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The FTC Intervenes in Franchise Relationships

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The U.S. Federal Trade Commission's (FTC) latest policy statement aims to dictate the outcome of contract negotiations between franchisors and their franchisees and to limit the potential negative impact on franchisees of certain types of contract provisions. Last week's "Policy Statement of the Federal Trade Commission on Franchisors' Use of Contract Provisions, Including Non-Disparagement, Goodwill, and Confidentiality Clauses" (policy statement) was issued along with an "Issue Spotlight" prepared by FTC staff, "Staff Guidance on the Unlawfulness of Undisclosed Fees Imposed on Franchisees" (staff guidance), and the launch of a webpage with FTC resources regarding its regulation and guidance for franchisors and franchisees.

Since 1979, the FTC has regulated franchising through the original Franchise Rule (16 C.F.R. Part 436), which requires the disclosure of specific information so that prospective franchisees can make informed investment decisions. This latest regulatory effort, however, was launched in March 2023, when the FTC issued a request for information seeking public comment on "franchise agreements and franchisor business practices, including how franchisors may exert control over franchisees and their workers." The FTC's press release announcing the request for information claimed that "the promise of franchise agreements as engines of economic mobility and gainful employment is not being fully realized, and the unequal bargaining power inherent in these contracts is impacting franchisees, workers, and consumers."

The FTC received 2,216 responsive comments, only 10% of which were from self-identified franchisors, attorneys, suppliers, or industry groups, while more than 50% were from franchisees. According to FTC staff, almost 75% of franchisors supported the status quo, compared with roughly 40% of franchisees. Based on these comments, the FTC's Issue Spotlight summarizes the top 12 concerns raised by franchisees:

1. Unilateral changes to franchise operating manuals;

2. Franchisor misrepresentations and deception;

3. Fees and royalties;

4. Franchise supply restrictions and vendor kickbacks;

5. Actual and feared retaliation;

6. Noncompetes and no-poach clauses;

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7. Franchise renewal problems;

8. Franchisor refusal to negotiate contract terms;

9. Franchise disclosure document issues;

10. Private equity takeovers;

11. Marketing fund transparency; and

12. Liquidated damages clauses and early termination fees.

Rather than amend its existing Franchise Rule or promulgate new rules, the FTC issued the policy statement. The FTC explained that a "practice is unfair if it causes or is likely to cause substantial consumer injury, which consumers cannot reasonably avoid, and which is not outweighed by benefits to consumers or competition." The policy statement asserts that a franchisor's use of standard confidentiality, nondisparagement, or goodwill provisions is "unfair" because they could be misinterpreted as prohibiting the reporting of illegal conduct to the government. The policy statement makes these pronouncements even though federal courts have generally treated contracts as unenforceable to the extent they forbid cooperation with law-enforcement investigations.

The policy statement vote was 3-2 along party lines, with both Republican commissioners dissenting. Both dissents were critical of the policy statement because it seeks to change or overstate Section 5's reach. Commissioner Melissa Holyoak explained her dissent and view on the FTC's role:

Certainty and clarity about the state of the law is a critical incentive to investment in and formation of new business. Today's Policy Statement neither provides useful guidance, nor does it increase certainty about the state of the law. Rather, it casts a pall over the use of non-disclosure, non-disparagement, confidentiality, and goodwill clauses in franchisor-franchisee contracts, in a manner that is unlikely to help franchisors comply with the law while potentially impeding franchisors' ability to protect their brands and intellectual property.

Commissioner Andrew Ferguson also criticized the policy statement as "go[ing] too far" and "an attempt to announce de facto rules . . . bypassing the procedural safeguards that govern [the agency's] rulemakings and denying regulated parties the benefit of ex ante judicial review."

The staff guidance states that it is illegal for franchisors to impose fees that were not disclosed to franchisees at the time of their decision to invest. A number of commentors complained of franchisors increasing fees for technology and payment processing and failing to disclose training, marketing, and facility improvement fees. The agency described such fees as "junk fees." The International Franchise Association, however, responded that the "FTC's guidance . . . regarding fee disclosure in franchise agreements stands to unnecessarily restrict franchisors' ability to innovate and evolve their system, damaging the equity of franchisees for whom the FTC actions are purposely taken."

The FTC reopened the comment period until October 10 as part of its interest in engagement with franchisees.

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