United States Government Accountability Office

Report to the Ranking Member of the Subcommittee on Innovation, Data, and Commerce, Committee on Energy and Commerce, House of Representatives

April 2023

FEDERAL TRADE COMMISSION

Actions Needed to Improve Education Efforts and Awareness of Complaint Process for Franchise Owners

GAO-23-105338

GAO Highlights

Highlights of GAO-23-105338, a report to the Ranking Member of the Subcommittee on Innovation, Data, and Commerce, Committee on Energy and Commerce, House of Representatives

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FEDERAL TRADE COMMISSION

Actions Needed to Improve Education Efforts and Awareness of Complaint Process for Franchise Owners

Why GAO Did This Study

Franchising enables prospective owners to purchase the right to operate a branch of a branded business. Franchise owners pay a fee to the franchisor, and in return receive the right to use the franchisor's name and to operate using its business model for a specified number of years. Section 5 of the FTC Act, which prohibits unfair or deceptive acts or practices in or affecting commerce, and the Franchise Rule provide FTC with authority to oversee certain aspects of franchising.

GAO was asked to review FTC's oversight of franchising. This report examines (1) challenges franchise owners reported facing in operating franchises and FTC's efforts to educate prospective franchise owners and (2) how FTC oversees franchising.

GAO reviewed laws and regulations related to franchising and FTC data and documentation on franchise-related complaints and investigations. GAO conducted nine discussion groups with 44 franchise owners, selected to represent a variety of industry types. GAO also interviewed FTC officials and 25 franchising stakeholders (attorneys, trade association representatives, and franchisors).

What GAO Recommends

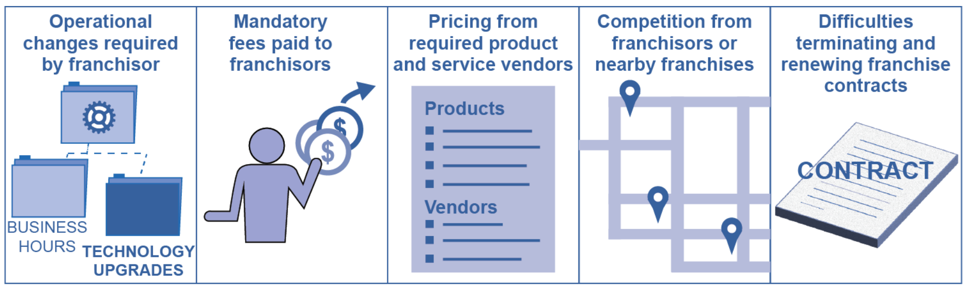
GAO recommends that FTC take steps to (1) enhance its consumer education efforts for prospective franchise owners, (2) increase publicity of its guide for franchise owners, and (3) improve franchise owners' awareness and understanding of FTC's complaint process. FTC agreed with GAO's recommendations.

View GAO-23-105338. For more information, contact Alicia Puente Cackley at (202) 512-8678 or CackleyA@gao.gov.

What GAO Found

Franchising is a popular type of business arrangement in the U.S. that can offer benefits to individuals interested in owning their own business. Franchise owners and stakeholders that GAO interviewed described risks and challenges faced after purchasing a franchise (see figure).

Risks and Challenges Franchise Owners Can Face In Operating a Franchise



Source: GAO analysis of interviews with franchisees and stakeholders. | GAO-23-105338

The Federal Trade Commission's (FTC) Franchise Rule requires franchisors to disclose in writing certain information to prospective franchise owners to allow them to compare the risks and benefits of purchasing a franchise. FTC also publishes a guide for prospective franchise owners that highlights challenges they may face and key aspects of the disclosure. However, according to some stakeholders GAO interviewed, prospective franchise owners do not always fully read the disclosure, even though it contains information essential for decision-making. In addition, participants in eight of GAO's nine discussion groups with franchise owners said they were generally unaware of FTC's guide. By enhancing its efforts to educate prospective franchise owners on the importance of the disclosure document and more broadly publicizing its guide, FTC could improve prospective franchise owners' ability to make informed decisions.

FTC uses consumer complaints to inform its oversight and enforcement activities, but franchise owners' concerns may be underreported. GAO's analysis of FTC's complaint data showed that from 2018 through 2022, there were about 5,900 franchise-related complaints, representing less than 1 percent of all complaints received. However, the number of complaints may not fully reflect the extent of problems experienced by franchise owners. For example, while franchise owners in all of GAO's discussion groups identified concerns about franchisors' practices, participants in eight of the nine groups said they had never filed a complaint with FTC because they were not aware they could do so. Stakeholders gave additional reasons why franchise owners may not file complaints with FTC. For example, they said franchise owners may fear violating the terms of their contracts by speaking out against their franchisors. FTC has modified its complaint system to make it easier for franchise owners to navigate. However, without additional efforts to increase outreach and education to the franchise community and work with stakeholders to improve franchise owner awareness and understanding of its complaint process, FTC may not have an accurate representation of concerns to inform its oversight and enforcement activity.

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Abbreviations

FDD	franchise disclosure document
FTC	Federal Trade Commission
FTC Act	Federal Trade Commission Act
NASAA	North American Securities Administrators Association
SBA	Small Business Administration

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
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April 17, 2023

The Honorable Jan Schakowsky
Ranking Member
Subcommittee on Innovation, Data, and Commerce
Committee on Energy and Commerce
House of Representatives

Dear Ms. Schakowsky:

Franchising is a popular type of business arrangement in the United States that can offer individuals the opportunity to own their own business.[1] According to the Census Bureau, there were almost half a million franchise establishments operating in the United States in 2017.[2] These establishments generated about $1.7 trillion in sales, receipts, or revenue and employed about 9.6 million workers in 2017.[3] Franchising can provide a business owner with brand name recognition, operational and marketing support, and training. However, the financial investment of purchasing a franchise can be significant, and there is no guarantee that the business will succeed.

The Federal Trade Commission (FTC) has regulatory and enforcement authorities for overseeing certain aspects of franchising. Specifically, FTC regulates and may take enforcement action pursuant to its Franchise

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[1]The Federal Trade Commission defines a franchise as a continuing commercial relationship or arrangement where the franchise seller (franchisor) promises or represents, orally or in writing, that the franchise buyer (franchisee) will have the right to operate a business, or offer, sell, or distribute goods, services, or commodities, that are identified or associated with the franchisor's trademark, under the condition that (i) the franchisee makes, or commits to make, a required payment to the franchisor or its affiliate and (ii) the franchisor will or has the power to exert a significant degree of control over the franchisee's business operation, or provide significant assistance in the franchisee's method of operation. 16 C.F.R. § 436.1(h).

[2]The 2017 Economic Census Franchise Statistics Report, the most recently available, published information on franchise establishments and used data from the 2017 Economic Census. This census is conducted every 5 years. Census Bureau, "EC1700FRAN—Selected Sectors: Franchise Status for the U.S. and States: 2017," accessed Dec. 9, 2021,
https://data.census.gov/table?y=2017&d=ECN+Core+Statistics+Selected+Sectors:+Franchise+Status+for+the+U.S.+and+States&tid=ECNFRAN2017.EC1700FRAN.

[3]Census Bureau, "Franchising Is More Than Just Fast Food," accessed Dec. 30, 2021,
https://www.census.gov/library/stories/2021/12/franchising-is-more-than-just-fast-food.html.

Rule and may also take action under Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits “unfair or deceptive acts or practices in or affecting commerce.”[4] The Franchise Rule requires franchise sellers (franchisors) to provide a franchise disclosure document (FDD) to prospective purchasers (franchisees) before they purchase a franchise.[5] The FDD includes information about the franchisor, its management team, estimated start-up expenses, and legal obligations to help potential franchisees evaluate the risks and benefits of the investment.

You requested that we review FTC’s oversight of franchising. This report examines (1) challenges franchisees reported facing in operating franchises and FTC’s efforts to educate prospective franchisees and (2) how FTC oversees franchising and enforces the Franchise Rule and Section 5 of the FTC Act.

To address both of our objectives, we reviewed relevant laws and regulations, including Section 5 of the FTC Act and FTC’s Franchise Rule.[6] We interviewed officials from FTC’s Division of Marketing Practices (within the Bureau of Consumer Protection) and Division of Consumer Response & Operations. We also interviewed a variety of franchising stakeholders, including regulatory officials from six states, nine franchise attorneys, six franchisors, and representatives from three franchise trade associations. We selected states to obtain variation in the type of franchise laws enacted in the states, among other factors. We selected attorneys that represent both franchisees and franchisors. Attorneys were selected based on factors such as their participation in legal forums on franchise law and referrals we received from other attorneys or stakeholders we interviewed. We selected franchisors from the same

[4]Pub. L. No. 63-203, 38 Stat. 717 (1914); 15 U.S.C. § 45(a)(1). FTC issued the Franchise Rule pursuant to its authority under the FTC Act. Furthermore, any covered violation of the Franchise Rule is deemed an unfair or deceptive act or practice in violation of Section 5 of the FTC Act. 16 C.F.R. § 436.2. *See also* 16 C.F.R. §§ 436.6(a), 436.9.

[5]In this report we use the terms “franchisee” and “franchise owner” synonymously.

[6]We reviewed FTC’s efforts to enforce the Franchise Rule and Section 5 of the FTC Act (unfair or deceptive acts or practices) against franchisors. We did not evaluate the effectiveness of the Franchise Rule or the extent to which various challenges described to us by franchisees or others constituted violations of the Franchise Rule, Section 5 of the FTC Act, or state law. FTC amended the Franchise Rule in 2007, and parties subject to the rule were required to comply with it beginning in July 2008.

industries—but from different franchise brands—from which we selected participants in our franchisee discussion groups (discussed below).

To address our first objective, we reviewed FTC documentation and resources, including its *Franchise Rule Compliance Guide, Consumer's Guide to Buying a Franchise,* and *Strategic Plan for Fiscal Years 2022–2026*. We reviewed the requirements of the Franchise Rule and drew on economic literature that describes the benefits of the franchise business model.[7] In addition, we assessed FTC's efforts to educate prospective franchisees against relevant objectives in its strategic plan.

We also conducted nine discussion groups with a total of 44 franchise owners. Seven of the groups consisted of franchise owners who were members of franchisee associations for specific industries and brands.[8] These associations represented the limited-service restaurant, hotel and motel, and beauty salon industries. We selected these industries to obtain variation in the number of franchise establishments and the number of franchise employees in the industry, among other factors. The remaining two discussion groups consisted of franchise owners from a variety of industries. The information gathered during our discussion groups and interviews is not generalizable to all franchisees' experiences.

To address our second objective, we analyzed documentation on FTC's enforcement practices and consumer complaint process, including policy statements and the ReportFraud.ftc.gov website. We analyzed franchise-related complaint data FTC received from 2018 through 2022. To assess the reliability of the complaint data, among other steps, we reviewed FTC documentation and interviewed knowledgeable agency officials. We concluded that the data were sufficiently reliable for the purpose of reporting the total number of franchise-related complaints FTC received. We compared FTC's approach for collecting and analyzing franchise-related complaints against relevant objectives in its strategic plan. Finally, we reviewed documentation on franchise-related investigations and

[7]See, for example, F. Lafontaine and M.E. Slade, "Incentive Contracting and the Franchise Decision," in *Game Theory and Business Applications*, eds. K. Chatterjee and W.F. Samuelson (Boston: Springer, 2002); David E.M. Sappington, "Incentives in Principal-Agent Relationships," *Journal of Economic Perspectives*, vol. 5, no. 2 (1991): 45–66; and K-A Sun and S. Lee, "Competitive Advantages of Franchising Firms and the Moderating Role of Organizational Characteristics: Evidence from the Restaurant Industry," *International Journal of Hospitality Management*, vol. 77 (2019): 281–289.

[8]Franchisee associations are membership organizations of franchise business owners who may share resources among their members and advocate on behalf of franchisees.

enforcement actions that FTC took from July 2008 through 2022.[9] A detailed discussion of our objectives, scope, and methodology can be found in appendix I.

We conducted this performance audit from July 2021 to April 2023 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Franchising and the Franchise Business Model

Franchising enables a franchisee to purchase the right to operate a branch of a branded business. Franchisees pay a fee to the franchisor and in return receive the right to use the franchisor's name and to operate using the franchisor's business model for a specified number of years. Franchisors may support franchisees in a variety of ways, such as helping them find a location for their business and providing initial training and advice on management, marketing, or personnel.

The relationship between a franchisor and a franchisee is governed primarily by a contract often referred to as the franchise agreement. The franchise agreement is a legal agreement that outlines the terms, conditions, restrictions, and other details of the arrangement between the parties. It can explain how long franchise owners have the right to operate their business, requirements for how products and services are to be marketed and sold, geographic areas in which franchise owners can operate, and ongoing support the franchisor may offer the franchise owner. The agreement may also set forth the various payments and fees that franchise owners must pay the franchisor. Ancillary agreements, such as any software license agreements and lease agreements that accompany the franchise agreement, also govern the relationship between the franchisee and franchisor.

FTC and Federal Protections for Franchisees

FTC is an independent law enforcement agency with both consumer protection and competition jurisdiction over a wide range of consumer protection issues. It has enforcement or administrative responsibilities for more than 70 laws. According to FTC, oversight of franchising generally

[9]We defined franchise-related investigations and enforcement actions as investigations or enforcement actions that involved alleged Franchise Rule violations or instances in which a franchisor was alleged to have engaged in an unfair or deceptive act or practice against a franchisee in violation of Section 5 of the FTC Act.

falls under its consumer protection responsibilities, and for the purposes of franchise oversight, FTC considers prospective franchisees to be consumers. Staff in FTC's Bureau of Consumer Protection are responsible for administering the Franchise Rule.

The Franchise Rule became effective in 1979 and was amended in 2007. The primary purpose of the Franchise Rule is to provide prospective franchisees—through the FDD—the material information they need to weigh the risks and benefits of purchasing a franchise. The Franchise Rule is not intended to regulate the substantive terms of the franchisee-franchisor relationship, but it requires franchisors to disclose certain information about the relationship and the business.

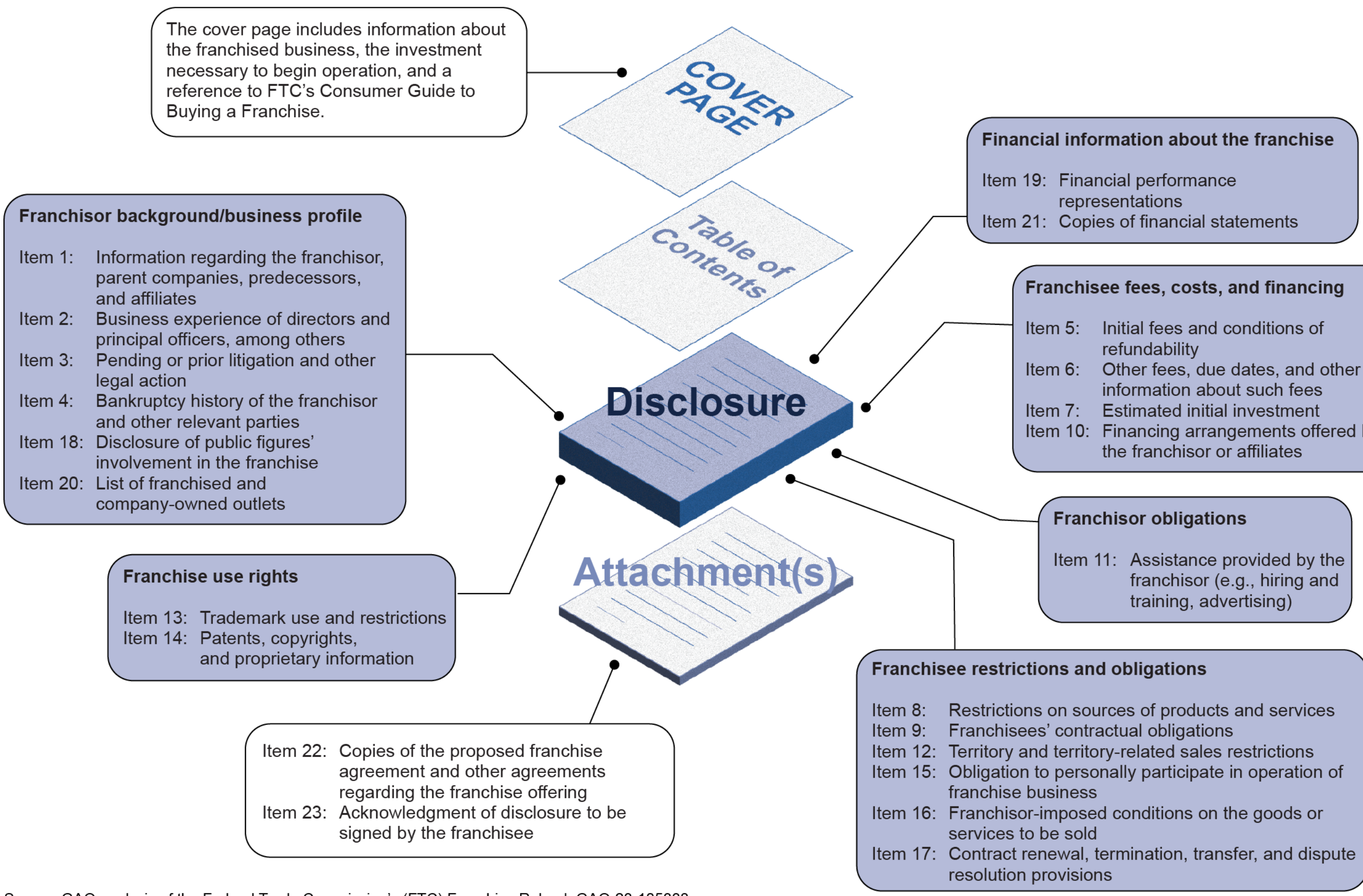
The Franchise Rule requires that a franchisor provide all potential franchisees with an FDD that covers 23 specified items (see fig. 1).[10] The FDD contains information about the franchisor's business background, the fees charged by the franchisor, requirements for renewing the contract, and contact information for current and former franchisees, among other things. Franchisors must provide prospective franchisees with the FDD at least 14 calendar days before they sign a contract or make a payment related to a franchise sale.[11] Franchisors are not required to register or file their FDD with FTC, and FTC does not review or approve FDDs; however, FTC does have the authority to request FDDs from franchisors.[12]

[10]For item 19 the Franchise Rule permits, but does not require, franchisors to make financial performance representations, which include actual or potential sales and earnings information, for their franchises. Any financial performance claims a franchisor makes must be disclosed in item 19 and must be consistent with the disclosure requirements in 16 C.F.R. §§ 436.5(s), 436.9(c).

[11]16 C.F.R. § 436.2(a). Prospective franchisees can request and receive a copy of the FDD earlier in the sales process. 16 C.F.R. § 436.9(e). The Franchise Rule also requires franchisors to provide potential franchisees with a revised franchise agreement or any related agreement at least 7 calendar days before the revised agreement is signed if the terms and conditions thereof are unilaterally and materially altered by the franchisor. 16 C.F.R. §§ 436.2(b), 436.9(g).

[12]16 C.F.R. § 436.6(h).

Figure 1: Information Required to Be Disclosed in the Franchise Disclosure Document



Source: GAO analysis of the Federal Trade Commission's (FTC) Franchise Rule. | GAO-23-105338

In addition to the Franchise Rule, FTC enforces Section 5 of the FTC Act, which declares unfair or deceptive acts or practices in or affecting commerce to be unlawful.[13] Section 5 provides FTC with the authority to declare an act or practice as unfair only when three specific criteria are met: (1) the act or practice causes or is likely to cause substantial injury to consumers, (2) the injury is not outweighed by countervailing benefits to consumers or to competition, and (3) the act or practice is not reasonably avoidable by consumers.[14] Further, FTC provides that it will declare an act or practice as deceptive when it involves a material misrepresentation,

[13] 15 U.S.C. § 45(a)(1).

[14] 15 U.S.C. § 45(n).

omission, or practice that is likely to mislead a consumer acting reasonably in the circumstances, to the consumer's detriment.[15]

Only FTC, not private parties, can enforce violations of Section 5 of the FTC Act, which would include violations of the Franchise Rule. The FTC Act provides FTC with a broad range of remedies for violations, including the ability to obtain cease-and-desist orders or injunctive relief as appropriate; seek redress for consumers and others injured by violations of the Franchise Rule; seek contract rescission, refunds, damages, and public notification for Franchise Rule violations; and impose civil penalties for knowing violations of the Franchise Rule.

FTC operates the Consumer Sentinel Network, which is an online database that compiles complaints the agency receives directly from consumers. The database also includes consumer complaints received by other organizations, including state, federal, local, and international law enforcement agencies and the Better Business Bureau. Franchisees can submit complaints to FTC through the ReportFraud.ftc.gov website, by calling FTC's Consumer Response Call Center, or by mail.

The Small Business Administration (SBA) also has a role related to financing small businesses, including franchises. SBA can provide financial assistance to prospective franchisees through its business loan programs.[16] Franchise brands must meet certain SBA eligibility criteria for franchisee applicants operating under that brand to be eligible to receive SBA financial assistance. Separately, franchisees themselves must also meet SBA's loan eligibility criteria. SBA also offers educational resources to prospective franchisees.

State Protections for Franchisees

The Franchise Rule sets a minimum federal standard for franchise disclosures, but some states have enacted laws regulating franchising that provide additional protections to franchisees and require more extensive disclosures.[17] Generally, there are three types of states:

- **Notice states.** States that have notice laws generally require the franchisor to submit documentation to the state before offering or selling a franchise to a prospective franchise owner. Depending on the state, this documentation could take a variety of forms. These

[15] FTC Policy Statement on Deception, Oct. 14, 1983.

[16] In addition to SBA assistance, funding options available to prospective franchisees include, among others, loans and lines of credit from financial institutions or other lenders.

[17] "Franchise" and "franchising" may be defined differently from state to state and in federal law.

states are often called “filing states” and do not require the franchisor to register with the state before selling a franchise.

- **Registration states.** States with registration laws generally require the franchisor to register its FDD and submit a copy to the state regulator for approval prior to offering or selling franchises in the state, absent an applicable exemption. According to FTC, 14 states require franchisors to register with the state or both register and file the FDD for review. These states employ franchise examiners to review and comment on FDDs before the state grants the franchisor an approved registration to sell its franchise in the state, according to the North American Securities Administrators Association (NASAA).[18]
- **Non-notice/nonregistration states.** Other states have no notice or registration requirement. These states are often referred to as “nonregistration” states.

In addition, states of all types may have laws in place that regulate certain substantive terms of the franchise relationship, such as termination, modification, or nonrenewal. These types of laws are often referred to as “relationship laws.” Furthermore, states use a variety of actions to enforce their franchise requirements, including for example, consent orders, cease and desist orders, initiating civil action, and imposing civil penalties.

NASAA’s Franchise and Business Opportunities Project Group (Franchise Project Group) consists of state regulators from states with registration laws. FTC and SBA officials serve on the Franchise Project Group’s Advisory Committee.[19] The Franchise Project Group supports states’ enforcement of their franchise regulations by providing model

[18]NASAA is a voluntary association whose membership consists of the securities regulators in the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, as well as the 13 provincial and territorial securities regulators in Canada and the securities regulator in México. In the United States, NASAA is the voice of state securities regulators that protect investors, promote responsible capital formation, and support inclusion and innovation in the capital markets. NASAA members license firms and their agents, investigate alleged violations of securities laws, file enforcement actions when appropriate, and educate the public about investment fraud. NASAA members also participate in multistate enforcement actions and information sharing. According to NASAA and FTC, the 14 states that require franchisors to register their FDD prior to offering or selling a franchise are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

[19]FTC and SBA officials serve in an ex officio capacity on this committee.

rules, guidance, and training and works to promote uniformity regarding franchise disclosure requirements.

Franchisees Reported Challenges, and Opportunities Exist for FTC to Improve Its Education Efforts

Franchisees Reported Facing Challenges Related to Fees and Lack of Control Over Key Business Operations

Economic theory suggests that a franchise business model can offer benefits for both franchisors and franchisees. For franchisors, the business model can reduce the need to oversee the franchised work directly. Specifically, in contrast to a corporate structure that employs staff and managers to oversee the work and uses a centrally controlled schedule of performance-based pay for employees, franchisors can provide incentives for franchisees to put in effort or make decisions that align with the franchisor's needs by providing the franchisee with the opportunity to keep profits from the franchise business. A franchise business model can also create attractive opportunities for prospective franchisees who believe they have the skills to operate profitably in positions independent of direct oversight, but do not have the capital or capacity to develop a brand from scratch.

However, franchisees do not control some aspects of their business and do not receive the full benefit of the risks they bear. Franchisees make significant investments to start and operate the business. However, in a franchising relationship, the franchisor rather than the franchisee may control certain aspects of the business and its operations that affect costs. For example, the franchisor may determine which vendors franchisees are required to use to purchase certain products or services, the hours they must operate, or how business funds, such as advertising funds, are spent. Furthermore, franchisees do not enjoy the full benefit of the risks they bear because they may also have to pay the franchisor a percentage of their gross income, even if they are losing money or if they terminate the agreement and close the business.

Our nine discussion groups with franchisees and interviews with 25 stakeholders—which included state regulators, attorneys, trade associations, and franchisors—identified the following challenges franchise owners can face in operating their businesses.[20]

- **Operations.** Typically, franchise agreements require franchise owners to abide by an operations manual developed by the franchisor. Although franchise agreements are not uniform, they generally include provisions that require franchise owners to implement operational changes a franchisor makes. These changes may affect franchise owners' profitability. For example, participants in one franchisee discussion group stated that the franchisor required franchisees to be open for a specific number of hours, even if they operated at a loss during those hours. Participants also expressed concerns about requirements to participate in promotions that undermined their existing prices or were not profitable for their business. Representatives from a trade association and an attorney we interviewed stated that franchisors make changes to their business operations at times to maintain the brand's position in the market and to respond to technological changes and competition from other providers or products.
- **Fees.** Franchise owners must pay a variety of fees to franchisors. Officials from two state regulatory agencies commented that high fees can create challenges for franchisees. High fees can affect the franchisee's profitability and must be paid even if the franchisee is losing money. In addition, an attorney we interviewed and participants in one of our franchisee discussion groups commented that the number of fees imposed on franchise owners in recent years has increased. For example, participants in the discussion group stated that in recent years, the franchisor added additional fees for cybersecurity and cyberinsurance.

  Further, franchise agreements may allow franchisors to use the revenues they collect from fees as they determine appropriate. For example, a franchisor may allocate advertising fees it collects from

[20]We did not assess the prevalence of the challenges experienced by franchisees. The challenges discussed in this report represent the challenges experienced among franchisees in our discussion groups, as well as the common types of challenges observed by other franchise stakeholders we interviewed. We also did not evaluate the extent to which these concerns constituted violations of the Franchise Rule, Section 5 of the FTC Act, or state law.

franchise owners for national advertisements or to attract new franchisees. Participants in one of our franchisee discussion groups expressed concerns that the franchisor was focusing its advertising resources on other brands that did not directly benefit their business.

- **Required vendors.** Franchisors may require franchisees to purchase certain products and services from particular vendors, which may charge above-market prices, according to representatives from one trade association, three attorneys, and officials from one state regulatory agency. The above-market prices can reduce franchisees' profitability. In addition, representatives from one trade association, three attorneys, and participants in one of our franchisee discussion groups stated that franchisors may receive rebates from the required vendors. However, these rebates may not be passed on to franchisees to reduce their costs. One of the attorneys stated that franchisors may keep the rebates as consideration for negotiating lower rates for products and services, and that in some cases, franchisors change vendors to get higher rebate amounts.

  All six of the franchisors we interviewed said they require the use of approved vendors to maintain brand quality or consistency, and five of the franchisors indicated that franchisees receive lower pricing based on the franchisor's purchasing power.

- **Territories and competition.** Franchisees may face competition from their franchisor, which may open a business in close proximity to the franchisee's location. The close proximity can reduce franchisees' sales, creating challenges for franchise owners, according to representatives from NASAA and three attorneys we interviewed. Franchise agreements may provide franchise owners an "exclusive" or "protected" territory that may prevent the franchisor and other franchise owners from opening competing outlets or serving customers in that geographic area. However, without an exclusive territory, franchisees may face competition from other establishments in the same brand that are located nearby or from other brands within the franchisor's portfolio, according to one attorney we interviewed.

  In addition, franchisors may sell products or services directly to consumers and compete with franchisees for business. Specifically, franchisors may include clauses in the franchise agreement that allow them to offer products directly to consumers within a franchisee's exclusive territory, and franchisees may face competition directly from franchisors that also sell their products online.

- **Renewals and terminations.** Franchise agreements may not be automatically renewed and can be terminated by franchisors or franchisees for a variety of reasons. According to FTC, if an agreement is terminated, franchisees may lose their investment. Franchisors may also change the terms of the agreement for renewal. According to one attorney we interviewed, franchisees may not know the terms of renewal until shortly before they must sign their renewal agreement. Participants in two of our franchisee discussion groups stated that renewal agreements often look very different from the agreement they signed initially. For example, the franchisor may raise fees or require renovations that may affect a franchisee's profitability.

Franchisees can also terminate franchise agreements but may find it difficult to do so because they may be required to pay royalty fees for the duration of the agreement, even if they terminate their contract agreement early and close their establishment. Participants in one discussion group said franchisees may be required to pay significant amounts to the franchisor to terminate their franchise agreement. In addition, following the termination of an agreement, the terms of the agreement may prevent a franchisee from operating a similar business within a certain distance of other franchise establishments for a certain period. This restriction limits what franchisees can do with their equipment and expertise, according to one attorney.

Communication or a collaborative approach to implementing changes can help facilitate positive relationships between franchise owners and franchisors, according to representatives from five franchisors, franchisees in three of our discussion groups, and two attorneys. When challenges do arise, franchise owners may seek outside counsel or reach out to a franchise association or a franchise advisory council to help address issues, according to representatives from a trade association.[21]

Beyond these methods, however, franchisees may have limited recourse to address disputes with franchisors, according to representatives from one trade association, two attorneys, and officials from one state regulatory agency. For example, some franchise agreements require that disputes be brought to arbitration rather than a court of law, according to FTC. In addition, some franchise agreements may prohibit class action lawsuits, according to an attorney we interviewed. Further, neither the FTC Act nor the Franchise Rule creates a private right of action that allows a franchisee to sue a franchisor under those laws.

[21]A franchise advisory council is a committee of franchise owners who work with the franchisor (and other franchise owners) to help improve the system and address common issues and concerns.

Many Prospective Franchisees Do Not Appear to Use Available Information about Franchising Risks

As noted earlier, an FDD must disclose the material information potential franchisees need to weigh the risks and benefits of purchasing a franchise. A number of the items that must be disclosed address some of the risks and challenges highlighted in our discussions with franchisees and other stakeholders (see table 1).

Table 1: Examples of Franchise Disclosure Document Items Related to Franchisee Challenges

Franchisee challenges	Related franchise disclosure document items
Fees	Item 5 requires the disclosure of initial fees—all fees, payments, or commitments the franchisee must pay before the business opens. Item 6 requires the disclosure of all other fees, including the type, amount, due date, and other relevant information. Item 11 includes broad information regarding advertising spending requirements and the franchisor's use of advertising fees. This includes the franchisor's obligation to conduct advertising, whether the franchisor must spend any amount on advertising in the area or territory where the franchise is located, and the percentage of any advertising funds the franchisor uses principally to solicit new franchise sales.
Required vendors	Item 8 requires disclosure of obligations to purchase certain products and services, along with restrictions on suppliers thereof. This includes information about the supplier and whether alternative suppliers may be available; whether franchisors may derive revenue from a franchisee's use of required suppliers; and whether the franchisor negotiates purchase arrangements with suppliers, including price terms, for the benefit of franchisees.
Territories and competition	Item 12 includes information concerning assigned territories and applicable sales restrictions. This includes the minimum territory granted to the franchisee, whether that territory is exclusive or whether the franchisee may face competition in the territory from other franchisees, and any present plans on the part of the franchisor to operate a competing business or franchise system offering similar goods or services.

Source: GAO analysis of the Federal Trade Commission's Franchise Rule. | GAO-23-105338

Note: The items included in this table do not reflect all franchisee challenges nor all franchise disclosure document requirements.

Use of the Franchise Disclosure Document

According to several stakeholders we interviewed, however, prospective franchisees do not always read the FDD in full, which may be the result of several factors:

- **Length and complexity.** FDDs can be long—the seven we reviewed ranged from 300 to 700 pages.[22] The length of the FDD can make it challenging for prospective franchisees to read the full document, according to representatives from two trade associations, one attorney, and officials from one state regulatory agency. In addition, FDDs can be complex or hard to understand, according to representatives from one trade association, officials from two state regulatory agencies, and one attorney.

[22]The page length of the FDDs we reviewed included the franchise agreement and other required attachments.

For example, in its 2019 public comment letter for FTC's Franchise Rule review, NASAA pointed out the complexity of FDD item 12, which covers a franchisee's territory.[23] NASAA indicated that the term "exclusive territory"—which the Franchise Rule can require franchisors to use—may not be well understood by prospective franchise owners and could be confusing since some franchisors use other terms for this concept. Further, public comment letters from NASAA and an attorney stated that disclosure information required by item 1 can include complex information on business structures. For example, NASAA's letter points out that franchisors that have been purchased by private equity firms may have extensive disclosures about the business structure and affiliates. As discussed later in this report, FTC is in the process of reviewing the Franchise Rule and, as part of this review, is examining aspects of the FDD, including its length and structure.

- **Reliance on other sources.** Some prospective franchisees rely on sources of information other than the FDD, such as franchise brokers or salespeople, according to officials from two state regulatory agencies.[24] However, these sources may not provide complete or accurate information and are only paid if a sale is made, according to FTC. This may discourage brokers or salespeople from disclosing risks and challenges to potential franchisees if doing so could jeopardize the sale.
- **Language barriers and limited business experience.** Many prospective franchisees do not speak English as their first language, according to representatives from one trade association, three attorneys, and officials from one state regulatory agency. In addition, one of the attorneys and officials from the state regulatory agency noted that some prospective franchisees have limited business experience.

Indications that some prospective franchisees do not fully read and understand the FDD, coupled with challenges franchisees described to

[23]In 2019, FTC began a review of its Franchise Rule as part of its periodic review of all FTC rules to examine their costs and benefits and regulatory and economic impact. We discuss this review of the rule in additional detail later in the report.

[24]Franchise brokers are included in the definition of "franchise sellers" under the Franchise Rule and are subject to certain provisions of the rule. Franchise brokers represent a portfolio of franchises and help match prospective investors with opportunities. Franchise brokers educate prospective franchisees on the types of franchises that are available and assess whether they may be a good fit for a brand. When a franchise is sold, franchisors may pay the broker a commission or a flat fee.

us, also suggest that some prospective franchise owners may not fully read and understand the terms and conditions of the franchise agreement itself. The franchise agreement contains information beyond that in the FDD and must be included as an attachment to the FDD. If prospective franchisees do not understand and use both of these documents, they may lack important information they need to make an informed decision. For example, the FDD may not fully describe the extent to which provisions in the franchise agreement may change—such as new fees that might be assessed after the agreement is in effect as a result of changes to a franchisor's business model.

Lack of Awareness about FTC's Consumer Guide

FTC developed *A Consumer's Guide to Buying a Franchise* to help educate prospective franchisees.[25] The guide includes information on the franchise business model, franchisee contractual obligations, and considerations for identifying and evaluating costs and potential earnings. The guide also highlights benefits and risks of operating a franchise and covers some of the challenges previously discussed. For example, the guide describes ways in which the franchisor may control how franchise owners conduct business to ensure uniformity across franchise establishments. In addition, the guide states that franchisors may require franchise owners to buy supplies only from an approved supplier, even if similar goods can be purchased elsewhere at a lower cost. The guide also points out that franchisors may require franchise owners to discount certain prices, which may affect their profits.

However, participants in eight of the nine discussion groups we conducted with franchisees stated that they did not use the guide and were generally unaware of it.[26] Two attorneys made similar observations that prospective franchisees are generally unaware of the guide. Further, FTC has also not made the guide available in languages other than English. As previously mentioned, many prospective franchisees do not speak English as their first language.

FTC has taken some steps to publicize its franchise guide. The Franchise Rule requires franchisors to include language about the guide on the cover page of the FDD. In addition, our search of FTC's Business Blog posts issued between September 2020 and August 2022 identified one post (out of five posts related to franchising) that contained a link to the consumer guide. Further, SBA's and NASAA's franchising resource

[25]Federal Trade Commission, *A Consumer's Guide to Buying a Franchise* (Washington, D.C.: September 2020).

[26]Participants in the remaining discussion group did not comment on the guide because we did not cover the topic due to time constraints.

webpages include links to the guide, and FTC officials noted that some states link to the guide on their websites.

FTC has used its blogs as a way to educate franchisees. For example, in its February 2022 and August 2022 blog posts, FTC described key actions to take when considering a franchise purchase and provided information on avenues of recourse available to franchise owners if they believe their franchisor has engaged in illegal conduct.

Additional steps by FTC to educate prospective franchisees could improve their understanding of franchising's risks and benefits. In previous years, FTC educated consumers about franchising through English- and Spanish-language radio public service announcements. FTC also issued a publication in conjunction with the Maryland Attorney General's Office dedicated to educating prospective franchise owners interested in purchasing a janitorial services franchise.[27] The publication contained information on challenges prospective franchise owners may encounter after purchasing such a franchise and highlighted the importance of reading and understanding the FDD and the franchise agreement. However, FTC has not taken similar actions in recent years.

FTC's efforts to educate prospective franchisees may have been limited because the agency had not prioritized franchising among its other efforts in recent years. Most FTC law enforcement initiatives include a consumer or business education component aimed at preventing consumer injury and unlawful business practices and mitigating financial losses, according to FTC's strategic plan for fiscal years 2022–2026. However, as we discuss later in this report, FTC has had limited enforcement activity related to franchising in recent years. Thus, its focus on franchise-related consumer education may have been similarly limited.

FTC's strategic plan states that one of the agency's objectives is to connect with businesses and others to provide practical knowledge, guidance, and tools. Among the strategies to achieve this objective, FTC lists improving the efficacy of public-facing materials, improving education and engagement efforts, and engaging with and educating small businesses. The plan also lists engaging with and reaching out to historically underserved communities among its strategies for supporting equity for these communities. Specifically, FTC aims to provide these communities with practical, language-appropriate, and user-friendly

[27]Federal Trade Commission and the Maryland Attorney General's Office, *Buying a Janitorial Services Franchise* (September 2001).

educational resources and information to help them understand how FTC is protecting them.

While franchising offers potential benefits, franchise owners can face significant losses if they do not fully understand the risks of their investment. Our analysis suggesting that franchise owners may not be aware of FTC's guide or fully understand the FDD or franchise agreement highlights opportunities to better inform prospective franchise owners. By enhancing its efforts to educate prospective franchisees on the importance of reading and understanding the FDD and the franchise agreement and increasing the publicity of its consumer guide, FTC could help ensure prospective franchise owners make informed investment decisions.

FTC Uses Consumer Complaints to Inform Its Oversight, but Franchisees' Concerns May Be Underreported

FTC Oversees Franchising by Reviewing Complaints and Other Information

FTC identifies potential violations of the Franchise Rule and Section 5 of the FTC Act by reviewing complaints it receives through the Consumer Sentinel Network, collaborating with states, obtaining information from industry stakeholders and others, and surveying franchisor practices.

- **Reviewing complaints.** FTC officials said they can search complaints in the Consumer Sentinel Network database using keywords, company names, specific time frames, and geographic regions to identify trends and to gather more information on an issue or subject brought to their attention. FTC does not individually respond to each complaint submitted to the agency, and it does not take action on behalf of individuals who submit complaints. Instead, the agency uses the information in the complaints to open investigations into potential legal violations that may rise to the level of an enforcement action. In deciding to take action on a complaint, officials said they consider, among other things, the number of complaints received, the nature of the complaints, the amount of economic harm involved, the existence of parallel state or criminal investigations, and whether the complaint falls within the scope of FTC's strategic planning.

- **Collaborating with states.** FTC collaborates with state regulators and law enforcement officials through NASAA's Franchise Project Group and the National Association of Attorneys General to identify potential franchise-related violations of law. Through these forums, FTC learns about the types of franchise-related practices states are observing and investigating. FTC officials said they collaborate with NASAA through telephone calls, email exchanges, and annual meetings, during which they exchange information with state regulators on franchise matters and on potential targets for investigation. FTC officials said they collaborate with members of the National Association of Attorneys General on an as-needed basis. For example, they may reach out to state attorneys general if FTC is investigating a particular franchisor to see if the states have any relevant information to share.
- **Obtaining information from stakeholders.** FTC also receives information directly from industry participants who alert the agency about franchisor practices or their experiences participating in a franchise relationship. Officials said they receive inquiries from industry participants by email or phone and meet with industry groups regularly to understand their concerns. Beginning in July 2021, FTC also began holding monthly commission meetings that are open to the public. The meetings have been conducted virtually, and members of the public who cannot attend may submit written comments. Franchisees from various industries, including restaurants, hotels, and dental offices, have used these meetings to share information about franchising challenges. Some franchise-related topics raised during the 2022 meetings included fees assessed by franchisors and arrangements franchisors have made with vendors.
- **Surveying franchisor practices.** FTC officials said they review news sources and the internet for concerning industry trends. In addition, officials told us they sometimes receive requests from Congress to review practices of certain franchisors.

In 2019, FTC began a review of the Franchise Rule as part of its periodic review of all FTC rules to examine their costs and benefits and regulatory and economic impact. Information collected during these reviews helps FTC to determine whether rules warrant modifications or rescissions. As part of its review of the Franchise Rule, FTC requested public comments on the continuing need for the rule, its economic impact, and its effect on the unfair and deceptive practices it was designed to prevent, among other things. FTC also convened a workshop to solicit additional feedback on topics raised in the public comments it received, such as the format of the FDD (i.e., its structure, layout, and length) and financial performance representations. As of March 2023, FTC's review of the Franchise Rule was ongoing.

In addition, in March 2023 FTC issued a request for information on franchise agreements and franchisor business practices. Through this effort, FTC seeks to gather information from a variety of stakeholders on a number of different aspects of the franchise relationship, including some of the challenges franchisees raised during our discussion groups. Specifically, FTC is seeking information on franchisees' ability to negotiate the terms of the franchise agreement, the ability of franchisors to unilaterally make changes to the franchise system during the course of the franchise relationship, franchisor enforcement of nondisparagement or similar clauses, and payments franchisors receive from third-party vendors, among other things. According to FTC, this information will help inform its policy and enforcement efforts to protect franchisees. Comments can be submitted to FTC through May 9, 2023.

Franchise Enforcement Activities Have Been Limited since FTC Amended the Franchise Rule

From July 2008 (when compliance with the amended Franchise Rule became mandatory) through 2022, FTC opened 11 franchise-related investigations and took one enforcement action.[28] To determine whether to open an investigation, FTC officials told us they consider the magnitude and significance of the harm and the likelihood of preventing future unlawful conduct. FTC's one enforcement action was against fast-food chain Burgerim.[29] A lawsuit filed in February 2022 by the Department of Justice on behalf of FTC alleges that the company and its owner used deceptive practices, targeted veterans, and withheld information affecting over 1,500 franchise owners in violation of the Franchise Rule and Section 5 of the FTC Act. As of March 2023, the case was ongoing and

[28]We defined franchise-related investigations and enforcement actions as investigations or enforcement actions that involved alleged Franchise Rule violations or instances in which a franchisor was alleged to have engaged in an unfair or deceptive act or practice against a franchisee in violation of Section 5 of the FTC Act.

[29]*United States of America, Plaintiff v. Burgerim Group USA, Inc.; Burgerim Group, Inc.; and Oren Loni, individually and as an officer of Burgerim Group USA, Inc. and Burgerim Group, Inc*. https://www.ftc.gov/system/files/ftc_gov/pdf/2022.02.07_complaint_filed_002_0.pdf.

the complaint sought injunctive relief, consumer redress, and civil penalties.[30]

As of February 2023, FTC had closed five of the 11 franchise-related investigations it opened since July 2008 without taking an enforcement action. The remaining six investigations were still open and were nonpublic.[31] According to FTC, it closed the five investigations because they did not meet the agency's criteria for pursing an enforcement action. According to FTC, these criteria include consideration of whether the enforcement action will have a positive effect on the marketplace, the likelihood of meaningful remedies, and whether there are alternatives to FTC taking action.

FTC officials explained that the limited number of franchise-related investigations and enforcement actions can be attributed to two key factors. First, the agency has received a relatively low number of franchise-related complaints, so franchising has not been a priority of FTC's law enforcement efforts. We discuss reasons for the low volume of franchise-related complaints FTC receives in the next section.

Second, many franchise-related issues fall outside the scope of the Franchise Rule, according to officials. FTC officials explained that the Franchise Rule regulates presale disclosures given to prospective franchisees and is not designed to cover issues that occur between the franchisee and franchisor after the sale of the franchise. According to officials, many of the franchise-related concerns the agency hears about and the complaints it receives are about issues that arise after the

[30]According to the complaint, the company sold more than 1,500 Burgerim franchises, charging between $50,000 and $70,000 in franchise fees. However, a large majority of franchisees were never able to open restaurants. Further, the action alleges that the company promised that if franchisees were unable to open a restaurant they would be refunded their franchise fee, but many did not receive a refund. In the complaint, the Attorney General seeks injunctive relief (i.e., compelling Burgerim to cease the actions in violation of the Franchise Rule), consumer redress (i.e., returning money to and making whole harmed consumers), and civil penalties (i.e., penalties to be paid for violating the law).

[31]Because these six investigations were still open and nonpublic at the time we conducted our review, we were not able to review related documentation to determine if they met our definition of a franchise-related investigation.

franchise contract is executed.[32] While FTC could potentially use its authority under Section 5 of the FTC Act to address some of these issues, officials told us that initiating an enforcement action under Section 5 can be difficult because the issues brought to their attention often do not meet the statutory criteria for declaring an act or practice as unlawful.

In 2021, FTC elevated enforcement of the Franchise Rule and remedying other unfair, deceptive, or anticompetitive practices against franchisees to an agency priority. In a September 2021 memorandum outlining FTC's vision and priorities, the FTC Chair highlighted issues of concern related to the franchise business model and some contract terms.[33] The memorandum discussed the need for increased inquiry into business models that centralize control and profits and outsource risk, liability, and cost. It also noted that FTC would focus work on certain contract terms that may constitute unfair or deceptive practices, such as those in "take-it-or-leave-it" contracts. The memorandum notes that franchisees are at a significant disadvantage when they are unable to negotiate freely over terms and conditions.

The Director of FTC's Bureau of Consumer Protection noted that a number of factors spurred this prioritization of franchising. These include FTC's focus on issues affecting small businesses (for which the agency received many complaints during the early stages of the COVID-19 pandemic), the agency's interest in the aspects of the franchise business model that are susceptible to abuses, actions taken by other countries related to franchising, and concerns staff were hearing directly from franchisees and Congress.[34]

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[32]Our analysis of FTC's complaints revealed a similar pattern. We reviewed a random sample of 125 complaints out of the total number of complaints FTC categorized as franchise-related. Of those 125 complaints, we determined that 52 (42 percent) were related to franchising, and of those, many concerned issues that developed after a franchise was sold (e.g., disputes regarding franchise policies or fees franchisees were being charged by the franchisor).

[33]Lina M. Kahn, "Memorandum: Vision and Priorities for the FTC," (Federal Trade Commission, Sept. 22, 2021), accessed December 23, 2021, https://www.ftc.gov/legal-library/browse/cases-proceedings/public-statements/memo-chair-lina-m-khan-commission-staff-commissioners-regarding-vision-priorities-ftc.

[34]For example, in 2019, the Australia Parliamentary Joint Committee on Corporations and Financial Services issued a report revealing a range of problems in the franchising sector and a need for regulatory reform. Parliamentary Joint Committee on Corporations and Financial Services, *Fairness in Franchising* (March 2019).

FTC Uses Complaints to Target Enforcement Efforts, but Complaints May Not Reflect the Full Extent of Franchising Concerns

As described previously, FTC's consumer protection responsibilities span a wide range of sectors of the economy, and the agency has enforcement or other responsibilities for more than 70 laws. As a result, FTC targets its law enforcement efforts to the issues it determines are causing the greatest harm to consumers. One way it does this is by evaluating the volume of consumer complaints it receives through the Consumer Sentinel Network on different topics. Between 2018 through 2022, FTC received a total of approximately 20 million complaints on a wide variety of topics. Our analysis of franchise-related complaints found that during that period, FTC received approximately 5,900 complaints—representing less than 1 percent of all complaints the agency received during this period.[35] For purposes of comparison, in 2017, there were approximately 500,000 franchises operating in the United States.

However, the number of complaints may not fully reflect the extent of problems experienced by franchisees. Our discussion groups with franchisees and interviews with other stakeholders identified various concerns owners had about their franchisors. However, as described in more detail below, franchise owners in eight of nine discussion groups also said they had never filed a complaint with FTC. Further, states have identified a number of problems with franchisor practices as evidenced by the number of enforcement actions taken. Our review of five states identified 196 enforcement actions taken pursuant to state law against franchisors from 2019 through 2021. These included 59 enforcement actions alleging the failure to provide an FDD to prospective franchisees and 72 enforcement actions alleging that the FDDs contained untrue material facts or omitted material facts.[36] Given the number of enforcement actions taken at the state level, it is possible that additional problems exist that are not being reported to FTC. In addition, FTC's decision to prioritize franchising was based on information the agency was hearing directly from franchise owners and observing elsewhere.

[35]FTC combines complaints about franchises and distributorships into one category in the Consumer Sentinel Network. A franchise is a promotion, requiring at least $500, to sell trademarked goods and services with significant assistance or control of the franchisor (promoter). A distributorship is an opportunity to sell a product for a profit but without the franchisor business model. The complaint data we reviewed included both franchise and distributorship complaints. As a result, the total number of complaints reported here may overstate the number of franchise-related complaints. The Consumer Sentinel Network contains data from the previous 5 years; data older than 5 years are purged from the database.

[36]One state had eight enforcement actions that were not public, so we were unable to determine the type of violations associated with those enforcement actions.

Collectively, these factors point to potentially broader concerns in franchising than are reflected in complaint data.

Attorneys, representatives of trade associations, state regulatory officials, and FTC officials with whom we spoke cited several reasons why franchisees with concerns often may not file complaints with FTC.

- **Lack of awareness.** Franchisees may not be aware of their ability to submit complaints to FTC. Two attorneys, one trade association, and participants in eight of our nine discussion groups told us that many franchisees do not know that they can submit complaints to FTC.[37] Participants in eight of our discussion groups also said they had never filed a complaint because they were not aware they could do so.
- **Fear of retaliation.** Franchisees may fear retaliation from their franchisor if they submit a complaint to a law enforcement agency. This fear may exist, in part, because some franchise agreements have nondisclosure or nondisparagement clauses, which franchisees may view as prohibiting them from complaining about the franchisor.[38] Participants in five of our nine discussion groups said they feared their franchisors might take adverse actions against them if they spoke up about concerns about their franchisor's actions. Participants feared adverse actions such as being removed from the brand or sued for violating their agreement's nondisparagement clause. In addition, some public comments submitted by attorneys and franchisees during FTC's Franchise Rule review state that such fears lead franchisees to file fewer complaints. The request for information FTC issued in March 2023 seeks comment on this issue.
- **Belief that a complaint is not effective or could be used against them.** Two attorneys and officials from one state regulator told us franchisees' attorneys may advise their clients against filing a complaint with FTC because FTC is unlikely to take action in response. They said if a complaint is filed by a franchise owner, FTC's lack of action on it could be used by a franchisor in a dispute resolution forum to argue that its actions did not violate applicable law. However, FTC officials pointed out that although the agency does release complaints in response to Freedom of Information Act requests, only the city and state of the complainant are released; all

[37]Participants in the remaining discussion group did not comment on franchisees' awareness of their ability to submit complaints to FTC because we did not cover the topic due to time constraints.

[38]Some franchise agreements may contain clauses stating, for example, that a franchisee may not make any statements or communications that could adversely affect the reputation and goodwill of the franchisor.

other personally identifying information is redacted. Accordingly, a franchisee's complaint is unlikely to harm their case, according to the officials.

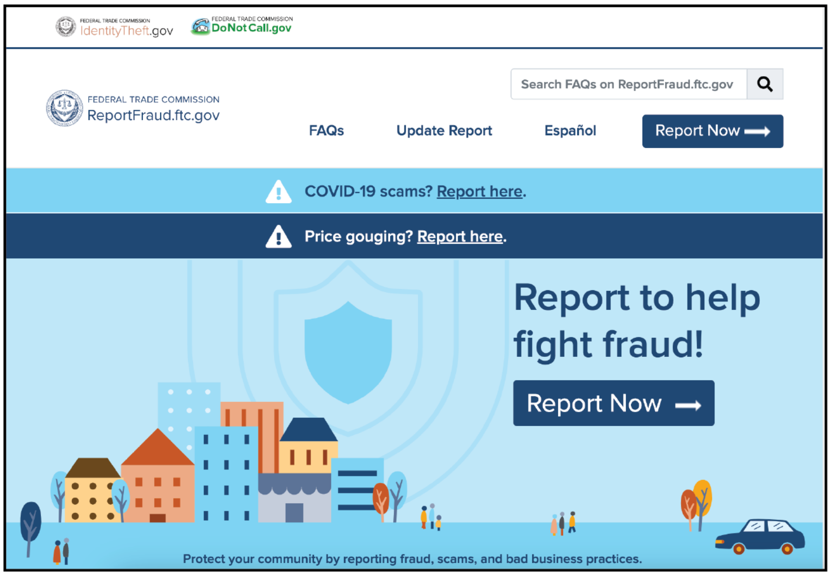
- **Website name.** The FTC website through which franchisees can file a complaint is ReportFraud.ftc.gov, and it may not be clear to franchisees that the website applies to them. Franchise owners may not view the issues they are experiencing with their franchisors as fraud-related and may therefore not recognize the website as the correct avenue to file a complaint. State regulatory officials, representatives from a trade association, and an FTC official told us that franchisees with whom they have spoken noted that it is not always clear to them that the ReportFraud.ftc.gov website is a place where they can file complaints.[39]

FTC has taken some steps to make it easier for franchisees to submit complaints. In September 2021, FTC modified its ReportFraud.ftc.gov website in response to stakeholders who expressed confusion regarding how to submit a franchise-related complaint to FTC. FTC conducted a usability study with a limited group of franchisees to determine what changes could be made to the website to ensure franchise owners knew it was where they should submit complaints and understood how to do so. The study resulted in FTC adding the word "franchise" to the website's menu options to help identify the correct pathway for franchise owners to submit complaints (see fig. 2).

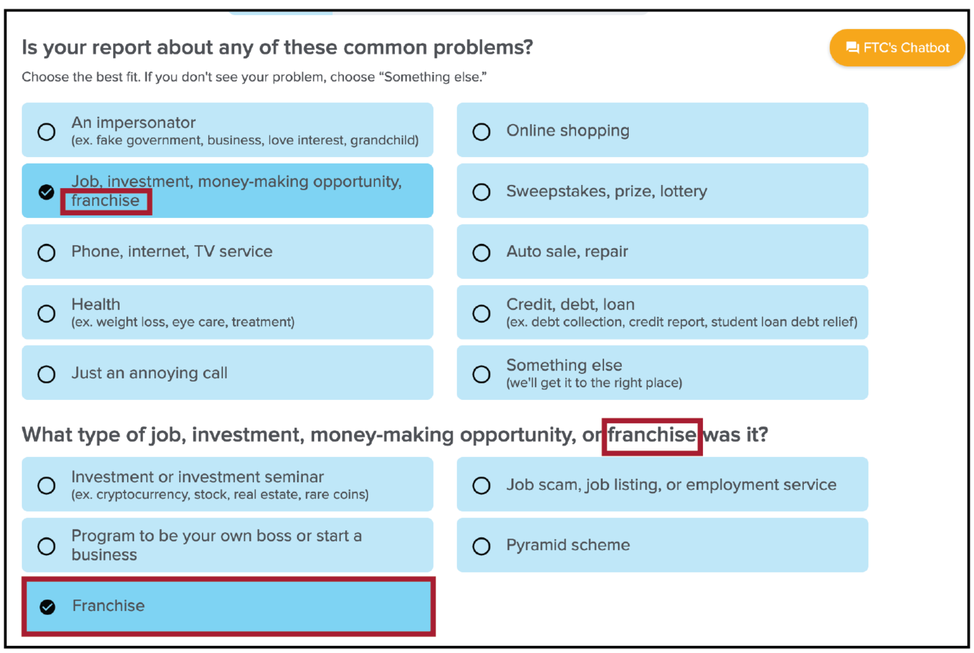
[39]FTC officials noted that the reasons we cite for why franchisees with concerns may not file complaints with FTC are not specific to franchising and may also apply to all types of consumer complaints. For example, see Federal Trade Commission, *Combating Fraud in African American & Latino Communities, The FTC's Comprehensive Strategic Plan: A Report to Congress* (Washington, D.C.: June 15, 2016).

Figure 2: Modifications Made in 2021 to ReportFraud.ftc.gov for Franchise-Related Complaints

Step 1:
Franchisees go to ReportFraud.ftc.gov.



Step 2:
Franchisees select franchise-related pathway to submit complaint.



Options added to the website in September 2021

Source: Screenshots from ReportFraud.ftc.gov. | GAO-23-105338

Prior to the September 2021 update, ReportFraud.ftc.gov did not have an easily identifiable way for franchisees to submit complaints. The word “franchise” did not appear on the website’s menu as a common problem a complainant could choose. Instead, franchisees had to choose the category to report a complaint about “something else” and respond to a series of questions asking them to identify the type of fraud they were reporting. FTC officials said that the purpose of the update was to simplify the process for franchisees to submit complaints to FTC and that they hoped it would result in more complaints.

FTC has also conducted some outreach to the franchise community to encourage more franchise owners to report complaints to the agency. For example, it announced the modification to ReportFraud.ftc.gov in its February 8, 2022, press release on its enforcement action against fast-food chain *Burgerim*. FTC also included discussion about the modification in a February 9, 2022, social media post about the same enforcement action. Two FTC blog posts (one in February 2022 and one in August 2022) also contained links to the ReportFraud.ftc.gov website encouraging franchisees to report questionable franchisor business practices. Further, in a June 2022 social media post, the FTC Chair shared a link to and encouraged the use of the ReportFraud.ftc.gov website.

After the September 2021 website modification, the number of franchise-related complaints FTC received increased nearly fivefold.[40] However, the number of franchise-related complaints remains low relative to all complaints received by the agency. While these modifications and FTC’s recent outreach efforts have had some success, further and more targeted outreach might reach additional franchisees, such as those who do not read FTC’s press releases or blogs. For example, FTC might reach additional audiences by using existing forums, such as franchisee organizations (which must be disclosed in FDDs), and through stakeholders such as state regulators and SBA. FTC officials told us they coordinate with SBA on an as-needed basis.

Further, FTC’s outreach materials and the changes to ReportFraud.ftc.gov do not fully address the reasons franchise-related concerns may be underreported to FTC. For example, these efforts do not address franchisees’ fear of retaliation or the belief by some franchisees and their attorneys that complaints do not make a difference.

[40]Specifically, FTC received a monthly average of 46 franchise-related complaints in the 15 months prior to September 2021 and a monthly average of 227 such complaints in the 15 months after September 2021.

To help address these issues, FTC's education and outreach could emphasize that franchisees can submit complaints anonymously and explain the importance of complaints in FTC's oversight and enforcement.

FTC's strategic plan states that FTC must identify and understand consumer protection issues affecting the public if it is to target its law enforcement toward areas of greatest public harm and fulfill its goal of protecting the public. Complaints are one of FTC's primary mechanisms for determining the areas of greatest concern within the scope of its oversight responsibilities. Further, the strategic plan sets goals of improving the efficacy of public-facing materials and improving education and engagement efforts.

Without additional actions by FTC to increase outreach and education to the franchise community and to work with stakeholders to improve awareness and understanding of the complaint process, franchisees may continue their apparent underreporting of concerns to FTC. As a result, FTC may not have an accurate representation of those concerns to inform how it targets its limited law enforcement and education resources. A more complete picture of franchisee concerns in FTC's Consumer Sentinel Network would also benefit state enforcement agencies that use this resource to help determine their own investigations and enforcement actions.

Conclusions

Franchising can offer benefits to individuals interested in owning their own business but is also a major financial investment that can come with significant risks. FTC seeks to ensure that prospective franchisees can make informed decisions through its consumer guide and its requirements that franchisors make disclosures in the FDD. However, we found that many prospective franchisees may not be aware of FTC's consumer guide and may not read or understand the FDD or the franchise agreement. By enhancing its efforts to educate prospective franchisees on the importance of the FDD and the franchise agreement and more broadly publicizing its consumer guide, FTC could help improve prospective franchisees' understanding of the risks of franchising.

FTC uses consumer complaints as a key indicator of potential consumer harm, but the number of complaints by franchisees may not fully reflect the extent of their concerns. Franchisees may avoid filing complaints because they are unaware of how to do so, fear retaliation from franchisors, or believe the complaint will have no effect. FTC's recent effort to facilitate complaint reporting by franchisees is a useful first step but may not fully address the underlying reasons for low reporting. By increasing outreach and education to the franchise community and working with stakeholders to improve awareness and understanding of the complaint process, FTC could ensure a more accurate representation of issues affecting franchisees. This information could, in turn, help FTC to better assess consumer harm and determine where to target its enforcement efforts.

Recommendations for Executive Action

We are making the following three recommendations to FTC:

The Director of FTC's Bureau of Consumer Protection should enhance FTC's efforts to educate prospective franchisees on the importance of reviewing and understanding the franchise disclosure document and the franchise agreement. (Recommendation 1)

The Director of FTC's Bureau of Consumer Protection should increase efforts to publicize FTC's consumer guide among prospective franchisees. (Recommendation 2)

The Director of FTC's Bureau of Consumer Protection should take steps to improve franchisees' awareness and understanding of FTC's complaint process. These steps could include expanding FTC's franchisee outreach and education efforts in this area and working with a variety of stakeholders to encourage reporting of complaints. (Recommendation 3)

Agency Comments

We provided a draft of this report to FTC and SBA for review and comment. FTC provided written comments, which are reproduced in appendix II. In its written comments, FTC stated that it agreed with our recommendations and that it continues to focus on and identify opportunities to increase outreach to current and prospective franchisees. FTC pointed out that some of the issues we identified in our report—including franchisees' concerns regarding filing complaints and whether they know about and review guidance materials—are not unique to franchising. However, FTC noted that it continues to evaluate how it can better address these issues and that deepening its engagement with the franchise community will continue to be a priority for the agency. FTC and SBA also provided technical comments, which we incorporated as appropriate.

We are sending copies of this report to the appropriate congressional committees, the Chair of FTC, the Administrator of SBA, and other interested parties. In addition, the report will be available at no charge on the GAO website at https://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

Sincerely yours,

Alicia Puente Cackley
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to examine (1) challenges franchisees reported facing in operating franchises and the Federal Trade Commission's (FTC) efforts to educate prospective franchisees and (2) how FTC oversees franchising and enforces the Franchise Rule and Section 5 of the Federal Trade Commission Act (FTC Act).[1]

To address both objectives, we reviewed relevant laws and regulations, including Section 5 of the FTC Act and FTC's Franchise Rule. We interviewed officials from FTC's Division of Marketing Practices (within the Bureau of Consumer Protection) and Division of Consumer Response & Operations. We also interviewed officials from the Small Business Administration to understand how it interacts with prospective franchisees and how it collaborates with FTC on franchise-related efforts.

Challenges Franchisees Face in Operating Franchises and FTC's Education Efforts

To address our first objective, we reviewed various FTC documentation and resources, including its *Franchise Rule Compliance Guide, Consumer's Guide to Buying a Franchise, Strategic Plan for Fiscal Years 2022–2026*, blogs, and press releases. We analyzed the Franchise Rule to determine the extent to which it requires franchisors to disclose information in their franchise disclosure document (FDD) related to various risks and challenges franchisees may face. We reviewed documentation associated with FTC's review of the Franchise Rule, including public comments and a public workshop transcript. We also drew on economic literature that describes principal-agent theory as it relates to the franchise business model, along with more recent literature on franchising. This literature summarizes some common hypotheses about the contexts in which franchising might be an advantageous business model, while also having some risks.[2] Finally, we assessed

[1]We reviewed FTC's efforts to enforce the Franchise Rule and Section 5 of the FTC Act as it relates to unfair acts or practices franchisors may engage in with prospective or current franchisees. We did not evaluate the effectiveness of the Franchise Rule or the extent to which various challenges described to us by franchisees or others constituted violations of the Franchise Rule, Section 5 of the FTC Act, or state law. FTC amended the Franchise Rule in 2007, and mandatory compliance with the amended rule took effect in 2008.

[2]For agency theory literature see, for example, F. Lafontaine and M.E. Slade, "Incentive Contracting and the Franchise Decision," in *Game Theory and Business Applications*, eds. K. Chatterjee and W.F. Samuelson (Boston: Springer, 2002); David E.M. Sappington, "Incentives in Principal-Agent Relationships," *Journal of Economic Perspectives*, vol. 5, no. 2 (1991): 45–66; and K-A Sun and S. Lee, "Competitive Advantages of Franchising Firms and the Moderating Role of Organizational Characteristics: Evidence from the Restaurant Industry," *International Journal of Hospitality Management*, vol. 77 (2019): 281–289.

FTC's efforts to educate prospective franchises against relevant objectives in its strategic plan.

To understand the types of challenges franchisees face in operating franchises, we conducted discussion groups with franchise owners and interviewed other franchising stakeholders, such as franchisors, state regulatory officials, attorneys, and trade associations. The information gathered during our discussion groups and interviews is not generalizable to all franchisees' experiences.

Franchisee discussion groups. We conducted nine discussion groups with franchisees who are members of franchisee associations. A total of 44 franchisees participated in our discussion groups, and their experience as franchisees ranged from 16 months to over 40 years. Seven of the discussion groups included members of franchisee associations for specific industries and brands.[3] Using data from the Census Bureau's 2017 Economic Census and 2020 Annual Business Survey, we selected three industry types for our discussion groups: limited-service restaurants, hotels and motels, and beauty salons. We selected these industries to obtain variation in the number of franchise establishments in the industry, the proportion of establishments in the industry that are franchises, the number of franchise employees in the industry, and the proportion of minority-owned franchises.

To assess the reliability of data in the 2017 Economic Census and 2020 Annual Business Survey, we reviewed publicly available documentation, interviewed knowledgeable agency officials, and conducted electronic testing of the data for missing data, outliers, or any obvious errors. We concluded that the data were sufficiently reliable for the purpose of selecting industries for our franchisee discussion groups.

Within each industry, we selected franchisee associations to obtain variation in the number of establishments within franchise brands.[4] Because there are many franchise brands in the limited-service restaurant industry, we further refined our criteria to also obtain variation in ownership type (public or private). We selected three franchisee associations in the limited-service restaurant industry, two franchisee associations in the hotel and motel industry, and two franchisee

[3]Franchisee associations are membership organizations of franchise business owners who may share resources among their members and advocate on behalf of franchisees.

[4]One hotel and motel franchisee association was not affiliated with a specific franchise brand. The association represented franchise owners from a variety of hotel and motel brands.

associations in the beauty salon industry. We held the additional discussion group with a limited-service restaurant brand because the limited-service restaurant industry contains significantly more franchise establishments than the other two industries. For each of the seven selected franchisee associations, we invited members of the association's board leadership or franchisee advisory councils to participate in the discussion group.[5] These board members and advisory council members were also franchisees. We conducted one discussion group with each association.

We also conducted two discussion groups with franchisees during the American Association of Franchisees and Dealers 2022 Franchisee Leadership Summit. These discussion groups consisted of franchisees from a variety of industries. In advance of the summit, we provided information on our study that the association included in email communications with all of its members. These email communications also invited all summit participants to participate in our discussion groups. Participation was on a first-come, first-served basis, and we were able to accommodate all interested participants. Employees of the American Association of Franchisees and Dealers or other franchising consultants did not attend the discussion groups.

The discussion topics of our nine discussion groups included the franchise buying process and experience with FDDs, the benefits and challenges of franchisees' relationships with their franchisors, and franchisees' awareness and use of FTC's educational resources and complaint process. The discussion groups were moderated by GAO analysts who sought to encourage broad participation among participants. The number of participants in our discussion groups ranged from two to 14. We analyzed the information collected during the discussion groups to identify challenges franchisees reported facing. For additional context on these discussions, we reviewed the FDDs for the franchisors of the selected franchisee associations that represented specific brands. The information gathered during our discussion groups is not generalizable to all franchisees' experiences.

Franchisors. We interviewed representatives of six franchisors. We selected franchisors within the same three industries selected for our franchisee discussion groups. To preserve franchisees' confidentiality with respect to their franchisors, we selected different brands for our

[5] A franchise advisory council is a committee of franchisees who work with the franchisor (and other franchisees) to help improve the system and solve common issues and concerns.

franchisor interviews than for our discussion groups with franchisee associations that represented specific brands. Within the limited-service restaurant industry, we selected three franchisors to obtain variation in the number of franchise establishments and ownership type (public or private). Within the hotel and motel industry, we selected two franchisor brands that are owned by parent companies with portfolios consisting of various hotel types (e.g., economy, midscale, luxury).[6] Within the beauty salon industry, we selected two franchisors to obtain variation in the number of franchise establishments.[7]

State regulatory officials. We interviewed regulatory officials from six states that have franchise laws. We considered the type of franchise laws enacted in the state and testimonial evidence from stakeholders we interviewed on the level of franchisee protection provided by the states' laws. The six states we selected were California, Maryland, New York, Oregon, Washington, and Wisconsin. We also interviewed state officials that serve on the North American Securities Administrators Association's Franchise Project Group.

Attorneys. We interviewed nine attorneys who specialize in franchise law: five that primarily represent franchisees and four that primarily represent franchisors. To identify attorneys, we reviewed Franchise Rule public comments, solicited referrals from franchise stakeholders, and reviewed resources from the American Bar Association Forum on Franchising. We then selected attorneys based on their participation in legal forums on franchise law; their level of involvement with FTC's Franchise Rule review, as measured by the number of comments they submitted to FTC; their participation in FTC's 2020 Franchise Rule Workshop; and referrals by other attorneys or stakeholders we interviewed.

Franchise trade associations. We interviewed representatives of the following trade associations that represent franchisors, franchisees, or both: the American Association of Franchisees and Dealers, Coalition of Franchisee Associations, and International Franchise Association.

[6]We reviewed data compiled by STR—a data benchmarking and analytics company for the global hospitality industry—to determine which hotel types different franchise brands owned.

[7]We made several attempts to schedule a meeting with one of the selected beauty salon franchisors, but were unable to gain their cooperation. Given the small size of the beauty salon industry, we determined that one franchisor was sufficient.

FTC's Oversight of Franchising and Enforcement of the Franchise Rule and Section 5 of the FTC Act

To address our second objective, we gathered and analyzed documentation on FTC's regulatory and enforcement practices and consumer complaint process. These documents included FTC policy statements, agency memorandums, press releases, congressional testimonies, and open meeting transcripts, as well as FTC's strategic plan, 2023 annual performance plan, and annual performance reports for fiscal years 2020–2022. We also reviewed publicly available documentation on FTC's current review of the Franchise Rule, including public comments FTC received.

To understand how FTC collects and analyzes consumer complaints, we obtained and analyzed complaint data from FTC's Consumer Sentinel Network. We analyzed all complaints FTC categorized as Franchise & Distributorships from 2018 through 2022 to identify the total number of franchise-related complaints in the database.[8] Because FTC combines franchise and distributorship complaints into one category, the total number of franchise-related complaints we report may be overstated. We also reviewed the complaint narratives for a random sample of 125 Franchise & Distributorships complaints from 2017 through 2022. We reviewed and summarized information on (1) the type of complainant (e.g., franchisee, franchisee employee, or franchise customer); (2) the industry of the franchise; (3) the subject of the complaint; and (4) the alleged problem or legal violation.

To assess the reliability of the complaint data, we reviewed FTC documentation, and interviewed knowledgeable agency officials. We concluded that the data were sufficiently reliable for the purpose of reporting the total number of franchise-related complaints FTC received and characteristics of the complaints.

Further, we reviewed documentation on FTC's processes for collecting and analyzing franchise-related complaints, including the Consumer Sentinel Network Annual Databooks and field descriptions, and the ReportFraud.ftc.gov website. We also interviewed officials from FTC's Division of Consumer Response & Operations to understand how FTC collects and processes the franchise-related complaints it receives through its toll-free helpline. We compared FTC's approach for collecting

[8]This subcategory is defined as complaints about franchises and distributorships. A franchise is a promotion, requiring at least $500, to sell trademarked goods and services with significant assistance or control of the franchisor (promoter). A distributorship is an opportunity to sell a product for a profit but without the franchisor business model. The Consumer Sentinel Network contains data from the previous 5 years; data older than 5 years are purged from the database.

and analyzing franchise-related complaints against relevant objectives in its strategic plan.

To determine the extent to which FTC took franchise-related investigations or enforcement actions from July 2008 through 2022, we reviewed documentation on closed investigations and enforcement actions, including matter initiation notices, matter update notices, civil investigative demands, email communications, and complaints. We chose July 2008 as the starting point for our review of FTC's investigations and enforcement actions because that is when individuals impacted by the amended Franchise Rule were required to comply with the amended rule.[9] We defined investigations or enforcement actions as franchise-related if they involved alleged Franchise Rule violations or instances in which a franchisor was alleged to have engaged in an unfair act or practice against a franchisee in violation of Section 5 of the FTC Act. For the investigations and enforcement actions that met our definition of franchise-related, we reviewed available information on (1) the date the investigation was opened, (2) the potential problem or violation being investigated, (3) the reason for closing the investigation, and (4) whether the investigation resulted in an enforcement action.

To provide context for assessing FTC's enforcement activities, we reviewed franchise-related enforcement actions identified by state officials from 2019 through 2021 from the six selected states identified above. One of the states did not take any enforcement actions during that time. We used a data collection instrument to collect information on each enforcement action, including (1) the franchisor's industry, (2) the type of violation, and (3) the type of enforcement action taken by the state.[10] We also interviewed officials from the six states about how they enforce their franchise-related laws and how they coordinate with FTC on franchise-related efforts.

Finally, we interviewed the franchise attorneys and representatives from franchise trade associations discussed previously, and we collected information from our franchisee discussion groups on FTC's franchise-related enforcement efforts and complaint process.

We conducted this performance audit from July 2021 to April 2023 in accordance with generally accepted government auditing standards.

[9]Based on the timing of our review, investigations or enforcement actions could have been predicated on the prior version of the Franchise Rule or the current version of the rule.

[10]One state had eight enforcement actions were not public, so we were unable to determine the type of violations associated with those enforcement actions.

Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Comments from the Federal Trade Commission

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

Office of the Director
Bureau of Consumer Protection

April 5, 2023

Sent Via Email
Christine McGinty
Assistant Director
Financial Markets and Community Investment
Government Accountability Office
(617) 788-0564
McGintyC@gao.gov

Re: GAO Engagement No. 105338

Dear Ms. McGinty:

We appreciate the opportunity to engage with GAO on your draft report titled *Federal Trade Commission: Actions Needed to Improve Education Efforts and Awareness of Complaint Process for Franchise Owners* (GAO-23-105338). In addition to the comments provided to GAO on March 31, 2023, we would like to specifically respond to the agency recommendations.

In the draft report, GAO made recommendations on FTC actions needed to improve outreach to, and engagement with, the franchise community. Specifically, "GAO recommends that FTC take steps to (1) enhance its consumer education efforts for prospective franchise owners, (2) increase publicity of its guide for franchise owners, and (3) improve franchise owners' awareness and understanding of FTC's complaints process."

The FTC appreciates and agrees with GAO's recommendations around increasing outreach to prospective and current franchisees. The FTC continues to focus on and identify opportunities to do so. Unfortunately, some of the issues raised in the report (for example, consumers' concerns regarding filing complaints and whether consumers know about and review the guidance materials) are not unique to franchising. As we noted before, we observe many areas where consumers vastly underreport concerns, and this is true across the board even in areas where we do receive significant numbers of reports.[1] Nevertheless, the FTC continues to evaluate how we can better address these issues. Specifically, with respect to franchising, as you note in the report, we are taking a number of steps to increase engagement with franchisees. Among other things, we have made it easier for consumers to file complaints with us – and,

[1] *See* Fed'l Trade Comm'n, *Combating Fraud in African American and Latino Communities, the FTC's Comprehensive Strategic Plan: A Report to Congress* (June 15, 2016), available at https://www.ftc.gov/system/files/documents/reports/combating-fraud-african-american-latino-communities-ftcs-comprehensive-strategic-plan-federal-trade/160615fraudreport.pdf.

although the complaint numbers remain low, they have increased significantly since making these changes. In addition, we continue to meet with franchisee advocates, trade associations, and other stakeholders to learn about current issues in the industry and broadly disseminate our educational materials.

Deepening our engagement with the franchise community will continue to be a priority for our agency.

Sincerely,

Samuel Levine/AR

Samuel Levine
Director, Bureau of Consumer Protection

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

Alicia Puente Cackley, (202) 512-8678 or cackleya@gao.gov

Staff Acknowledgments

In addition to the contact named above, Christine McGinty (Assistant Director), Aku Pappoe (Analyst in Charge), Rachel Batkins, Abigail Brown, Lauren C. Capitini, Joseph P. Cruz, Sharon E. Jan, Sylvia A. Kramer, Jill Lacey, Charlene J. Lindsay, John McGrail, Marc Molino, Jennifer Schwartz, and Elizabeth A. Scott made key contributions to this report.

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