and \$2 cold cut combo sandwich promotion where we lost huge amounts of money. Subway never reduced its royalty fees during these promotions. As Subway has made profit on this promotion, the franchise owner has to pay the burden all the costs and expenses like food cost, labor cost, etc. Subway has also saturated the market by coercing franchise owners to open Subway stores too close to other stores which destroys the business of existing stores. We have to spend money to remodel our stores. We have no way out. And when you complain, they use unethical business technique by putting your store out of compliance and force you to shut up."*<sup>141</sup>

**Vishal Sharma, former Subway owner in Reno, Nevada:** *"I regret ever buying this Subway franchise. It was one of the worst decisions of my life. I had a successful store but the franchisor rigged the rules to force me out of business and I lost everything. I am still fighting this battle in court on my own, this has drained all my funds, but I am doing my best to fight this injustice."*<sup>142</sup>

### *Curves*

Curves gym for women was a fast-growing franchise that had more than 10,000 locations in the U.S; today, as of April 30, 2020, only 284 remain in operation.<sup>143</sup> Franchisees went to court in two separate cases against new owners, who allegedly stripped wealth out of franchisees' businesses.<sup>144</sup> Franchise owners claimed that Curves misrepresented information relevant to their decision to enter franchise agreements and that the brand later violated those agreements. In 2017, a Texas jury returned a unanimous verdict in favor of 52 qualifying Curves franchise owners, awarding them 80% of their net operating losses, totaling approximately \$1.5 million.<sup>145</sup> Curves appealed the decision to the United States Court of Appeals for the Fifth Circuit. The parties ultimately settled while the case was on appeal.<sup>146</sup>

In February of 2020, 32 former Curves franchise owners sued the investors who purchased the Curves company. The franchise owners alleged that a 2012 study by the investors' consultants reported an expected 15% failure rate; the study was not shared with the franchise owners.<sup>147</sup> Instead of making changes, the new owners sought to increase their profits by increasing royalties and selling products to franchise owners.

**Megan Edwards, California:** *"Less than 24 months after buying the Curves franchise, I was in financial ruin. All of this occurred as I struggled to successfully manage the franchise and meet never-ending corporate purchasing demands and haphazard rollouts. At no point were we ever able to show a legitimate profit that included a true owner draw or that wasn't used to reimburse money already 'spent out of pocket.' On August 31, 2014 the Club was shuttered, 2 1/2 years into the 5 year Franchise Agreement. The lack*

*of honesty, transparency, respectful communication and misleading franchising agreements, devastated us and other franchise owners. My savings were depleted. I was forced to sell my house and I took out a title loan on my vehicle; and I'm in litigation with several creditors. I don't have the money to visit my 93-year-old mother in Canada.*<sup>148</sup>

## 7-Eleven

Franchise owners of this large convenience store chain have reported pressure to sign unfair agreements that allow the company to exert pervasive control over its owners both financially and operationally.<sup>149</sup> They say these contracts have taken away much of the control over day-to-day operations from franchise owners, including staff work assignments; owners give as much as a marginal rate of 59% of all gross profits directly to the corporation despite declining store gross profit. In 2018, 7-Eleven required a large number of franchise owners to sign new contracts as part of their renewal option. Franchisees report that this new contract was significantly different from the previous contract and included a \$50,000 franchise renewal fee, and required franchisees to pay 100% of liability insurance for property and equipment, even though that equipment was not owned by franchisees. The contract also included a more regressive profit-sharing model that franchisees allege heavily favors the corporation, one-sided legal fees, mandatory and often overpriced vendors, and mandated operation hours (including Christmas Day). Some owners say that closing during the night would actually be safer for their staff and the community, but they are not allowed to make that decision.<sup>150</sup>

Gasoline pricing has been another point of contention. Franchisees say that retail gasoline prices are set by the corporation, and franchisees receive an exceedingly small fixed commission based on the number of gallons sold. Gasoline pricing is often set higher than the competition, which tends to reduce the number of gallons sold. Gasoline acts as a loss leader for franchisees and can fail to cover the cost of gas operations.<sup>151</sup> The fresh food and hot foods that 7-Eleven offers also yield a lower net profit due to a high amount of waste when food expires before it can sell. Food items also add increased labor costs. Franchise owners allege that the financial impacts of these fixed prices for gas and fresh or hot foods are not disclosed in the FDD.<sup>152</sup>

Press reports, including from the *New York Times* and *Bloomberg*, have also highlighted that 7-Eleven's franchise agreement allows the corporation to take back stores if franchise owners violate immigration law.<sup>153</sup> Some franchise owners believe that the company may have used Immigration and Customs Enforcement (ICE) to target specific franchisees and take away ownership of profitable stores, and as a result, they are suspicious of immigration officers issuing inspection notices and arresting undocumented immigrants at stores.<sup>154</sup> A significant majority of 7-Eleven franchisees are immigrants or minorities who invested their life's savings or borrowed money, often at high interest rates, in pursuit of the "American Dream." Many of these franchisees started with very little, they and their families often work long hours with little or no time off to build the business. At one time,

franchisees felt like the Independent Contractors the 7-Eleven agreement claims them to be, allowing them the latitude to make decisions to ensure their financial success, but many say that is no longer the case.

Furthermore, franchise owners contend that the corporation requires franchise owners to sign one-sided legal provisions in the event of legal disputes between the corporation and franchise owners. These provisions force franchisees to pay 7-Eleven's court fees even if they win, give up their right to a jury trial, and subject them to Texas' governing laws regardless of where they operate, depriving them of the benefits of their home state laws and court systems.<sup>155</sup>

**Anonymous, Southwest United States:** *"We do not have the support we need to financially succeed. Investing in a 7-Eleven is not a good decision. [The company] does not get the lowest cost of goods from its vendor partners, nor does it have the franchisee's best interest at heart."*<sup>156</sup>

### *Huntington Learning Centers*

The Huntington Learning Center franchises provide scholastic tutoring. In 2011, an SBA Office of Inspector General report found that when Banco Popular originated Huntington Learning Centers (HLC) franchise loans, the bank did not adequately assess borrower repayment ability.<sup>157</sup> Instead, the lender approved the loans based on inflated gross revenue projections submitted by loan brokers in SBA loan applications.<sup>158</sup> According to one Connecticut franchise owner, HLC's loan consultant steered him towards Banco Popular and provided first-year revenue projections totaling just over \$500,000, which allowed him to receive a \$300,000 loan.<sup>159</sup> As the franchise owner's business started to fail, he wondered why he was so short of the projections he'd been given. He found other franchise owners opening at the same time were also far short of their projections. Then, he found out that actual first-year revenue for a typical HLC was really \$249,000, less than half his given projection. "According to what he learned, a mature location had average revenue in the low \$400,000s."<sup>160</sup> He believes that his loan was reversed-engineered with false information to qualify for the \$300,000 SBA loan.<sup>161</sup> To qualify for a guarantee from SBA for a \$300,000 loan, the franchise owner would need a revenue estimate of more than \$500,000. HLC collected a \$60,000 franchise fee. Some franchise owners filed for bankruptcy.

**Commenter to the FTC, Connecticut:** *"Just imagine you receiving a phone call out of the blue from someone you've never met and being asked how much money you make....[N]OT ONE franchisee told me the truth. NOT ONE. Why? First, because they weren't going to tell a complete stranger their income. Second, because they didn't know if I was a fake call from the franchisor testing them to see if they were bad mouthing the system and 'denigrating the mark' - which is a major default in the franchisors eyes."*<sup>162</sup>

## Quiznos

In 2008, there were nearly 5,000 Quiznos franchise restaurants, but as of the end of 2018, only 306 stores survived.<sup>163</sup> Since 2000, Quiznos has been the target of at least five class action lawsuits filed by franchise owners.<sup>164</sup> Quiznos owners complained for years about the company charging too much money, not just for ingredients but also for any other item the restaurants needed. In court, Quiznos admitted that it sold franchises to entrepreneurs who had “little or no relevant experience,” which often led to restaurant failures that harmed the brand and the rest of the chain.<sup>165</sup> Additionally, Quiznos contracts required franchise owners to pay 7% in royalty fees and another 4% for advertising — rates higher than the industry average of 6% in royalty fees and 2% for marketing.<sup>166</sup> After filing for Chapter 11 bankruptcy, Quiznos began lowering the costs of ingredients.<sup>167</sup>

**Bhupinder Baber owned two Quiznos franchises in 2006:** *Mr. Baber committed suicide in his store, despondent over his future. In the note he left behind, he wrote, “Someone must do something about what Quiznos is doing to the trapped franchise owners....I deeply regret getting into Quiznos. I wish I had never heard of them.”*<sup>168</sup>

## Massage Envy

When the Federal Trade Commission requested comments on its Franchise Rule, Massage Envy franchise owners submitted the most comments. The nearly four dozen Massage Envy commenters — and others who did not comment to the FTC but spoke to Senator Cortez Masto’s staff — allege that mismanagement of a new point-of-sale system, problems with gift cards and holiday promotions, required sales of inferior skin care and other products that do not sell, overpriced goods including liability insurance and technology systems, and unrealistic revenue projections have been financially damaging to their businesses. Massage Envy corporate leaders were the only corporate leaders of any of the named franchise corporations to respond to the request to speak with Senator Cortez Masto staff. The company alleges that most franchise owners are doing well and have no complaints with how the franchise operates; they also sent a letter signed by an affiliated franchise owners’ advisory board that supported franchise leadership.<sup>169</sup>

Founded in 2002, the Massage Envy franchise has more than 1,100 locations employing 35,000 individuals.<sup>170</sup> While the company was initially ranked as one of the best investments by sources such as *Forbes* and *Entrepreneur* and long-time franchise owners were happy with the brand<sup>171</sup>, however, when the company sold to a new investment corporation, some franchise owners reported a dramatic loss in revenue. Massage Envy franchise owners told the FTC about a litany of problems they allege harmed their ability to be profitable. These include requirements to purchase overpriced and inadequate liability insurance from brokers affiliated with Massage Envy.<sup>172</sup> One owner reported paying three times as much for coverage as she could have gotten at a different insurer.<sup>173</sup> Franchise owners also report being overcharged on design “help”; marketing costs; unwanted and poor quality creams, lotions, sunscreens, and massage machines; and technology

systems. Some franchise owners allege that changes to Massage Envy's Operations Manual severely impacted business owners and their ability to succeed by requiring additional payments for a variety of reasons from the franchise owner to the corporation.<sup>174</sup> They report being forced to comply with these requirements at the risk of losing their ownership of stores.<sup>175</sup>

**Anonymous, Southern Franchise:** *"I purchased [my two locations] in 2015 as high-performing clinics. [When the brand sold to a new owner, profits moved from the owner to the corporation] They have rolled out new services, one after another, with zero accountability for their success or failure. Each is designed to be a revenue stream for [Massage Envy Corporate], regardless if it is for us (and almost all have failed). When a new service/product doesn't sell, they then create a national promotion that requires us to give it away. Massage Envy required we relinquish our individually-owned internet accounts which averaged \$100/month and use their third party vendor, hardware and point-of-service program which is more than \$1,200/month. The vendor provides inferior service including inaccurate reporting and billing and poor response time."*

## V. Four Factors Leading to Franchise Failures

While some may argue that no one makes someone buy a franchise and that franchise owners bear the responsibility to avoid problematic brands, it can be difficult for franchisees to avoid companies that might treat franchise owners unfairly.<sup>176</sup> Companies also change; they may go public or be bought by private equity. With ownership and leadership changes, profitable brands can become problematic. Federal and state governments have laws prohibiting unfair, deceptive, and fraudulent practices to ensure people entering business contracts receive fair treatment. Franchise owners who feel they have been treated unfairly have the option to hire an attorney and participate in arbitration or litigation – and some do – but too many lack the funds to do so after spending savings to rescue their businesses and avoid bankruptcy.

This section highlights four factors in franchise relationships that may lead to failure for the franchise owners – no matter how hard they work or how closely they follow the franchise plan. Some of these problems are due to contract terms within the FDD, which some franchise investors do not realize is not a government-approved and vetted document. The four factors include:

- Unfair contracts and agreements.
- Inaccurate financials.
- Overpriced or missing services.
- Requirements to buy from preferred vendors and resulting kickbacks.

## Unfair Franchise Agreements Allow Franchise Corporations to Retain Excessive Control

Franchise corporations market the franchise as a way to “own your own business.” Yet franchise contracts may give nearly all power to the franchise corporation. Clearly, franchise corporations must be able to set a certain standard of performance in order to maintain the brand’s consistency and quality; they would not want customers to walk into a hamburger restaurant and find bicycle repair services. However, some franchise corporations may use contract provisions in ways that are abusive or deceitful. These contracts make it impossible for franchise owners to survive and to pay fair wages and benefits to workers.<sup>177</sup>

Franchise agreements that include the following elements are fraught with risk for franchise owners:

- 1. Preventing franchise owners from forming associations.** Associations allow franchise owners to collaborate and share information that could make their stores and the franchise brand stronger. Yet some franchisors discourage these associations, even going so far as to retaliate against franchisees who join them. For example, the CEO of Dickey’s Barbecue described franchisees who shared their concerns and participated in an independent association as having “loud, negative voices ... with fierce hatred ... and being cynical, envious.”<sup>178</sup>
- 2. Banning free speech.** Franchise corporations sometimes include language requiring non-disparagement and non-disclosure requirements. While disgruntled franchise owners could cause problems for a brand, this language prevents future investors from learning the truth about an investment while doing their due diligence. Some franchise corporations, in lieu of providing financial data, provide prospective owners with a list of other franchise owners to contact. But contracts with non-disparagement clauses may inhibit franchise owners from speaking honestly about their business, even to potential new owners. Current franchise owners may not tell the prospective franchise owner the truth, either because they fear legal action or they just do not feel comfortable sharing how much they earn. In one instance, a prospective Huntington Learning Center franchise owner reported calling every franchise owner on the list provided by the franchise and receiving assurances that the profits he was provided were accurate.<sup>179</sup> After buying the franchise, he learned that the other franchise owners had lied to him, including one who was actively in bankruptcy; none felt able to tell him the truth because their contracts contained non-disclosure/disparagement clauses.<sup>180</sup>
- 3. Requiring mandatory arbitration clauses.** Mandatory arbitration clauses can prevent franchisees from getting their day in court. Arbitration gives franchise corporations a home-field advantage, which is very difficult for a franchise owner to overcome. A 1998 *Fortune* article highlighted Subway’s particularly egregious practices around mandatory arbitration of disputes.<sup>181</sup> More than twenty years later, arbitration remains a pervasive problem for Subway franchise owners. In 2017, Subway took 955 actions

against franchise owners including 702 against U.S. franchise owners; in 2018, Subway initiated 718 arbitration actions against franchise owners.<sup>182</sup> In contrast, there was one arbitration action by McDonald's, two by Dunkin', and none by Pizza Hut, Burger King or Wendy's.<sup>183</sup>

4. **Including clauses allowing for changes to rules.** Franchise agreements often include language permitting the franchise corporation to change rules at any time and for any reason. These rule changes typically occur in the Operations Manual; franchise contracts require franchise owners to follow the most recent Operations Manual. An Operations Manual change may be needed, as when Burger King introduces a new sandwich and franchise owners need to offer it. But some franchisors have used it in far-reaching ways, such as requiring new store remodeling policies or imposing limits on the sale of franchises.<sup>184</sup> When a new owner took over the Curves women's gym corporation, franchise owners were forced to sell food and clothes and buy new, overpriced, and unnecessary equipment. They were also required to permit reciprocal memberships that allowed a client to join a lower-cost gym but have access to a higher-cost one.<sup>185</sup>
5. **Requiring franchise owners to stay open hours that are not appropriate for them.** Some contracts require franchise owners to provide services at late hours that are not profitable, and in some cases, not safe for the community. When corporations require stores to be open late at night or all night, provide breakfast service, or stay open on holidays, they undercut the ability of franchise owners to own and control their businesses. Franchise owners operating 7-Eleven are obligated to be open 7 days a week, 24 hours a day, 365 days a year, including Christmas Day.<sup>186</sup> This policy was implemented through clauses requiring compliance with the Operations Manual, which in effect changed the terms of the original contracts. In another example of the risks of these clauses, during the coronavirus pandemic, franchise owners that closed or limited hours due to government-ordered shutdowns were told they were in violation of their contracts and would be registered as non-compliant unless they agreed to contractual changes or signed releases.<sup>187</sup>
6. **Requiring franchise owners to accept unprofitable prices and promotions.** Some promotions – Subway's \$5 foot longs or \$2.99 6" subs, Burger King's \$6 box, or various franchises' \$1 menu items – cost franchise owners money. Franchise owners do not want to be forced to offer food that costs more to make and serve than they earn or to accept gift cards that provide them no revenue. For example, Dickey's Barbecue Pit offered gift cards that were not functional; the card always appeared to have money available even when it had been spent, and so the franchise owner received no payments on these gift cards.<sup>188</sup> Conflicts over promotional pricing that increases revenue but reduces profit is common in the franchise industry, because most franchisors make their money based on a percentage of the sales revenue, even when franchise owners are left with little or no bottom-line profit.<sup>189</sup> These deep discounts drive low wages in the industry and limit philanthropic community support.

In fact, franchisors often calculate break-even points based on the revenue required to hire employees at the minimum-wage.<sup>190</sup>

7. **Allowing corporations to easily seize franchise stores.** Franchise owners have complained that Subway's business practices allowed regional store owners to seize their stores.<sup>191</sup> At Subway, the regional Business Development Agents (BDA) are responsible for inspections of the stores in their territory. Inspectors or Field Consultants sent by BDAs would write up stores for violations. Multiple violations reported by a single Field Consultant can put a restaurant into termination in a few months, with no one confirming that Field Consultant's work. If the restaurant is terminated, the franchise owner is often given a short timespan to sell the franchise. However, the BDA must also approve any buyer. If no buyer is found or approved, the BDA can then buy that restaurant, often at a discounted rate. This creates a system that has great potential for a conflict of interest and corruption. In another example, 7-Eleven franchise owners believed that the corporation was working with federal immigration agents to request raids as a tool to seize stores from owners.<sup>192</sup>
8. **Limiting store sales.** Some franchise agreements require a franchise owner to walk away at the end of the contract term with no payment for their decades of work building up a franchisebrand. Franchise owners should be able to receive some equity from their investment—also referred to as monetized equity. Other franchisors refuse to easily approve sales from one franchise owner to another. In one instance, a franchise owner of a restaurant in California needed to sell her store to take care of her dying child. She alleged that the regional Development Agent (DA) refused to approve the owners she recruited, instead dragging out the process as she continued to lose money. Finally, after months without agreement on buyers, the DA bought the store himself at a price lower than those of previous interested buyers. The time delay resulted in her losing her family's home, where she had memories of her now-deceased daughter.<sup>193</sup> In addition, some franchise contracts include non-compete requirements that make it more difficult for a franchise owner to start a new business in their area of expertise.

### Missing or Misleading Financial Disclosures

When selling a franchise to an investor, a franchise corporation has the obligation, if financial representation information is provided, to include historical financial performance, without any false, misleading, or unsupported information. Prospective franchise owners rely heavily on these representations in the FDD when choosing whether to invest in a business. Franchisors and their trade association, the International Franchise Association, often claim that owners fail to do their due diligence in carefully studying the FDD. Yet the FDD can be hundreds of pages and written in an unclear or unbalanced way. Item 19 of the FDD, where the franchisor can make claims about the income, sales or earnings of its stores, is not required, and even when it is present, it can omit critical data.<sup>194</sup> Franchise owners can be discouraged from spending money on an independent attorney to review the contract; they are often told by corporations not to waste their money on such review because the investment is vetted by the federal government—a false assertion.<sup>195</sup>

A 2013 Government Accountability Office (GAO) study found that franchisors often leave financial performance data out of the FDD.<sup>196</sup> A 2011 audit conducted by the SBA Office of the Inspector General found that when franchisors did include revenue projections, they could be significantly higher than historical actuals.<sup>197</sup> The FTC's website notes that financial disclosure claims can be easily distorted to provide a rosier outlook than the reality.<sup>198</sup>

Deception can include failing to provide information to determine how performance data was calculated or about how many stores achieve a given level of earnings. Reported average income can also be skewed higher by only selecting a few high-performing franchises. Gross sales may not reflect actual costs or profits of the average franchise. Without an accurate financial picture, potential franchise owners are unaware of the real costs and profits associated with a business.

Notably, lenders require accurate financial performance data to determine loan type, amount, and payment schedule, and at times, they receive it directly from corporations. Lenders have incentives to make loans that they suspect will fail because lenders make money on the fees and collateral and are likely to get the majority of their money back through SBA guarantees. Bank regulators do not monitor government-guaranteed loans made by banks and other lenders. Lenders may also sell the loan to investors, as SBA loans can be packaged and sold as government-guaranteed loans on the secondary market. The SBA and its Office of Inspector General have been lax in holding lenders and franchisors accountable.<sup>199</sup>

Franchisees can be oblivious about crucial financial performance information about the business they are investing in, even though this same information is compiled and distributed to their lenders. As the author of a law review article put it, "One of the ironies regarding [financial performance representations] 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 franchise owners seeking financing to purchase the franchise."<sup>200</sup> Because the franchise owners are often unaware of these numbers, the owner cannot later determine whether false financial data was given to a financial institution to qualify for a loan the franchise owner must repay. The franchise corporation is generally the party with more business experience. The corporation has a duty of due care to ensure that all relevant information, including accurate financial performance, is provided in the Financial Disclosure Document (FDD). Moreover, franchise corporations can partially protect themselves from being held accountable for misrepresentations by providing inaccurate misrepresentations outside the FDD – a loophole that can cost franchise owners dearly. If the FDD contains no financial information in Item 19, but provides financial information in another manner, the franchise owner is not supposed to rely on that information in making its decision. But that is often unclear to the franchise owner, who often receives revenue numbers from other franchise owners, salespeople, franchise corporation-provided loan consultants, and articles or newsletters.

## Overpriced Fees and Missing Services

There is a cost to purchasing and operating a franchise. Franchise owners are required to pay initial fees, renewal fees, advertising fees, and royalty fees. Initial franchise fees can be as low as \$15,000 or upwards of \$60,000 or more. Royalty fees are typically around 4 – 5% of gross sales, but can go up to 8% or more. Advertising fees can add 1-2% for some franchises, or up to 4.5% or more. Some franchise owners complain that they received no follow-up assistance to set up or manage the business after the sale was concluded.<sup>201</sup> Others report paying fees for marketing, computer, or training services that are never provided, and certainly not reported in a transparent manner.<sup>202</sup>

- 7-Eleven is unusual in requiring an ever-increasing gross profit split. 7-Eleven now requires franchisees to give the corporation as much as a 59% share off the top, even as franchise owners must absorb higher operating costs. Franchise owners complain that they cannot renew their contracts without accepting these higher profit splits and other requirements related to hours and product sourcing.<sup>203</sup> In addition, 7-Eleven franchisees never actually own the businesses; they hold no title to their store, even though they paid for everything.
- Burgerim franchise owners reported being asked to pay \$5,000 for a loan consultant who provided what franchisees allege was no services. Burgerim franchise owners were also charged \$50,000 per franchise location but report receiving none of the promised assistance, training, or materials.<sup>204</sup>
- Dickey's Barbecue Pit franchise owners complain that, over the past five years, more than \$52 million has been paid into the corporation's marketing fund by franchise owners.<sup>205</sup> Although the marketing fund is entirely financed by franchise owners, Dickey's has full discretion and control over how this budget is allocated for the purposes of advertising; the company's only real limitation in using the marketing fund is that it is prohibited from spending the budget on its own general operating costs or for franchise owner recruitment. However, these prohibitions can be loosely applied. For example, expenses for an executive traveling to a region may be charged to the marketing fund because the executive is "promoting the brand". In its agreement terms, Dickey's explicitly states that application of the marketing fund will not be used to promote individual franchise sales specifically, but instead to create campaigns at the national level, which may benefit franchise sales indirectly. Because Dickey's decides where all of its advertisement projects are publicized geographically, the company will not necessarily make expenditures that are equivalent or proportionate to an individual franchise owner's 4% marketing fund fee contribution. Thus, some franchise owners may receive no marketing benefits at all; furthermore, owners have complained that most local advertising purchased in the franchise owner's market is ineffective because it is often organized by a promoter who is unfamiliar with the relationships between restaurants and their local communities.<sup>206</sup>

## Requirements to Buy from Preferred Vendors and Resulting Kickbacks

Most franchises require franchise owners to receive their products from preferred vendors. They may require franchise owners to build their stores with preferred architects and contractors. While such an agreement may make sense in order to achieve a consistent aesthetic or meet safety standards, those costs can be inflated.<sup>207</sup> In addition, some franchise owners complain that beverage and food companies provide rebates to the franchise corporation, but not to the franchise owners who are paying the bills.<sup>208</sup> When franchise corporations talk to prospective franchisees, they often state that one advantage to buying a franchise is the group purchasing power. This claim of group discounts is one of the biggest myths in the franchise industry. These vendor rebates become nothing more than indirect royalties to the corporation.<sup>209</sup>

- Store owners report that their required suppliers provide rebates directly to 7-Eleven.<sup>210</sup> Franchise owners say there is no guarantee that the cost of goods they receive from the 7-Eleven supply chain will be lower than what they could buy at a local big-box retailer.
- Curves gym owners reported being forced to purchase flat-screen TVs, new exercise equipment, clothing, clothing racks, food, and other unnecessary and overpriced materials from preferred vendors.<sup>211</sup>
- Massage Envy franchise owners were required to sell various lotions and massage equipment even if their clients were not interested in making such purchases.<sup>212</sup> Massage Envy franchise owners also stated they were forced to purchase overpriced and inadequate liability insurance.<sup>213</sup> Other franchise owners report being forced to use specific architects whose services cost twice as much as a local architect.<sup>214</sup> Massage Envy corporate leaders dispute these allegations made by more than a dozen franchise owners.

## **VI. Solutions: Establish Fair Franchise Practices**

Below are recommendations that Congress, federal agencies, state governments, and the franchise corporations and owners themselves can follow to ensure franchise owners are being treated fairly. These policy changes include greater disclosure, fair contracts, stronger government oversight over federal dollars, and robust enforcement against bad actors.

### **What Franchise Corporations Should Do**

All of the problems detailed in this report could be fixed by the franchise corporations and their trade association, the International Franchise Association (IFA). IFA should establish best practices and guidelines for fair trade and marketing practices. Many of these suggestions – for fair contracts and revenue disclosure – come from the franchise owners themselves.<sup>215</sup> The Coalition of Franchisee Associations highlights 13 specific recommendations, such as freedom of association, fair dealing, and right to earn equity in a business as well as others such as encroachment, right to price, and right to transfer a franchise to a qualified purchaser.<sup>216</sup> Even if Congress, state governments, or regulators fail to act, franchise corporations and franchise owners should work together to make these improvements. Franchise corporations should support policies that treat their franchise owners as their critical customers. Franchises that make money on selling franchises, not on the success of the franchise over the long term, should be exposed and sanctioned by the franchise trade association. The sector could also mandate licensing requirements with annual educational requirements for franchise brokers, consultants, and salespeople. This could be similar to the real estate industry and would include a fiduciary responsibility to the prospective franchisee with whom they work. Franchise corporations and owners should work together to preserve their businesses and improve their economic resiliency for the future.

### **What Can Congress Do?**

Franchise issues have been a long-standing concern for Congress. In the 1990s, Congressman John LaFalce (D-NY), Chair of the House Small Business Committee, repeatedly introduced the Federal Fair Franchising Practices Act. The bill would have allowed a private right of actions for damages and recovery of attorneys' fees, and it would have permitted actions by state attorneys general. The bill would also regulate both disclosure and the franchise relationship, address fraud, address discrimination in the sale of franchises, and regulate termination and cancellation, purchasing requirements, non-competition clauses, fiduciary, good faith and due care duties, encroachment, and mandatory arbitration. Congressman LaFalce was unable to pass it after the control of the House changed in 1995 and he was no longer Chair of the Small Business Committee. Then, in 1999, Representatives Howard Coble (R-NC-6) introduced the Small Business Franchise Act of 1999 (H.R.3308). During the 114<sup>th</sup> – 116<sup>th</sup> Congresses, Representative Keith Ellison (D-MN-5) introduced two franchise bills, the Fair Franchise Act and the Small Business Administration (SBA) Franchise Loan Transparency Act. Senator Catherine

Cortez Masto (D-NV) introduced a revised version of the SBA Franchise Loan Transparency Act (S. 2383) in the 116<sup>th</sup> Congress.

In 2019, the Economic Policy Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs held a hearing on economic mobility that included a witness who described concerns with franchising.<sup>217</sup> In response to constituent complaints, and the witness at the hearing, the Cortez Masto personal office staff began research into the governmental role related to the franchise sector, research that resulted in this report. At a 2020, House Energy and Commerce hearing, FTC Commissioner Rohit Chopra raised concerns about franchise practices and has continued to do so in many venues.<sup>218</sup> In 2020, numerous legislators submitted letters regarding franchising to the FTC and SBA.<sup>219</sup>

Congress should strengthen laws to improve the franchise process from inception to the end of the contract term and provide adequate funding for agencies charged with ensuring fair treatment. For example, the Federal Trade Commission needs full-time staff dedicated to providing oversight of franchise businesses. Legislation should:

- 1. Require Disclosure of Financial Performance Data.** Many investments, such as stocks and bonds, require that prospectuses include accurate costs and historical performance data; franchises should be required to provide this information as well. Congress should enact laws that require disclosure of financial performance information by franchise brand for all SBA-guaranteed loans. The FTC should require that all FDDs include accurate and comprehensive financial performance representation data in Item 19. Franchise owners seeking an SBA loan should receive accurate first-year and historical revenue data and store closure information, including closures within the first 12 months. These disclosures would ensure that franchise owners get needed information and are not misled by corporations or salespeople providing false or skewed numbers. Congress should also require SBA to publish loan performance data for all franchise brands. Default rates could be published within 72 hours of learning of a default. The technology exists for lenders to provide accurate real-time reports available to the public. Franchises with high levels of defaults are risky for investors and the government. Timely reporting is an investor protection. Lenders that fail to report should be disqualified from receiving a loan guarantee. Such disclosures would result in fewer government payouts for failed loans.
- 2. Provide for a Private Right of Action:** The FTC currently lacks adequate resources for a robust franchise oversight office, nor does it prioritize enforcement of the Franchise Rule. Adding a private right of action to the Franchise Rule would provide franchise owners the right to sue franchise corporations for Franchise Rule violations.
- 3. Ensure Fair Treatment:** Although federal agencies like the FTC and SBA can require that contracts exclude problematic language and challenge unfair practices, Congress should enact legislation that ensures fair treatment.

These provisions include:

- a. Allowing franchise owners to form associations without interference or retaliation;
- b. Prohibiting non-disparagement clauses that prohibit potential franchise owners from learning about the business from current franchise owners;
- c. Ensuring contracts include a private right of action guaranteeing franchise owners a day in court if problems arise;
- d. Providing termination rights to franchise owners to ensure due process is afforded to all franchise owners when exiting a contract; and
- e. Providing transfer rights to ensure that franchise owners can transfer property and monetize the equity they have earned.

### What Can the Federal Trade Commission Do?

The FTC should follow up on its recent efforts to strengthen the Franchise Rule and improve the Franchise Disclosure Document (FDD) to ensure FDDs provide accurate data to potential franchisees in addition to requiring more accurate disclosure and fair treatment in general. The FTC should:

- 1. Include a Summary or Overview.** Provide an overview or summary on the first page of the FDD that has the basics any franchisee should know, including franchise financial performance, store openings, store closings, and sales and revenue information, as well as a description of what support the corporation provides franchisees and what responsibilities franchisees have. The FTC should convene a working group to develop this summary. The summary/overview should be available in addition to the FDD rather than replacing it.
- 2. Require Financial Performance (Item 19) be mandatory.** Ensure all FDDs include historic financial revenue information for all franchise businesses in Item 19 in accordance with the North American Securities Administrators Association (NASAA) Financial Performance Representations Commentary.<sup>220</sup> Item 19 should include disclosures on revenues, costs, and other data for both first-year stores and mature stores. In addition, Item 20 should include the number of outlets that closed during the first 12 months; first-year store closings are not contained in Item 19.
- 3. Ensure Access to All Materials.** Mandate that all information related to the franchise that is shared with lenders, consultants, brokers, or other third parties must also be made available to the franchise investor/owner. The FTC should also impose a licensing requirement and fiduciary responsibility for third-party franchise brokers, consultants, and salespeople that engage in the sale of franchises.<sup>221</sup>

4. **Require Fair Contract Terms.** Ban the inclusion of non-disparagement clauses and mandatory arbitration clauses in the Franchise Agreement, as well as clauses that prohibit franchisee associations. Franchisees should not lose their free speech rights, their right to litigate a dispute, or their right to freely associate with other franchise owners as part of their franchise agreement. In addition, franchisees should be given a private right of action, so that they can litigate violations of the Franchise Rule.
5. **Ban Some Disclaimers and Questionnaires.** The FTC should prohibit FDDs from including disclaimers that allow franchisors to amend their policies outside the specific language of the franchise agreement that has been disclosed in the FDD, such as by making changes to the Operations Manual that are contractual, not operational. FDDs should not include language that effectively permit franchise corporations to change contract terms at will. Any required changes should only be directly related to daily operations, such as the recipe for a new menu item. The FTC should also require any questionnaires be provided with the initial FDD. The franchisor should not be permitted to change any practice from the initial FDD without a vote of the franchise owners. The FDD should also ban questionnaires and disclaimers that are used by franchisors to avoid responsibility for contract disputes. No questionnaire or disclaimer should be used to avoid a claim of deceptive practices of fraud by a franchise owner.
6. **Protect Limited English Proficient Investors.** If a franchise markets to people in a language other than English, the franchise company should be required to provide the FDD in the language of the people to whom they are marketing. For example, some bubble tea, nail salons, and cleaning services market to potential franchise owners in languages other than English. The FTC should work with state governments to establish an oversight capacity for FDDs in languages that are not in English.
7. **Ensure FDDs are Publicly Available on the FTC website and Require FDDs Be Made Available Online and Searchable.** FDDs must be available on the FTC or franchisor website. Basic data regarding revenue, expenses, and rules should be easily searchable from within the document. The Securities and Exchange Commission's in-line XBRL provides a model.<sup>222</sup>

Congress should provide the FTC the resources it needs to develop a more balanced FDD that ensures fairer contracts for franchisees. The FTC should not only improve the Franchise Rule but also use its powers under Section 5 of the Federal Trade Commission Act, which prohibits "unfair and deceptive acts or practices in or affecting commerce."<sup>223</sup> Hardly any enforcement actions have been taken against the numerous franchises that have allegedly engaged in unfair and deceptive practices. The FTC should dedicate enforcement staff to investigate mistreatment of franchise owners. The FTC should recognize that even a moderate volume of complaints can still signal a significant problem.

A franchise brand with fewer than 100 outlets is unlikely to ever meet the volume of complaints for the FTC to consider it a big issue. However, while the volume of complaints may be small, the FTC needs to take into account the size of a franchisee's investment and the level of risk for the franchisee when determining investigation and enforcement priorities. When sixty entrepreneurs lose tens of millions of dollars in a failing franchise, the FTC should investigate. The FTC should ensure that any penalties assessed take into account the damage done to franchise owners.

### **What Can the Small Business Administration Do?**

The Small Business Administration (SBA) plays both an instrumental and an insidious role in franchise lending. About 13 percent of SBA guaranteed loans are made to franchises. These loans make it possible for many people to buy and operate a franchise. In many cases, these are success stories and examples of government funds helping business owners. However, the opposite is also true; the SBA has been the enabler for some problematic franchise brands.<sup>224</sup> Franchise corporations have learned how to grow quickly without accountability, by helping franchise owners who cannot get private financing to obtain an SBA loan with financial data that may be overly rosy, leading to defaults and bankruptcy for the franchise borrowers.<sup>225</sup> With taxpayer dollars on the line, the SBA must demand higher due diligence for any loan it guarantees.

The SBA should:

1. Require that any franchise owner receiving an SBA loan receive disclosure of average and median first-year revenues for franchise outlets, average and median revenues for all outlets, and total number of franchises that closed or were transferred overall and within the first year.
2. Prohibit the franchise corporation from disclosing to a prospective or current franchisee, either directly or through a third party, any information relating to revenue that conflicts with the information provided in a disclosure document.
3. Publish the number and amount of loan defaults by the franchise brand on the SBA website.
4. If the FTC does not make the recommended changes to the FDD to protect franchisees, the SBA should require those elements be included or excluded from the FDD where appropriate for any loan the SBA guarantees, in order to ensure the ability of the franchise owner to repay the loan.
5. Establish a franchisee help line to work with franchise owners facing issues. Too often, franchise borrowers must fend for themselves, including during a systemic failure of the franchise brand.



## **VII. Conclusion**

In the past few years, numerous complaints about the practices of some franchise corporations have been reported to state governments, Congress, and federal agencies. Alarming media stories, despondent calls and letters from franchise owners, comment letters to the Federal Trade Commission, and worrisome franchise loan performance data all point to the need for action to curb these problematic practices. It is clear that federal and state agencies are not doing enough to ensure fair treatment of investors in franchise models. This not only leads to a plethora of failed businesses but also waste, fraud, and abuse. From losses on government-guaranteed loans to unemployment benefits for franchise employees, taxpayers bear part of the burden of these problematic franchise practices.

The franchise business model can and should be a model for economic mobility and for individuals to realize the American Dream. A fair franchise system will lead to higher wages for employees, more secure investments for franchise owners, and more stable businesses in communities. However, an unchecked industry has damaged the finances of owners and workers while franchise corporations continue to earn profits.

Congress should use the appropriate power of federal and state government regulation and enforcement to enhance and protect free and fair markets for the franchise owners, their employees, and their communities. The franchise corporations should partner with the franchise owners to create a fairer and more profitable system for all. As people work to rebuild in the wake of the COVID-19 pandemic, the franchise model will tempt many as an opportunity for financial success; it would be a travesty if some of them found themselves trapped with franchise businesses that resulted in financial devastation that could be easily avoided if franchise corporations followed the guidelines for fair treatment recommended in this report.

## **VIII. Special Thanks**

The Office of Senator Cortez Masto is grateful to the many franchise owners, both in Nevada and across the country, who reached out to share their stories. Special thanks to Keith Miller of Franchisee Advocacy Consulting, Federal Trade Commissioner Rohit Chopra, Sam Levine, Theresa Leets, Elise Bean, Michael Hataway, Vishal Sharma, Mark Shor, Jay Hackstaff, Gina Siepierski, Megan Edwards, and the dozens of franchise owners who spoke out to protect future franchise investors. We hope others reading this will be inspired by your courage and take action to prevent unfair franchise practices in the future.

## IX. End Notes

<sup>1</sup> *Economic Mobility: Is the American Dream in Crisis?*, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Economic Policy. 116<sup>th</sup> Cong. July 17, 2019. <https://www.banking.senate.gov/hearings/economic-mobility-is-the-american-dream-in-crisis>.

<sup>2</sup> Patrick Clark. "Franchise Loans Keep Blowing Up, and the Government Keeps Backing Them." *Bloomberg*, May 14, 2015. <https://www.bloomberg.com/news/articles/2015-05-14/franchise-loans-keep-blowing-up-and-the-government-keeps-backing-them>;

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Federal Trade Commission. "Public Workshop Examining the Franchise Rule." September 10, 2020. <https://beta.regulations.gov/document/FTC-2020-0064-0001/comment>.

More than 50 franchise owners and attorneys representing franchise owners submitted comments to the FTC requesting changes to the Franchise Rule to protect franchise owners from practices they allege are unfair and deceptive.

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<sup>46</sup> Per the Franchise Rule, this information includes the initial fees and estimated initial investment required; the litigation and bankruptcy history of the franchisor, its officers, and key executives; the financial performance of existing company-owned and franchised outlets; contact information for current and former franchise owners; and financial statements reflecting the ability of the franchisor to provide promised services and support. The FDD also requires disclosure of any restrictions on the sources of goods and services; any required purchases; a franchise owner's contractual obligations in the establishment and operation of the franchise; the terms of any financing offered by the franchisor; the training and assistance provided by the franchisor; the extent to which the franchise owner's outlet is protected from competition by the franchisor and other franchise owners; any restrictions on what the franchise owner may sell; the circumstances in which the franchise may be prematurely terminated or in which the franchise owner's sale or renewal of the franchise may be refused by the franchisor; how and where any disputes will be resolved; any restrictions on the franchise owner's ability to engage in the same or similar business during and after the termination of the franchise; and the number of outlets created, sold, and closed during the past three years.

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<sup>47</sup> Howard Bundy. "Franchise Rule Workshop: Reviewing the Franchise Rule." Federal Trade Commission, November 10, 2020. 13. [https://www.ftc.gov/system/files/documents/videos/reviewing-franchise-rule-workshop-discussion-disclaimers-waivers-questionnaires/franchise\\_rule\\_workshop\\_transcript\\_-\\_discussion\\_of\\_disclaimers.pdf](https://www.ftc.gov/system/files/documents/videos/reviewing-franchise-rule-workshop-discussion-disclaimers-waivers-questionnaires/franchise_rule_workshop_transcript_-_discussion_of_disclaimers.pdf).

<sup>48</sup> The Item 19 disclosure reads: "other than the preceding financial performance representation, [name of franchisor] does not make any financial performance representations. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. 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."

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<sup>51</sup> "Disclosure Requirements and Prohibitions Concerning Franchising." *Federal Register* 84, no. 49 (March 13, 2019): 9051 – 9053. <https://www.federalregister.gov/documents/2019/03/13/2019-04466/disclosure-requirements-and-prohibitions-concerning-franchising>;

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<sup>55</sup> Dianna L. Seaborn (Small Business Administration) to Senator Catherine Cortez Masto. June 17, 2019. <https://www.cortezmasto.senate.gov/imo/media/doc/SBA%20Response.pdf>.

<sup>56</sup> John Ford (Small Business Administration). Email message to Staff of Senator Cortez Masto. February 10, 2020.

<sup>57</sup> Ford. Email.

<sup>58</sup> U.S. Small Business Administration. “FOIA: SBA 7(a) and 504 loan data reports.” Small Business Administration, January 30, 2020. <https://www.sba.gov/about-sba/open-government/foia#section-header-32>.

<sup>59</sup> U.S. Small Business Administration. “SBA 7(a) and 504 loan data reports.”

<sup>60</sup> U.S. Small Business Administration. “SBA 7(a) and 504 loan data reports.”

<sup>61</sup> Cortez Masto staff analysis of public SBA data found at [http://imedia.sba.gov/vd/general/foia/FOIA%20-%20504%20\(FY1991-Present\).xlsx](http://imedia.sba.gov/vd/general/foia/FOIA%20-%20504%20(FY1991-Present).xlsx) and [http://imedia.sba.gov/vd/general/foia/FOIA%20-%207\(a\)\(FY2010-Present\).xlsx](http://imedia.sba.gov/vd/general/foia/FOIA%20-%207(a)(FY2010-Present).xlsx).

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<sup>68</sup> Clark. “Franchise Loans Keep Blowing Up, and the Government Keeps Backing Them.”

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<sup>76</sup> United States Government Accountability Office. *Small Business Administration Review of 7(a) Guaranteed Loans*.

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<sup>79</sup> Office of Inspector General. *Banco Popular Did Not Adequately Assess Borrower Repayment Ability*.

<sup>80</sup> United States Government Accountability Office. *Patriot Express: SBA Should Evaluate the Program and Enhance Eligibility Controls*. GAO-13-727 (Washington, DC: Government Accountability Office, 2013).

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<sup>100</sup> Maze. "Burgerim Loses Franchise Registration in More States."

<sup>101</sup> Department of Financial Protection and Innovation, State of California.

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<sup>105</sup> Michael Hataway (former Complete Nutrition franchisee) in discussions with Staff of Senator Cortez Masto. January 2019-2020.

<sup>106</sup> Anonymous Complete Nutrition franchise owners. Email messages to Staff of Senator Cortez Masto. 2019.

<sup>107</sup> Hataway in discussions with Staff of Senator Cortez Masto;

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<sup>108</sup> Hataway in discussions with Staff of Senator Cortez Masto.

<sup>109</sup> Dianna L. Seaborn (Small Business Administration) to Senator Catherine Cortez Masto, September 19, 2019.

<sup>110</sup> Seaborn (Small Business Administration) to Senator Cortez Masto.

<sup>111</sup> Hataway in discussions with Staff of Senator Cortez Masto.

<sup>112</sup> Jonathan Maze. "Dickey's Barbecue Pit Closes 113 Units." *Restaurant Business*, September 14, 2018. <https://www.restaurantbusinessonline.com/financing/dickeys-barbecue-closes-113-units-franchise-owners-bolt>.

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Notice of Partial Dismissal on September 16, 2015 and agreed to have their action transferred to the U.S. District Court, Western District of Texas, Waco Division and assigned Case No. 6:15-cv-00294-WSS. In their action, franchisees and former franchisees allege that they were induced to buy a Curves franchise by false and misleading information provided by Curves International, Inc. in violation of the Texas Business Opportunities Act and the Texas Deceptive Trade Practices–Consumer Protection Act. Additionally, plaintiffs allege that once they began operating their franchises, Curves International, Inc. violated the implied covenant of good faith and fair dealing and breached their contracts by not providing assistance, concealed facts and took affirmative actions that hurt each plaintiff, all in violation of the Texas Business Opportunities Act, the Texas Deceptive Trade Practices–Consumer Protection Act, and Federal Trade Commission Regulations. This lawsuit went to trial on April 10, 2017. The jury returned a verdict in favor of the plaintiffs. The parties entered a settlement agreement wherein Curves International, Inc. settled with each plaintiff.

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<sup>220</sup> “Franchise Resources.” North American Securities Administrators Association, 2019.

<https://www.nasaa.org/industry-resources/franchise-resources/>.

<sup>221</sup> Miller. “Comment on the Federal Trade Commission (FTC) Notice: Public Workshop Examining Franchise Rule.”

<sup>222</sup> Inline XBRL is a format that allows franchisers to embed XBRL data directly into a HyperText Markup Language (HTML) document.;

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<sup>223</sup> 15 U.S.C. § 45(a)(1).

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<sup>224</sup> Spada. “Comment on the Federal Trade Commission (FTC) Notice: Public Workshop Examining Franchise Rule”;

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<sup>225</sup> Stephen Olear. SBA Lending: Considerations for Franchisors and Franchisees. American Bar Association 37<sup>th</sup> Annual Forum on Franchising. October 15-17, 2014. 18-19. SBA requires projections meet a debt coverage ratio established under SBA Standard Operating Procedures. In 2014, SBA’s Chief Franchise Counsel, Stephen Olear, recommended that franchisors consider providing a projection directly to the lender by passing the franchise investor (the ultimate borrower). *“..Most importantly in the financing context, the requirements in Item 19 for the preparation of financial performance representations do not apply to information provided directly by the franchisor to lenders of prospective franchisees. Franchisors who do not provide financial performance representations to prospective franchisees but want to provide information to prospective lenders, or who wish to provide additional information to these lenders, are free to do so. This provides franchisors the opportunity to give valuable information to facilitate the financing of its franchisees without being bound by the requirements of Item 19. However, this can introduce a new set of risks the franchisor must be prepared to manage...First, any information provided to lenders should only be provide after obtaining a confidentiality and non-disclosure agreement from the lender...”*

<sup>226</sup> “The Franchise Registration States.” Internicola Law Firm.

<sup>227</sup> Cordell, Leets and Lewis. “Responding to Franchise Enforcement Actions.”

<sup>228</sup> Cordell, Leets and Lewis. “Responding to Franchise Enforcement Actions”;  
Ferguson, Washington State.

## X. **Appendix I:** Comments Regarding FTC Franchise Rule Submitted in Fall 2020 Comment Period

Below are summaries of some of the comments to the FTC during a 2020 comment period regarding feedback on and changes to the Franchise Rule. These comments discuss problems with franchisors, the current functioning of the Rule, and proposed changes or amendments. These comments note individual letters but do not include the mass campaigns from Subway (75 comments); 7-Eleven (9) and Massage Envy (31). The comments are organized by state and indicate the franchise the comment pertains to, if available. The full comments are available online at <https://www.regulations.gov/document/FTC-2020-0064-0001/comment>.

### Arizona

- **Subway** - Owner requests the FDD disclose regions vs owners when disclosing production.

### Arkansas

- **Massage Envy** - Franchise owner owns two stores in Arkansas with 48 employees. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, had to use certain vendors and suppliers that were too expensive, made changes to the operations manual, and objected to a misused marketing fund that is ineffective.
- **Massage Envy** - Franchise owner has two locations in Arkansas purchased in 2015. Starting in 2016, ME made changes to the company that decreased EBITDA. Required renovations were non-disclosed and expensive due to required vendors. The national marketing co-op has no accountability or benefits. New required services and products hurt franchisees. Highlights products that were expensive and auto shipped that clients didn't want. A required insurance vendor is more expensive than the open market and a compliance vendor is overpriced. Operations Manual has been used to change the franchise agreement. Still has high gross revenue, but business is not profitable and may not survive the year. FDD does not indicate the problems with the franchise and that revenue is not based on success but various vendor streams.
- **Unnamed franchise** - franchisor forces franchisees to buy products that franchisor gets a rebate/kickback on and requires liability insurance that puts all the liability on the franchisee. FDD is an example of hiding things in contracts. Financial data is useless because it is "averaged out" and profits/break evens are overstated.

- **Choice, Wyndham, Red Roof, Hilton, Radisson (Hospitality Brands)** - Franchisee of multiple hotel brands. Argues that hotel franchises double dip fees, vendor exclusivity eats into profits and franchisor gets rebates/kickbacks, franchisor forbids class action lawsuits, institutes unreasonable mandates (like remodels and brand refreshes), allows franchisees to compete in territories, and sells loyalty points to generate cash.

## California

- **Curves** - Discusses the impact of a private equity firm purchasing Curves - highlights a class action lawsuit and the lack of settlement funds. Advocates for franchise owners to be treated as shareholders, including the right to vote, quarterly and annual shareholder reports, ability to sell ownership at will without penalty if there is a change in corporate leadership and ownership.
- **Dental Fix** - Had to declare bankruptcy after buying a Dental Fix franchise when it failed after less than two years.
- **Dental Fix** - Dental Fix has been bad for their lives and livelihoods - wants to make sure it doesn't happen to anyone else.
- **Massage Envy** - Supports the SBA Franchise Loan Transparency Act of 2019 – argues that if these provisions were in law, this franchise owner would not be ruined financially. Discusses how her Massage Envy closed within 11 months of opening. Argues that projections used to estimate SBA loan were incorrect, inaccurate, and unachievable. Invested over \$250,000 until they ran out of money. Discusses how hard it was to end contracts and the additional \$80,000 spent to exit contracts.
- **Massage Envy** - Owns two Massage Envy stores in California - sent a letter to the corporation requesting a return of investments. Business has had three bankruptcies in their region. One third of area units are not making money and were sold to new owners at a loss. Highlights problems with Massage Envy's management. Claims erosion of profit margins, bad vendors, unauthorized fees, misspent advertising and marketing fees, and nonresponsive franchisor and representatives.
- **Massage Envy** - Owns two Massage Envy locations. Highlights oversaturation of market with locations, inaccurate point of sale system that is flawed and overpriced, force-shipped retail products, and a shortage of massage therapists. Discusses franchisor's deals with required vendors that sell products at prices more expensive than the open market. Fellow franchisees in area have not achieved EBITDA or profit, with many closings and bankruptcies. Clinics, once resold, are cheaper than the investments. Asks FTC, SBA, banks, and other agencies to launch an investigation.
- **Massage Envy** - Discusses experience as a ME franchisee that closed. ME's business practices, in addition to COVID, led to closures. Discusses a misleading business model that did not reflect the truth. Profit generation was impossible due to corporate requirements and auto shipping of products. Discusses market saturation and recruiting challenges to hire therapists. Also discusses purchasing

supplies from specific vendors regardless of cost and a changed point of sale system that made things worse. Also discusses forced retail brands and mandatory orders for holiday and special occasions that hurt profits. Highlights required conferences and technology overhauls that hurt business more and eroded profits. During COVID closures, ME continued to collect marketing and operational fees and did not help stores that closed.

- **Unnamed franchise** - Franchisor made changes to the operations manual that impacted profit of franchisee owner.
- **Franchise Advocacy Consulting** - Discusses the receipt of financial information outside the FDD and other problems within the franchise industry. Advocates for mandatory financial representations, providing basic data for financial representations, licensing requirements for third party brokers or consultants, required disclosure on commissions, a fiduciary responsibility to prospective franchisees, and the "tightening" of information in Items 6 and 7. Recommends that the FTC needs to examine complaints differently.
- **Unnamed franchise** - Franchisors need to provide their best data to prospects and franchisees looking to expand. Franchisors must disclose changes in demographic and psychographic data that impact a location's success
- **Comment from franchisee lawyer** - who believes FTC should require mandatory profit and loss data in Item 19 disclosures, ban disclaimers outside of the FDD process and ban no-reliance clauses, acknowledgements, and questionnaires, distinguish integration clauses from no representation and no reliance clauses, and prohibit disclaimers of additional information provided by the Franchisor outside of the FDD. Argues that FDD should include executive summaries, allowing for toggling, and be part of a public database.
- **Comment from franchise attorney** - who opposes mandatory financial performance representations (FPRs), believes there should be no reliance clauses and other disclaimers, believes FDDs are not too long, does not support a summary FDD, believes there can be some changes to make it more user friendly.

## Colorado

- **Massage Envy** - Owner of Massage Envy in Colorado. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, and had to use certain vendors and suppliers that were too expensive. Noted that the franchise corporations made changes to the operations manual and required contributions to a misused marketing fund that is ineffective.
- **Comment from franchisee lawyer** - who advocates for changes to the FDD (with Items 8 and 9), allowing for electronic-only FDDs with no physical or physical media copies, including a summary document, and reforming Item 19 disclosures.

## Connecticut

- **Huntington Learning Center** - Highlights how SBA's loan policies have circumvented the FTC Franchise Rule. Requests franchisors provide gross revenue numbers for all first-year franchisees (and potentially second-year numbers) for the previous five years.

## District of Columbia

- **Comment from franchise attorney** - FPRs should not be mandatory, should allow for disclaimers, waivers, and questionnaires, and should require a cautionary statement. Discusses pros and cons of the current FDD format and particular changes to FDD sections.
- **Comment from franchise attorney** - Argues that the Franchise Rule does not need major changes. No need for FPRs, allow for questionnaires and admonitions for disclosure, do not need to shorten/summarize the FDD, FDDs do not need to be reformatted, summary FDD does not need to be required.

## Florida

- **Dental Fix** - Veteran who bought a Dental Fix said franchise ceased all support (initial training, continuing education, franchise coach, tech support, marketing, billing) within 12 months. Franchisee lost 90% of savings.
- **Experimax** - Says Experimax misled franchisee on revenue and says they were coached on how to get an SBA loan. Argues equipment was overpriced and store never performed according to the numbers that were expected. Experimax did not bring sales or merchandise support. Franchisee has now closed store and lost life savings.
- **Unnamed franchise** - Argues that financial projection requirements in FDDs would be too costly and difficult to compile and that requiring an FPR would be an impediment to franchising. Small franchises can't scale up with these requirements. At an early stage, FPR is cost prohibitive and difficult to maintain. Franchisees don't need handholding and these requirements would stifle business.
- **Unnamed franchise** - Franchisor mandates purchasing from certain vendors at higher costs. Marketing fund has no accountability, and this franchisee questions whether the fund benefits the franchisees. Franchisors are not dealing fairly and have created more brands within the company to dilute returns, increase risks, and increase fee collections.
- **Subway** - Franchisor made changes to the operations manual that impact profit.
- **Subway** - Owns six Subways in Florida - highlights mandatory, non-disclosed investments in programs and remodels, changes to the operations manual, increases in rebates and fees from required vendors, and problems with marketing fund.

- **Subway** - Highlights constant need for renovations and new programs that do not come with a business model and do not generate profit. Subway has made changes that reduce profitability. No disclosure on increased rebates from vendors – franchisee pays higher costs and fees for products. No marketing fees go towards helping franchisees.
- **Unnamed franchise** - Franchisor made changes to the operations manual that impact profit.

## Georgia

- **Bruster's** - Owns a single Bruster's in Atlanta with a staff of 20. Given franchise information that wasn't included in the FDD and was prevented from using that information to make a decision. Has been asked to make investments in programs and remodels that were not disclosed in the FDD. Franchisor made changes to the operations manual that impact profit and has required increased rebates and/or fees from vendors that were not disclosed. Franchisor charges a marketing fee but does not use funds for marketing.
- **Massage Envy** - Owns four Massage Envy locations with a staff of nearly 120. Highlights changes to the FDD that include forced retail product purchases, purchase requirements from vendors that are more expensive than the open market, and changes to the operations manual. Highlights high costs for insurance through required carriers. Asks the FTC to regulate how franchisors amend the FDD.
- **Unnamed franchise** - Has owned and operated franchise restaurants for more than 15 years. Believes that franchisors do not respect the FDD/UFOC, particularly in jurisdictions with no state oversight. FTC is less likely to pursue cases with fewer than 100 plaintiffs or claims less than tens of millions of dollars. The franchisee-franchisor relationship is weighted to the franchisor and highlights bankruptcy code.

## Illinois

- **Massage Envy** - Owns four Massage Envy locations in Illinois with nearly 90 employees. Highlights non-disclosed investment requirements for new programs, forced retail items, and expensive remodels. Discusses changes to the operations manual that impact cost, such as inflated insurance requirements, required supply purchases, and additional services that do not have a proven business model. Also includes required purchases from vendors and a marketing fund that is not utilized. Also highlighted difficulties with member credits.
- **Unnamed franchise** - Franchisors require costly renovations and demand capital improvement plans with no guarantees of revenue or investment.
- **Subway** - Owns four Subway franchises in Illinois with a staff of 22. Highlights investments that were not disclosed in FDD for new programs or remodels.

## Kansas

- **Massage Envy** - Owns two Massage Envy locations in Kansas with 75 employees. Given inaccurate financial information, asked to make investments that were not disclosed in the FDD, had to use certain vendors and suppliers that were too expensive. Franchisor made changes to the operations manual and requires contributions to a misused marketing fund that is ineffective.

## Louisiana

- **Baskin Robbins** - Discusses Baskin Robbins' rejection of franchisees' proposed relocation selections because of territory overlap or market economics. Franchisee is being asked to forfeit fees to renew the contract since they could not get a location.
- **Dental Fix** - Owns a Dental Fix franchise that makes no money. Believes they were lied to and that Dental Fix committed fraud - requests investigation by FTC, SBA, and other agencies. Lives paycheck to paycheck and has lost all retirement.
- **Experimax** - Purchased two Experimax franchises. Earnings productions were off, and claims about product availability and sourcing were not true. As a result, franchisee lost over \$500,000 and couldn't open second location. Highlights that several other franchises were forced into bankruptcy because of inaccurate projections.
- **Unnamed franchise** - Calls franchising "modern/legal indentured servitude" and says franchisee was convinced to sign on a 10-year SBA loan and 30 years of franchise fees. Business isn't profitable, royalties and fees need to be paid, and products must be purchased from certain suppliers due to contracts.

## Maryland

- **Unnamed franchise** - FDD said marketing fund contributions would be used to benefit franchisees and that the franchise corporation had a board of trustees made up of franchisees. 10 years ago, this changed, and now company makes all decisions with a board containing no franchisees. Advisory board of franchisees has little/no input, and there is no accountability on how money is spent or the efficacy of disbursements. Questions whether the funds are used to benefit franchisees.

## Massachusetts

- **Sanford Rose Associates International** - Franchisee alleges they were defrauded by an executive search franchise, Sanford Rose Associates International, and highlights that the FTC has a duty to protect all parties. Current franchise rule is ineffective. Franchisee highlights the ways the FDD promotes fraud, and franchisee goes on to provide solutions to support franchisees.

## Michigan

- **Unnamed hotel franchise** - Longtime hotel franchisee for over 15 years. Brands double and triple dip on revenue. Franchise corporation levies fees for cost of business that are passed on to franchisees. Hotels abuse early termination fees and mandated upgrades/remodels.

## Minnesota

- **Comment from franchise attorney** - Supports keeping financial performance disclosures as voluntary, should not impose further restrictions on disclaimers, and should keep FDD format with some modest updates.

## Nevada

- **Be Amazed Sandwich Co** - Longtime franchisee owner who owns two different franchises - previously was an owner in three different systems. Believes there are several improvements to be made to the FDD and the Franchise Rule.
- **Unnamed franchise** - Franchisee for 26 years with different brands - currently owns two brands they have been with for 26 years and 12 years, respectively. Worked with four other brands but no longer has a franchise of those brands. Believes there is no protection for franchisees. FDD should be given out at first contact and read before discussions take place, and the FDD should disclose success rate. Argues that the Franchise Rule should be updated to include an overview/summary and mandated FPR. The FTC should make FDDs available online and searchable, protect Limited English Proficient consumers, require fair contract terms, ban some disclaimers and questionnaires, prohibit disclosures outside of third parties, and increase staff and enforcement actions at the FTC.
- **Unnamed franchise** - Franchisor requires products and services purchased from certain companies at higher markup than products available on the open market. Disclosure gives revenue amount for affiliated companies but does not give profit or markup to franchisor. Undisclosed costs are royalties to franchisor but are additional costs to franchisee.
- **Unnamed franchise** - Franchise keeps increasing rebates and fees earned from vendors - this is not disclosed in the disclosure document and the document does not limit these requirements. These franchise practices negate the benefit of group purchasing power, and the franchisee in fact pays higher fees than what's available on the general market.
- **Unnamed franchise** - Franchisors implement unreasonable and irrelevant requirements that hurt franchisees, like requiring answering machines and brand refreshes.

## New Jersey

- **Honor Yoga** - Believes that the 2020 FDD given by Honor Yoga contained inaccurate FPR information in Item 19. Franchisee has no recourse to get audited information and has to trust what's in the FDD. There should be a requirement to provide this information and have it be audited.
- **Unnamed franchise** - Franchisee submitted an additional separate complaint that the FTC complaint form is not set up for franchisees to file about problems.
- **Massage Envy** - Comment from Massage Envy franchisee who owned three locations but is down to one. Franchisee decided to sell units because business had changed and impacted profitability. Believes that FDDs need to be reformed - information on profitability in ME FDD was inflated due to liabilities for prepayment of services. ME implemented new business policies, vendor requirements, technology systems, marketing programs, product purchase requirements, and human resource requirements that were not disclosed in the FDD and led to a decrease in profits. Burden now lies on franchisees to run the business model. The FDD language prevents franchisees from joining in collective legal actions and requires individual claim filings.
- **Unnamed franchise** - Franchisees need help to survive and need Congress to regulate franchisors.

## New York

- **Experimax** - Highlights investments in Experimax of nearly \$500,000 in order to stay afloat. Argues that company provided false revenue projects so that franchisee could secure SBA-backed loans. As the number one store in the company, they estimate a 30% profit shortfall compared to the revenue projections for the SBA-backed loans. Accuses Experimax of deceitful collateral models, conspiracy to cover up a lack of distribution channels, conspiracy to provide false revenue projections, breach of territory, illegal marketing, trademark infringement, failure to retain support staff, and high closure rate. The franchisee family now receives government assistance with no path forward with company.
- **Unnamed franchise** - Requests the FTC update the Franchise Rule Compliance Guide to account for changes in technology and trends; FDD should be simplified and specific, accurate, in plain language and disclosed info should be properly placed and timed; tables and data visualization should be meaningful; FTC should test effects of disclosure; FTC should identify and consider costs and benefits of disclosure requirements. FTC should clarify FDD requirements.
- **Unnamed franchise** - Franchisees need more input with franchisors. Advisory board does not represent franchisees. More transparency is also needed.
- **Unnamed franchise** - FTC needs to examine the "loophole" in franchise agreements that gives franchisors a wide latitude in imposing new requirements. Financial conflicts of interest exist because franchise corporations receive compensation from suppliers and vendors. FTC should require specific disclosure,

such as the amount of compensation that franchise corporations receive and the identity of the suppliers/vendors.

- **Comment from franchise attorney** - Allow for audio and video in the FDD, create a cover page, create an FDD database, include supplemental disclosure letters, mandatory FPRs, include NASAA's recommended changes to the Franchise Rule, clarify the purpose of Item 19, and include clarifications on disclosures and acknowledgements outside the FDD.
- **Comment from practicing franchise attorney** - who thinks requiring financial performance representation would be a burden on franchisors; summary of an FDD would not be good because it would deter reading the whole FDD; and requiring that the franchisor not use any disclaimers in the FDD is not practical.

## North Carolina

- **Massage Envy** - Franchisee notes that the FDD document is complicated and does not disclose information. Required vendors for purchasing supplies. No group purchasing power. ME also allows investor groups to have the right of first refusal when franchises are for sale, rather than allowing franchisees to choose whom to resell to.
- **Unnamed franchise** - Franchisee fees increase every year while franchisors fail to bring in business and charge hefty marketing fees. Requiring purchasing from certain vendors is another way for franchise corporations to generate profit.

## Oklahoma

- **Unnamed franchise** - Argues that the Franchise Rule should reform Termination and Release Agreements and make it unlawful for franchisors to file SLAPP lawsuits against franchisees. Believes that the 2007 Franchise Rule does not address many aspects of what is in FDDs.

## Pennsylvania

- **Experimax** - Franchisee who says that they lost over \$250,000 and that all the information franchisee received was fabricated. Charged for a moldy \$54k furniture package, a \$30k inventory package of junk, and a \$10k name change. Lawsuit by Apple was not disclosed and none of the services in the FDD were provided. Experimax tried to make franchisee sell the store, but franchisee closed store. Wants Experimax to be prosecuted and calls it a fraudulent business.
- **Subway** - Owns three Subway franchises in PA with a total staff of 15. Highlights difficulties with local inspectors who rule things out of compliance with arbitrary requirements. Franchisor required franchisee to purchase certain machines. Discusses how the \$5 footlong promotion is not profitable. Corporate never shares true profits. Franchisee was asked to invest in programs/remodels with no proven

ROI or business model. Franchisee discusses changes to the operations manual, required vendor purchases, and a marketing fund with no transparency.

## Tennessee

- **Dental Fix** - Alleges Dental Fix is a sham that scammed franchisee out of \$50,000. Accuses Dental Fix of false advertising.
- **Mobility City** - Franchisee highlights changes to the operations manual that impact profitability and notes difficulties with the marketing fund.

## Texas

- **Unnamed franchise** - Franchisors abuse the marketing fund to highlight the parent company instead of specific brands. Brands change requirements and add new fees and include vendor requirements that are more expensive. Franchisors aren't held accountable for the way they spend their marketing funds.
- **Unnamed franchise** - Believes there is an increasing imbalance between franchisor and franchisee. Over years, the agreement has been modified and is now so heavy handed that the franchisee is willing to walk away from business. Relationship is one sided in favor of the franchisor, and federal government needs to intervene.
- **Comment from franchise attorney** - Opposes mandatory FPR requirements, provide greater clarity and flexibility on explanations in the FDD, oppose efforts to abolish questionnaires, and encourage the use of technology for reading an FDD.
- **Tutor Doctor** - FDD does not include clear standards for franchisors. For example, Tutor Doctor does not have a good customer relationship management system. Brand marketing fund is also not reported out on and is not held accountable.
- **Which Wich Superior Sandwiches** - Owns one franchise with a staff of 12 - down from 15 franchises with a staff of more than 200. Franchisee was given franchise info that wasn't included in the FDD and was prevented from using that data to make a decision. Franchisee was asked to make investments in programs and remodels that weren't disclosed in the FDD. Changes to the operations manual impact profit, and franchise corporation has required increased rebates and/or fees from vendors that were not disclosed. Franchisor collects marketing fees but does not use funds for marketing.

## Utah

- **Batteries Plus Bulbs** - Owns two Batteries Plus Bulbs stores in Utah with six full-time and two part-time employees. Since opening, franchisor has purchased corporate locations with no disclosure on profitability. Franchisor has required store opening hours that are not disclosed in the FDD. Franchisee fears being bought out a low price and wants the disclosure to include discussion of the franchisor's

strategy and tactics, especially with corporate-owned stores and policies regarding expansion/contraction.

- **Massage Envy** - Highlights required vendors for purchasing products. Believes franchisor is seeking to drive down Earnings Before Interest, Taxes, Depreciation and Amortization in order to allow for other private equity groups to buy out franchises.
- **Unnamed franchise** - Argues that rules are not properly enforced and that franchisee has little chance of being able to hold their own legally.

## Virginia

- **Dental Fix** - Former Dental Fix franchisee was influenced to invest after a ride along with a franchisee that turned out to include exaggerated claims by a pushy sales person. Franchisee discusses meeting with an SBA lender who told him to "inflate the value of his home" to get more funds. Highlights insufficient training program that cost \$15,000. After signing the franchise agreement, he ran out of money after one year and is currently stuck paying off the SBA loan. His credit score plummeted from 800 to 600, he lost 60% of retirement account, and he has marriage problems and depression. He can't afford to go to the doctor and is worried about paying for his daughter's education. Through work with a fellow franchisee in Virginia, he got a small settlement, but still regrets being involved. Hopes to have SBA debt discharged.
- **Dental Fix** – Spouse of franchisee who owned a Dental Fix in 2017. Highlights that royalties and fees were expensive. Franchisor does not support owners.
- **Experimax** – Former Experimax owner who is filing for bankruptcy. Experimax's parent company (UFG) did not disclose legal problems, used false numbers to obtain an SBA loan, employed misleading tactics to get an equipment lease, did not have adequate business systems, allowed for territory competitions, levied expensive marketing and royalty fees, incurred high store closure rate. Highlights that the store failed to make a profit despite 50-60% margins and poor initial inventory.
- **Massage Envy** - Writing on behalf of an LLC that owns seven Massage Envy locations in Virginia with a staff of 190 employees. Highlights that the FDD does not disclose information on offers and purchases. Franchise corporation requires purchases from specific vendors that are more expensive than at market, requires purchase of liability insurance that is more expensive, and has failed to disclose criminal and civil liability incurred by Massage Envy. No clear use of marketing fund or disclosure on how funds are spent. Franchisee encourages FTC to correct deficiencies in the FDD, require disclosure, and generally improve the franchise system.
- **Unnamed Franchise** - Calls for support from the government to oversee franchisors and discusses how digital points as currency are detrimental.
- **Comment from franchise attorney** - Believes FTC should not add prohibitions or sanction practices that prohibit franchisors from providing accurate and truthful

information. Does not support banning merger clauses, believes questionnaires are accurate and widely available.

## Washington

- **Dental Fix** - Franchisee is currently considering bankruptcy. Calls the company a well-crafted scam with subpar training and false claims about the rate of business. Company misleads on marketing and pits franchisees against each other. Franchisee took on lots of debt, had to sell house, and has \$40k in credit card debt.
- **Comment from franchise lawyer** - Requests mandating financial performance data. Notes problems with the FDD and disclaimers. Believes old Franchise Rule has failed franchisees and needs serious reforms.
- **UPS** - Alleges that franchisors make decisions that impact franchisees negatively. Include requiring remodels that do not have a proven business case. Prohibiting UPS stores from using DHL for international shipments negatively impacted franchisees. Franchisees want to sell but required remodels make it difficult.

## Wisconsin

- **Experimax** - Experimax needs to be examined and general practices need to be examined. The franchisee was told lies and forced to use someone to create business plan and fudge numbers for an SBA loan approval. Franchisee was promised all kinds of help in the FDD and a well-priced supply chain, but did not receive that.
- **Unnamed franchise** - FDD does not prohibit franchisor from making policy changes that impact franchisee. Franchisor can do whatever it wants at franchisee's expense, such as promotions. This benefits franchisor's revenue while hurting franchisees.

## National Organization or State Not Provided by Submitter

- **CBD American Shaman** - Need tighter controls over franchisees and need protection against franchisees that have an online presence and can poach customers.
- **Subway** - Subway is offering cheaper sandwiches during COVID, but franchisee has to make up the difference. Makes franchisee use different catering plate form that adds additional costs to franchisee.
- **7-Eleven** - Highlights risks with 7-Eleven and difficulties with financial projection disclosures. Notes instances of unfair and opportunistic behavior. Discusses undisclosed risks (with gasoline sales), declining gross margin, minimum wage increases, focus on costly fresh foods and hot foods, cost of goods, equipment

maintenance, poor disclosures, and specific instances of poor behavior by 7-Eleven corporate.

- **Dental Fix** - Franchisee invested all of his life savings into Dental Fix, and he highlights that most information available at time of purchase turned out to be untrue. Contends that the franchise has a high rate of failure - company was found to be fraudulent in Virginia after a lawsuit.
- **Discovery Point Franchising** - Says Discovery Point Franchising sells real estate at inflated, unsustainable prices with SBA loan guarantees. Colludes with banks and provides illegal profit estimates. Franchise sells centers and equipment under different names. FDD includes fraudulent cash flow estimates and did not disclose corporate-owned centers. FDD should list all closed locations and publish yearly statistics over the past five years. Franchisor manipulates the loan amount and equipment is sold at an inflated price. After franchises fail, taxpayers bail out the bank, and the franchisor profits from the loan. Discusses the churning of centers.
- **Massage Envy** - Owned a Massage Envy for eight years with 25 employees. Highlights changes to the disclosure document for new programs with no verified business model or proven ROI. Financials in FDD were misleading, and franchisor relies on revenue from required vendors that charge more for products than the open market.
- **Unnamed Franchise** - Owns an equipment repair business and had to make changes in order to see profitability. Main problem is the franchisor has more freedom than franchisee, including creating a competing company and requiring franchisees to purchase goods from certain sources. It's impossible to get out of an FDD, and franchisors have a leg up.
- **Service Employees International Union (SEIU)/Change to Win** - Highlights five franchisor practices (incomplete or misleading financial performance representations, significant capital investments, retaliation against franchisees that join associations, unfair termination or nonrenewal of franchise agreements, and arbitrary denial of transfer requests) as problematic. Submits contractual research and an update on franchise issues that illustrate how problems related to the model have persisted or worsened.
- **7-Eleven** - Please look into 7-11 as a franchisor. They have predatory policies, and franchisees have no way of getting relief.
- **Unnamed franchise** - Argues that most buyers don't understand the FDD and believes most FDDs are accurate. Has instituted guardrails to protect brokers from fraudulent claims. Encourage buyers to seek legal counsel and explain the business. Argues that the marketplace is fixing Item 19 and correcting itself.
- **Unnamed franchise** - Franchise contracts lock franchisees in for long terms and include non-compete clauses. Contracts favor franchisors and lack real protections for franchisees. Franchisors aren't interested in the profitability of the businesses that franchisees own and offer no support or procedures, forcing franchisees to walk away and lose money.
- **Unnamed franchise** - Says franchisor controls all aspects of the business even though franchisee invests. Franchisee is in the hotel business, so pays a

commission to websites on top of royalty fees. Evaluation and brand requirements don't make sense.

- **Unnamed franchise** - Need additional rules and laws to protect franchisees from corporations. Franchisor finds loopholes and takes percentages in retail. Also franchisor requires use of certain insurance and gets a kickback on that. Franchisee was promised a new computer/software system that doesn't work. Franchisor has forced franchisee to promote giveaways, free vouchers, and holiday offers that come out of profits.
- **Unnamed franchise** - Item 8 and Item 19 need to be changed to help franchisees. Item 8 does not disclose enough information about rebates to vendors - requests disclosure on markups of products. Asks for mandatory disclosure of FPR. Franchise Rule should prohibit franchisors from using disclaimers and questionnaires to avoid liability.
- **Unnamed franchise** - Need adequate resources to oversee and enforce the Franchise rule. Request a disclaimer in FDD that states that any conflicts/changes/additions to policies disclosures or other procedures outside the FDD are null and void. Recommends that FTC eliminate pre-dispute binding arbitration clauses, make the FDD be legally binding regardless of change in ownership, prohibit disclosure, obligations, or earnings outside of the FDD, require documentation of financial disclosures, earnings, investment requirements and include mandated disclosures (legal, financial, item 20 disclosures and general improvements) in FDD.
- **Fair Franchising Initiative (FFI)** - Current structure of FDD coupled with lack of regulation and enforcement hurts small businesses and generates profit for franchisors and Wall Street. The current system puts additional risk on franchisor. Franchisors use questionnaires and disclaimers to avoid responsibility and protect themselves from liability for false claims. Franchisors make changes to Operations Manuals that impact franchisees and limit profits.
- **International Franchise Association** - Supports the Franchise Rule in its current form. FPRs should not be mandatory and should not require executive summaries, and questionnaires and integration clauses should not be banned.
- **Asian American Hotel Owners Association** - Supports improvements to Item 19, reining in the use of disclaimers, and changing the format of the FDD that includes mandatory FPR and other information.
- **American Association of Franchisees & Dealers** - FTC has the authority to reform the Franchise Rule, reform financial performance representations to include all material financial impacts, adjust the force of liability waivers, and impose stronger enforcement of the FTC rule with Article 5 of the FTC Act. Argues that the Franchise Rule is not adequate as is.
- **Independent Association of Franchisees** - Highlights examples of abuse by franchisors and supports changes to the Franchise Rule that include strong consumer protections.
- **Oxford Learning** - Says FTC backing implies that FTC reviews and validate material in FDD when that is untrue. Franchisors are able to hide misleading claims.

FTC must require franchisors to include documents supporting material claims, such as patents, lawsuit judgements, education certification/diplomas/degree confirmation of company executives, income statement and balance sheets filed with the IRS and SEC. FTC should also require franchisors to include consolidated income statement of franchises and franchisees that is updated annually and to provide response to complaints filed.

- **Seniors Helping Seniors** - Seniors Helping Seniors franchisee with 50 employees. Marketing fund has no accountability and has not benefited any franchisee. National Promotional Fund is also not helpful, and there is no verification that it benefits the franchisees. Impossible for franchisees to hire legal representation.
- **Seniors Helping Seniors** - Seniors Helping Seniors implemented an additional fee for the Regional Advertising Fund, which has no reporting on how it is used on its finances. FDD notes that the option to charge a fee is possible, but there's no disclosure on how the funds are used. Franchisee wants more disclosure and reporting on how the fund is used.

## XI. Appendix II: Letters to/from Small Business Administration

CATHERINE CORTEZ MASTO  
NEVADA

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United States Senate

COMMITTEES:  
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URBAN AFFAIRS  
ENERGY AND NATURAL RESOURCES  
INDIAN AFFAIRS

May 21, 2019

Mr. Chris Pilkerton  
Acting Administrator  
U.S. Small Business Administration  
409 3<sup>rd</sup> Street, SW  
Washington, DC 20416

Dear Acting Administrator Pilkerton:

I write to request information regarding Small Business Administration (SBA) guaranteed loans to four franchises. In recent months, my staff have heard about problems with Complete Nutrition, Dickey's Barbecue, Experimac and Subway from franchisee owners who have SBA-guaranteed loans and are having trouble with the franchisor. These problems reported by Nevada business owners are similar to that of other franchisees across the nation:

- Complete Nutrition. Franchisees with SBA-guaranteed loans told us that Complete Nutrition had made it very difficult for them to be profitable by raising the price they paid for goods, restricting access to certain products to earn higher franchise payments, prohibiting internet advertising and harvesting customers' data from the store and then marketing to the customer directly via email offering discounts that the franchisee could not match and taking away other services from franchisees that were providing them revenue. In March, Complete Nutrition told its franchisees it would no longer be a franchise and the individual stores would become independent. The franchisees were also required to make a payment to become independent. In April of this year, Complete Nutrition eliminated franchisees' access to the point-of-sale system, removed franchisees' locations from its website and sent an email to the customers of the individual stores telling them that their stores had been sold and that customers should order online. A few days later, Complete Nutrition sent an apology email to all the customers of its stores saying the email was sent in error. Complete Nutrition leadership has not responded to numerous requests for information from my office. From our research, it appears as many as 66 Complete Nutrition franchise stores which provide nutrition, health supplements, and other related beauty products have SBA loans. Some data shows at least 12% percent of the loans have been charged off.

- Dickey's Barbecue. Press reports find that Dickey's Barbecue franchises are closing at an alarming rate, including two in my state over the past few years.<sup>1</sup> According to Dickey's Barbecue Franchise Disclosure Document (FDD) dated September 4, 2018, for the fiscal year ended May 1, 2018, the brand opened 72 new franchised units, but had 89 terminations and 24 ceased operations, for a net store loss of 41 units.<sup>2</sup> They ended the year with 521 units. An additional 44 units transferred to new owners. The previous year showed 88 units opened, 70 ceased operations, and 67 transfers. It appears that some of the loan failures may be due to Dickey's Barbecue providing misleading and inaccurate information to potential franchisees, resulting in failed businesses and bankrupt owners.<sup>3</sup> It appears Dickey's Barbecue was telling franchisees to expect revenue of up to \$80,000 per month but stores earned much less than that.<sup>4</sup> Last year, at my request, your staff provided default data to my office that showed taxpayer-guaranteed loans to Dickey's Barbecue franchisees failing at a higher rate than is typical for fast-casual restaurants. It appears that a change in ownership at Dickey's Barbecue has dramatically raised costs for the franchisee.
- Experimac. Between January 2010 and September 2018, SBA recorded 63 loans to Experimac franchisees. A number of these franchisees feel the estimated revenue provided by Experimac was inaccurate and that they have never earned the revenue reported as typical. Experimac required unusually high initial payments of \$49,500 per franchisee. Experimac also required franchisees spend \$130,000 to design the store and buy the supplies. SBA guaranteed 63 loans to Experimac franchisees, of which 86% were made by Celtic Bank. Celtic Bank quickly sold them to investors. To date, at least 23% of these loans have failed. All the charged off loans, and nearly all the loans (54 loans or 86% of all loans) were financed by Celtic Bank Corporation, based out of Salt Lake City, Utah. In addition, Experimac was sued by Apple for patent violations, i.e. "Mac" without telling franchisees of the lawsuit threat.
- Subway. Subway franchisees across the nation are struggling to survive with expensive promotional offers and corporate decisions that undermine the franchisees' survival. A recent story noted that nearly 3% of SBA guaranteed loans for Subway franchisees have

<sup>1</sup> Maze, Jonathan. "Dickey's Barbecue Pit Closes 113 Units." September 14, 2018. *Restaurant Business*. Available at: <https://www.restaurantbusinessonline.com/financing/dickeys-barbecue-closes-113-units-franchisees-bolt>

<sup>2</sup> Dickey's Barbecue Restaurants, Inc. (2018)." Franchise Disclosure Document (Rep. No. 620051)." *Wisconsin Department of Financial Institutions*. Accessed May 20, 2019. Available at: <https://www.wdfi.org/apps/FranchiseSearch/details.aspx?id=620051&hash=1542075382&search=external&type=GENERAL>

<sup>3</sup> Miller, Keith. "Can Dickey's BBQ Franchise Owners Survive? Franchisees Claim They Received Misleading Numbers." *Blue MauMau*. October 1, 2018. Available at: <https://www.bluemaumau.org/blog/2018/10/01/can-dickeys-bbq-franchise-owners-survive-franchisees-claim-they-received-misleading>

<sup>4</sup> *Ibid.*

been charged off. Subway is accused by its franchisees of using minor infractions to steal the stores from owners through a rigged arbitration system.<sup>5</sup>

I would like to inform my constituents of the resources SBA can provide to help them avoid default. I would also like to ensure other franchisees do not receive government-guaranteed loans for franchises with a history of complaints about unfair and deceptive practices. Therefore, I request the following information:

1. How is the SBA working with franchisees with SBA loans when a franchisee runs into trouble?
  - a. Specifically, when the SBA notices high rates of defaults in a franchise, what action does your staff take to prevent loan failures?
  - b. If there is a major change in an agreement, like those that occurred with Complete Nutrition, Subway or Dickey's Barbecue, what recourse does the SBA have to prevent loan failures?
  - c. How does SBA review ownership changes and what can SBA do when such changes have the potential to harm the revenue of franchisees with existing SBA loans?
  - d. Regarding Complete Nutrition, what can SBA do when a franchisor terminates the franchise agreement entirely? Does Complete Nutrition have affiliated brands seeking SBA-guaranteed loans? If so, what are the other brands?
  - e. Are there examples of other SBA-guaranteed franchisors making similar decisions as the one Complete Nutrition made to stop being a franchise? If so, how were the franchisees compensated? Did the franchisor make payments on outstanding loans of the franchisees?
  - f. Can the SBA exclude a brand if there are significant problems with one of the franchises in its portfolio? Has the SBA stopped loan guarantees to one brand because of problems in a franchise within its portfolio? If so, which franchise brands and franchise owners and when?
2. How many total loans did SBA make to the four mentioned franchises over the past six years -- 2013-2019? Please break out the loans by year and state.
3. How many of the four franchises have loans that defaulted? How soon after the loan closed were those loans charged off? Please break out this information by year and state.
4. How many of the four franchises mentioned are behind in their loans but are not listed as defaulting yet? How soon after the loan closed were those loans charged off? Please break out this information by year and state.

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<sup>5</sup> Kosman, Josh. "Subway's arbitration for minor infractions is out of control: franchisees." New York Post. May 5, 2019. Retrieved from: <https://nypost.com/2019/05/05/subways-arbitration-for-minor-infractions-is-out-of-control-franchisees/>

5. What information on revenue, defaults and store closings does the SBA require franchisors to provide to franchisees seeking SBA-guaranteed financing? Is that information provided within the Financial Disclosure Document?

According to a 2018 report from the International Franchise Association (IFA), Nevada is predicted to have the fastest franchise growth in the nation.<sup>6</sup> While many of my constituents are successful franchise owners, I am troubled by increasing complaints from entrepreneurs about unfair practices that are causing them financial difficulties. Please respond to this request by June 21, 2019. For more information please contact Carol Wayman on my staff at 202.224.3542 or [Carol\\_Wayman@cortezmasto.senate.gov](mailto:Carol_Wayman@cortezmasto.senate.gov).

Sincerely,



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Catherine Cortez Masto  
United States Senator

CC: United States Senate Small Business Committee Chairman, the Honorable Marco Rubio  
United States Senate Small Business Committee Ranking Member, the Honorable Ben Cardin

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<sup>6</sup> IHS Markit Economics. "Franchise Business Economic Outlook for 2018." *International Franchise Association*. January 2018. Available at: [https://franchiseeconomy.com/files/Franchise\\_Business\\_Outlook\\_Jan\\_2018.pdf](https://franchiseeconomy.com/files/Franchise_Business_Outlook_Jan_2018.pdf)



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, DC 20416

June 17, 2019

The Honorable Catherine Cortez Masto  
United States Senate  
516 Hart Senate Office Building  
Washington, DC 20510

Dear Senator Cortez Masto,

Thank you for your letter of May 21, 2019, to Acting Administrator Pilkerton regarding U.S. Small Business Administration (SBA) guaranteed loans to four franchises: Complete Nutrition, Dickey's Barbeque, Experimac, and Subway. Acting Administrator Pilkerton has asked me to respond on his behalf.

As you may be aware, while SBA is an important resource for financial assistance for would-be small business owners without access to credit on reasonable terms, the Federal Trade Commission (FTC) is the key agency for the American public to obtain and report information about various business entities, including franchises. Because it appears that the concerns you raised in your letter fall within the area of responsibility of the FTC, we have referred your letter to their Bureau of Consumer Protection for further review /action. As the federal agency with responsibility for protecting consumers by stopping unfair, deceptive or fraudulent practices in the marketplace, the FTC conducts investigations, sues companies and people that violate the law, develops rules to ensure a vibrant marketplace, and educates consumers and businesses about their rights and responsibilities.

In fact, the FTC has a special responsibility when it comes to franchise systems. The FTC requires franchisors to update their Franchise Disclosure Document (FDD) each year, which includes statements to inform a prospective franchisee about historical representations (how much existing franchisees have earned in the past) or projections (how much an individual prospective franchisee is likely to earn in the future). Although franchisors may decide how they wish to disclose financial performance of the brand (provided that disclosure meets FTC requirements), the FTC prohibits a franchisor from making a financial representation that is not true or unsubstantiated.<sup>1</sup> Complaints regarding specific franchisors are normally handled by the FTC under federal law or through state agencies under state franchise laws. The FTC has resources available to help members of the public spot scams involving businesses, including franchise businesses. The FTC also provides a link on their website for the public to file complaints. Complaints are shared with law enforcement partners

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<sup>1</sup> For more information about the FTC's requirements for franchisors, including required disclosures by franchisors, see [https:// www.ftc.gov/ enforcement/rules/rulemaking-regulatory-reform-proceedings/franchise-rule](https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/franchise-rule).

and are used to investigate fraud and eliminate unfair business practices. The FTC also releases an annual report that provides information about the number and type of complaints they receive.

SBA's engagement in franchise businesses includes its guarantees of loans that are made by its lending partners to small businesses that operate under an agreement with a franchisor (a franchisee). A relatively small percentage of SBA's guaranteed loan portfolio, fifteen percent, is made up of loans to businesses that operate under franchise agreements. Under SBA's current franchise review process, SBA reviews franchise brands only to determine if the brand is eligible for SBA financial assistance based on SBA size standards (including determining if there is affiliation between the franchisor and its franchisees) and type of business activity. SBA does not endorse or recommend franchise brands. Rather, SBA lists those brands found to be eligible under size and affiliation standards on a publicly available directory so that before making an SBA loan to an applicant, SBA Lenders may rely on the directory for the franchise brand's eligibility for SBA financial assistance. However, it is important to note that those lenders are responsible for analyzing and making a determination as to the creditworthiness of the brand and of the small business Applicant (franchisee).

SBA's monitoring of ongoing franchise loans is generally limited to the performance of participating lenders through its Office of Credit Risk Management (OCRM). OCRM conducts monthly as well as a semiannual performance analysis of the loan portfolio generally, and with segmentation, including loans made to franchisees. OCRM also reviews lender performance and provides individual lender performance data to SBA Lenders through a lender portal. SBA Lenders are expected to review the portal on a regular basis, which enables the Lender to identify its loan portfolio performance down to the individual loan level. OCRM will engage SBA Lenders when identifying trends with respect to loans to borrowers operating under a franchise agreement. The Lender would be expected to take action to mitigate risk. If an SBA Lender were to determine that the performance of a franchise brand did not meet its credit parameters, the Lender would curtail lending to that franchise to minimize its risk of loss. If an SBA Lender were to become aware of any information indicating that fraud may have occurred in connection with an SBA loan, the Lender would be required to report the suspected fraud to the SBA Office of Inspector General. 13 CFR 120.197.

When a franchisee with an SBA loan experiences financial difficulty, the SBA Lender would typically work with the small business to attempt to address the issues. In addition, SBA's resource partners, such as Small Business Development Centers, SCORE, Women's Business Centers and Veterans Business Outreach Centers, are available to work with small businesses experiencing difficulties.

Below is SBA loan approval and charge-off<sup>2</sup> data for the last ten years (2019 information is year-to-date) on the four franchises identified in your letter, both nationally and for the State of Nevada. (Please note that SBA loans to Experimac did not predate 2016.

1. Experimac (Fiscal Years 2016-2019)

Number of SBA loans approved: 77 nationally, 2 in Nevada

Number of SBA loans charged off: 23 nationally, 1 in Nevada

2. Complete Nutrition (Fiscal Years 2009-2019)

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<sup>2</sup> Generally, charge-off occurs when all reasonable efforts to achieve recovery on the loan have been exhausted or the loan balance is deemed legally uncollectible.

Number of SBA loans approved: 67 nationally, 2 in Nevada

Number of SBA loans charged off: 8 nationally, 0 in Nevada

3. Dickey's BBQ (Fiscal Years 2009-2019)

Number of SBA loans approved: 246 nationally, 4 in Nevada

Number of SBA loans charged off: 41 nationally, 0 in Nevada

4. Subway (Fiscal Years 2009-2019)

Number of SBA loans approved: 1,551 nationally, 10 in Nevada

Number of SBA loans charged off: 184 nationally, 3 in Nevada

We encourage Congressional offices to reach out to the FTC to learn more about franchise issues as well as their state Bureau of Consumer Protection for relevant information on franchisors operating in their states.

We appreciate your support of SBA and the Nevada small business community.

Sincerely,



Dianna L. Seaborn  
Director  
Office of Financial Assistance

cc: United States Senate Small Business Committee Chairman, The Honorable Marco Rubio  
United States Senate Small Business Committee Ranking Member, The Honorable Ben Card

CATHERINE CORTEZ MASTO  
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## United States Senate

COMMITTEES:  
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URBAN AFFAIRS  
ENERGY AND NATURAL RESOURCES  
INDIAN AFFAIRS

August 1, 2019

Ms. Dianna L. Seaborn  
Director  
Office of Financial Assistance  
Small Business Administration

Dear Administrator:

We write regarding your June 17, 2019 letter responding to Senator Cortez Masto's request for information about Small Business Administration (SBA)-guaranteed loans to four franchises. Your response did not fully address the questions, nor did you confirm whether the SBA is following its own protocols when guaranteeing loans to entrepreneurs purchasing a franchise.

In your response, you reported that the SBA guaranteed 256 loans to entrepreneurs from four franchise brands who were later unable to repay them; hundreds of entrepreneurs lost their collateral, their savings, may have lost their home, and even forced to declare bankruptcy after buying one of these four franchises. Your letter noted that nearly one in three loans to Experimac franchises failed within three years of operation.<sup>7</sup>

Your letter provided information on loan failure rates in Nevada, but failed to provide the information about failure rates in other states as requested. Your response also failed to provide the information about default rates by year, as was requested. Without charge-off rates by year, it is impossible to see if defaults are historic, recent or chronic.

Your letter implies that once a franchisee has signed a contract with a franchise, then every loan that meets "SBA size standards and types of business activities" is eligible as long as a lender wishes to make the loan. However, the SBA's own Standard Operating Procedure -- Lender and Development Company Loan Programs, SOP 50 10 5(J)<sup>8</sup> -- clearly requires the SBA ensure that the lender does a financial analysis to verify the loan is likely to be repaid:

1. "Thus, if the Lender's financial analysis demonstrates that the Applicant lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan

<sup>7</sup> Seaborn, Dianna. Small Business Administration Letter to Senator Catherine Cortez Masto. June 17, 2019.

<sup>8</sup> Small Business Administration. "Lender and Development Company Loan Programs. Standard Operating Procedure. SOP 50 10 5(J)." January 1, 2018. Retrieved from:  
[https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29\\_FINAL\\_.pdf](https://www.sba.gov/sites/default/files/2017-10/SOP%2050%2010%205%28J%29_FINAL_.pdf)

request must be declined, regardless of the collateral available or outside sources of cash.”  
Page 170. Underlining in original.

2. “a) Lender’s Credit Analysis: Lender’s credit memorandum and analysis must address the Applicant’s ability and likelihood to repay the loan from the cash flow of the business and past performance by documenting the following:

[...] ii. Financial analysis of repayment ability:

- (a) For existing businesses based on the three most recent years of historical financial information (tax returns or balance sheet with debt schedule and income statement) plus an interim financial statement. (13 CFR § 120.191) SOP 50 10 5(J) Subpart B. Page 172
- (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required.
- (c) The financial analysis for all Applicants must address the following as applicable:

(i) Historical cash flow for existing businesses, that demonstrates total debt service coverage after the SBA loan; if the historic cash flow does not show sufficient debt service coverage, Lender must obtain from the Applicant and analyze two years of detailed projections including the supporting assumptions;

(ii) Calculation of operating cash flow (OCF) defined as earnings before interest, taxes, depreciation and amortization [...]

- (b) For new businesses, detailed projections, including the supporting assumptions which reflect positive cash flow within 2 years will be required.” Page 171-172.

3. “Debt Service (DS) is defined as the future required principal and interest payments on all business debt inclusive of new SBA loan proceeds. The Applicant’s debt service coverage ratio (OCF/DS) must be equal to or greater than 1.15 on a historical and/or projected cash flow basis and 1:1 on a global basis. To perform a complete analysis of debt service, it is important for a Lender to obtain a current debt schedule prepared by the Applicant, including any shareholder debt.” Page 172.

4. “b) The Borrower and/or OC will maintain proper books and records, allow Lender and SBA access to these records, and furnish financial statements or reports annually or whenever requested by Lender;” Page 227.

We request more information about SBA-guaranteed loans to these four franchises. We also request information that explains how the SBA provides oversight of lenders. Problems noted a few years ago continue to occur, including:

1. In a July 2011 report, the SBA Office of Inspector General (OIG) reported that SBA must enforce its requirements and ensure the bank receive and verify financial performance data

prior to making a loan.<sup>9</sup> SBA's OIG found that a bank violated 7(a) loan program rules by disregarding relevant and available data, which indicated that the franchises' revenue projections were unreasonable. Had the lender complied with SBA's requirements to use and assess the feasibility of realistic projections, 12 loans to Huntington Learning Center franchisees would have been declined. The OIG recommended that the SBA "[I]mprove the quality of franchise loan data by implementing a plan to ensure the completeness and accuracy of data pertaining to new franchise loans made in the future and correct existing incomplete loan records."

2. A September 2013 Government Accountability Office (GAO) report concurred, finding that "franchisees noted difficulties meeting anticipated revenue estimates." GAO noted that franchisors' "limited access to information that would aid [franchisees] in business planning." According to GAO's analysis, "the first-year projected revenues on loan applications involving [a] loan agent or her employer were, on average, more than twice the amount of actual first-year revenue for 19 of the 24 franchisees reviewed." GAO noted that first-year revenue estimates are not necessarily available to potential franchisees in the franchise organization's financial disclosure document nor do federal regulations require franchise organizations to provide actual first-year average revenues for start-up businesses in their disclosure document. The GAO recommended that SBA improve its oversight of its loans portfolio, such as default status, number of loans, and loan agent information.<sup>10</sup>

Please answer the following questions:

1. How is the SBA working with franchisees with SBA loans when a franchisee runs into trouble?
  - a. Specifically, when the SBA notices high rates of defaults in a brand, what action does your staff take to prevent loan failures?
  - b. If there is a major change in an agreement, such as changes that occurred with Complete Nutrition or Dickey's Barbecue, what recourse does the SBA have to prevent loan failures?
  - c. What can the SBA do when a franchisor, such as Complete Nutrition, terminates the franchise agreement entirely? Can the SBA require the franchisor make payments on outstanding loans of the franchisees? Has the SBA collected the guarantees paid out by SBA from any franchisor? Will the SBA seek recovery from the lender of all purchase amounts disbursed if the underlying financial information was inaccurate?

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<sup>9</sup> Office of Inspector General, U.S. Small Business Administration. "*Banco Popular Did Not Adequately Assess Borrower Repayment Ability When Originating Huntington Learning Center Franchise Loans.*" Report Number: 11-16. July 13, 2011. Retrieved from: [https://www.sba.gov/sites/default/files/oig/Audit%20Report%202011-16\\_0.pdf](https://www.sba.gov/sites/default/files/oig/Audit%20Report%202011-16_0.pdf).

<sup>10</sup> GAO. "Review of 7(a) Guaranteed Loans to Select Franchisees." September, 2013. Retrieved at: <https://www.gao.gov/assets/660/657723.pdf>.

- d. Can the SBA exclude an owner of a troubled franchise brand who has other franchises if there are significant problems with one of the franchise brands in their portfolio?
  - e. Has the SBA stopped loan guarantees to one franchise because of problems in another franchise with the same ownership? If so, which franchise brands?
6. Please provide charge off loan data for all states<sup>11</sup>, broken down by state, for Complete Nutrition, Experimac, Subway and Dickey's Barbecue. Please list the defaults for each franchise brand by state for all states.
7. How many SBA backed loans to these four franchises are behind in their exempt status but are not yet listed as defaulting?
8. Of the 256 charge offs to SBA-guaranteed loans to Complete Nutrition, Experimac, Subway and Dickey's Barbecue franchisees, how soon after the loan closed were those loans charged off? Please provide information for each franchise by how many loans defaulted within a year, two years, three years, etc. and by state for all states as appropriate.
9. Were any of the agents associated with any of those franchise brands previously suspended from the SBA program for misconduct or another reason?
10. Franchisors are not required to provide actual financial information in the Franchise Disclosure Document to franchisees. However, the SBA still requires lenders receive historic financial data. What information on revenue, default and store closings does the SBA require lenders receive from franchisors? Of that material, what is provided to the franchisees taking out the loan to buy the franchise?

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<sup>11</sup> "States" is defined to include all 50 states, territories, and the District of Columbia.

Please respond to this request by September 9, 2019. For more information, please contact Carol Wayman at 202.224.3542 or at [Carol\\_Wayman@cortezmasto.senate.gov](mailto:Carol_Wayman@cortezmasto.senate.gov).

Sincerely,



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Catherine Cortez Masto  
United States Senator



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Tammy Baldwin  
United States Senator

CC: Senate Small Business Committee Chair Marco Rubio  
Senate Small Business Committee Ranking Member Benjamin L. Cardin



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, DC 20416

September 19, 2019

The Honorable Catherine Cortez Masto  
United States Senate  
516 Hart Senate Office Building  
Washington, DC 20510

The Honorable Tammy Baldwin  
United States Senate  
709 Hart Senate Office Building  
Washington, DC 20510

Dear Senators Cortez Masto and Baldwin:

Thank you for your follow up letter of August 1, 2019, regarding U.S. Small Business Administration (SBA) guaranteed loans to franchisees in four franchise systems: Complete Nutrition, Dickey's Barbeque, Experimac, and Subway.

Attached per your request is a data table that discloses, by fiscal year, the number and dollar amount of loans approved for each of the four franchise systems by state, as well as the charge off rate by units and dollars, and the SBA's pro-rata portion of the losses. Also attached are data tables which provide charge off loan data for all states, broken down by state, and how many loans defaulted within a year, two years, etc., as well as how many loans are current/non-current (but not yet in default).

You have asked about the prevention of loan failures by franchisees in SBA's guaranteed loan program. SBA financial assistance is designed to give small businesses that lack credit elsewhere an opportunity to start, build and grow their business. Unfortunately, not all SBA borrowers will succeed. The probability of success and risk of loan failure are assessed by the lender and the small business applicant prior to the lender making the loan. SBA provides lenders with detailed guidance on eligibility and underwriting standards in Standard Operating Procedures (SOP) 5010, "Lender and Development Company Loan Programs." Lenders must consider, among other things, the creditworthiness of the applicant and the feasibility of the applicant's business plan. In accordance with SBA Loan Program Requirements, loans are not considered creditworthy unless the lender has determined up front that there is reasonable assurance of repayment from the operations of the small business.

Pursuant to the Federal Trade Commission's ("FTC") amended Franchise Rule, 16 CFR Part 436, franchise systems ("Franchisors") are required to disclose certain information to

prospective franchisees ("Franchisees") in the form of a Franchise Disclosure Document ("FDD") and Franchise Agreement prior to any payment by the Franchisee to the Franchisor. SBA requires lenders to obtain a copy of all documents that a Franchisor requires a Franchisee to sign in order to open and operate a franchise as part of the application for an SBA-guaranteed loan. When considering an application for an SBA-guaranteed loan, lenders are required to exercise the same level of prudence and care in extending credit that they do for their similarly-sized, non-SBA guaranteed commercial loans.

Once a lender makes a loan to a Franchisee, SBA requires the lender to service the loan in a commercially reasonable and prudent manner. SBA provides additional written guidance through SOP 50 57 2, "7(a) Loan Servicing and Liquidation" in the event that certain servicing actions become necessary during the life of the loan. SBA will work with the lender and the small business, if necessary, to try to resolve any issues.

Should an SBA-guaranteed loan become seriously delinquent or classified in liquidation, SBA requires that lenders make a good faith effort to negotiate a workout plan on the loan, whenever feasible. Generally, a workout agreement restructures the material terms and conditions of the debtor's delinquent loan in order to: avoid the need for actions such as foreclosure or bankruptcy; enable the debtor to cure defaults and improve repayment ability; and enable the creditor to maximize recovery on the loan. SBA's prior written approval of a workout plan is not generally required.

In addition, SBA's resource partners, such as Small Business Development Centers, SCORE, Women's Business Centers and Veterans Business Outreach Centers, are available to support small businesses (including small franchisees), whether or not they seek financing, and particularly when experiencing operational issues.

You have also asked about situations where there are changes to a franchise agreement. After the initial review of an agreement and placement of a brand on the SBA Franchise Directory ("Directory"), SBA requires Franchisors to make an annual certification regarding any changes to the franchise agreement that might affect the eligibility (*i.e.*, size/control and nature of the business) of the franchise system for SBA financial assistance. Franchisors that use SBA's standard form of addendum are not required to provide an annual certification.

You also asked if SBA seeks recovery from the Franchisor in the event that a Franchisee defaults on a loan. SBA is not a party to the franchise agreement and, as a result, SBA has no contractual or other direct relationship with the Franchisor. Further, the Franchisor is not a guarantor of the loan. It is the responsibility of the lender to make and collect all loans for which they received an SBA guaranty. In accordance with SBA Loan Program Requirements, the lender must determine up front that there is reasonable assurance of repayment from the operations of the small business. In accordance with SBA Loan Program Requirements and prudent lending standards, the lender sets the terms and conditions of each loan and the loan is funded and collected in accordance with those terms and conditions.

In the event of default and liquidation, the lender must seek recovery based on the note terms from all sources identified and, with respect to 7(a) loans, must liquidate all business personal property collateral prior to requesting SBA to honor the guaranty. SBA reviews purchase requests and supporting documentation when presented to one of SBA's purchase centers

and determines if the loan met eligibility and credit requirements at the time of approval. Should the lender not have followed the Loan Program Requirements, SBA may be released from its liability to honor the guaranty and the lender bears the entire loss, if any.

As we indicated in our letter of June 17, 2019, SBA has created the Directory of all franchise and other brands reviewed by SBA that are eligible for SBA financial assistance. The Directory only includes business models that SBA determines are eligible under SBA's affiliation rules and other eligibility criteria. If SBA determines the franchise system or business model does not meet all of SBA's eligibility criteria, the brand will not be included on the Directory. Please note that "eligibility" criteria do not include repayment ability, which is an indicator of creditworthiness.

You have asked "[h]as the SBA stopped loan guarantees to one franchise because of problems in another franchise with the same ownership?" SBA has not stopped guaranteeing loans to franchisees of one franchise system because of problems in another franchise system with the same ownership.

Individuals and entities suspended, debarred, revoked, or otherwise excluded under the SBA or Government-wide debarment regulations are not permitted to conduct business with SBA, including participating in an SBA-guaranteed loan. Lenders are responsible for consulting the General Services Administration's System for Awards Management's (SAM) Excluded Parties List System (EPLS) or any successor system to determine if an employee or an Agent has been debarred, suspended or otherwise excluded by SBA or another Federal agency. There have been no Agent suspensions or debarments in connection with the subject franchise brands.

You have asked about the availability of financial data related to a franchise system. Pursuant to the FTC's amended Franchise Rule noted above, Franchisors may include representations about their financial performance in their FDDs, and if they do so, must follow the guidance in the FTC's Compliance Guide, specifically Item 19. (See, <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-ruse-complicance-guide.pdf>.) The financial information provided in a brand's FDD, generally, does not include financial information for a specific location. Under all SBA loan programs, not just loans to a franchise brand, lenders are required by regulation (13 CFR § 120.150) and SOP (SOP 50 10 5(K) to address in their credit analysis for each loan application the Applicant's ability and likelihood to repay the loan.

Lenders should follow their normal procedures in obtaining the required financial information when analyzing the credit for a loan to a franchise. This information may come from the FDD, the seller of the business, or the projections of the applicant. We do not require lenders or Franchisors to provide revenue, default or store closings information to SBA, nor do we provide such information to any franchisee.

The Office of Credit Risk Management ("OCRM") is responsible for oversight of all lenders participating in SBA loan programs. OCRM conducts regular review and examination of lenders and their respective loan portfolios to ensure compliance with SBA Loan Program Requirements. Lenders receive information regularly to identify any areas of concern, with

recommendations for corrective actions. SBA has no authority to review or examine Franchisors and only reviews the brand for affiliation and eligibility for SBA financial assistance and placement of the brand on the Directory.

We encourage Congressional offices to reach out to the FTC to learn more about franchise issues as well as their state Bureau of Consumer Protection for relevant information on Franchisors operating in their states.

We appreciate your continued support of SBA and the Nevada and Wisconsin small business community.

Sincerely,



Dianna L. Seaborn  
Director  
Office of Financial Assistance