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Fees, Glorious Fees: What Do FTC and State Regulator Guidance Really Mean and What Is the Potential Impact for Franchise Systems?

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Fees, Glorious Fees: What Do FTC and State Regulator Guidance Really Mean and What Is the Potential Impact for Franchise Systems?[1]

On July 12, 2024, the Federal Trade Commission issued three guidance documents that were the seed for this IFA Legal Symposium panel. The three documents were:

- Policy Statement of the Federal Trade Commission on Franchisors' Use of Contract Provisions, Including Non-Disparagement, Goodwill, and Confidentiality Clauses (the "Franchise Policy Statement")

- Staff Guidance on the Unlawfulness of Undisclosed Fees Imposed on Franchisees (the "Staff Guidance")

- Issue Spotlight: Risks to Small Business Success in Franchising (the "Issue Spotlight")

On the same date, the FTC also re-opened the comment period for its March 10, 2023 Request for Information ("RFI") seeking public input on the franchising industry. The FTC also pointed the public to its newly-launched "FTC franchise website" at www.ftc.gov/news-events/features/franchise-guidance.

In this paper, we focus in particular on the issue raised in the Staff Guidance – new and changed fees charged in franchise systems. This issue, of course, is not the only one highlighted in the July 12, 2024 actions, and our focus on fees is not meant to diminish other issues. In this paper, we also examine parallel activity on fees by state franchise regulators and in litigation by private parties.

I. The Recent FTC Activity on Franchising

At the outset, it is important to understand the legal standing of each of the July 12, 2024 actions by the FTC.

A. Franchise Policy Statement[2]

A Policy Statement is a statement issued by the Commission itself – i.e., the five Presidentially-appointed, Senate-confirmed members of the agency's governing board. Critically, *a Policy Statement does not have the force of law*. It is only an expression of the Commission's point of view about a particular topic. Every Policy Statement is issued with the following disclaimer:

[1] This paper represents the collective work of David Koch and Nicole Micklich (Mr. Cantone did not participate in the writing of the paper). Any views expressed in the paper do not necessarily represent the individual views of all authors and presenters.
[2] Policy Statement of the Federal Trade Commission on Franchisors' Use of Contract Provisions, Including Non-Disparagement, Goodwill, and Confidentiality Clauses, https://www.ftc.gov/legal-library/browse/policy-statement-of-the-ftc-on-franchisors-use-of-contract-provisions (accessed April 9, 2025).

This Policy Statement does not confer any rights on any person and does not operate to bind the FTC or the public. In any enforcement action, the Commission must prove the challenged act or practice violates one or more existing statutory or regulatory requirements. In addition, this Policy Statement does not preempt federal, state, or local laws. Compliance with those laws, however, will not necessarily preclude Commission law enforcement action under the FTC Act or other statutes.

In other words, a Policy Statement is not an enforceable rule, like the Franchise Rule. They are essentially Industry Guides -- that is, "administrative interpretations of laws administered by the Commission for the guidance of the public in conducting its affairs in conformity with legal requirements," as provided in Rule 1.5 of the Commission's Rules of Practice.[3] The FTC cannot charge a private party with a violation of law solely on the basis that the party's conduct was contrary to the views expressed in a Policy Statement. If the FTC did so, its enforcement action would be subject to challenge, because the agency would in effect be treating the Policy Statement as a promulgated rule – without having taken the steps legally required for the issuance of a rule.

The FTC could, of course, allege that conduct contrary to the views expressed in the Policy Statement was also contrary to a law or trade regulation rule that does have the force of law. For example, the FTC could allege that the conduct violated an express requirement of the Franchise Rule or that it otherwise constituted an unfair or deceptive act or practice under Section 5 of the FTC Act. In that case, however – as noted in the Policy Statement disclaimer – the agency must prove its case as in any other enforcement action.

The bottom line is that the Franchise Policy Statement should be viewed as simply a warning. Basically, it says to the public, "Here are some things that the Commission thinks may be contrary to a law or rule that we enforce. We haven't proved it yet, but we might try."

The FTC Act provides that no more than three of the five Commissioners may be of the same political party. Traditionally, Policy Statements have been developed by the Commissioners on a bipartisan basis and usually issued with unanimous support (sometimes with concurring statements to express a Commissioner's reservations about particular elements). Historically, they have been created through months of internal negotiations among the Commissioners in an attempt to develop consensus. This is because no Policy Statement can be labeled as a Commission Policy Statement unless the Commission has approved the Policy Statement by vote; that is, "with the affirmative concurrence of a majority of the participating Commissioners," as prescribed by Rule 4.14(c) of the Commission's Rules of Practice.[4]

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[3] 16 C.F.R. § 1.5.
[4] 16 C.F.R. § 4.14(c).

The Commission Rules do not prescribe a particular process for the issuance of Policy Statements. In practice – at least until recently – the Commission has almost always followed procedures comparable to those the Administrative Procedure Act[5] prescribes for APA rules before issuing Policy Statements in final form.

As elsewhere in politics and government, however, the longstanding bipartisan process has broken down. The Franchise Policy Statement was issued over the dissenting statements of the two Republican commissioners, Andrew Ferguson and Melissa Holyoak. They did not disagree with the premise of the Policy Statement – that using non-disparagement, goodwill, or confidentiality clauses in franchise agreements to prohibit reporting law violations to the government is likely to be an "unfair" practice under the FTC Act. What the dissenters objected to was what they saw as "an attempt to announce *de facto* rules through an ostensibly nonbinding Policy Statement, bypassing the procedural safeguards that govern our rulemakings and denying regulated parties the benefit of *ex ante* judicial review."[6]

At the FTC, just as in the court system, it is always important to pay attention to dissenting statements and concurring statements, because the make-up of the Commission or the court may change. Commissioner Ferguson is now the FTC Chair, with the power to shape the agency's agenda. Based on his dissenting statement, it is safe to say that: (a) for the foreseeable future, the FTC will not be taking the position that non-disparagement, goodwill, or confidentiality clauses are inherently prohibited in franchise agreements; but (b) a franchisor that actively invokes such clauses to prohibit communication with regulators would be taking a big risk.

The Franchise Policy Statement did not address the focus of the rest of this paper: ongoing fees charged to franchisees. Accordingly, we will not speak of it much more in this paper. However, it's important for the franchising community to understand how Policy Statements work, in case of further FTC policy statements addressing franchising.

B. Staff Guidance[7]

A Staff Guidance document is the staff-level equivalent of a Commission-issued Policy Statement. It does not have the force of law; it is only an expression of the responsible FTC staff's point of view about a particular topic. It does not purport to represent the views

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[5] Pub. L. 79-404, 60 Stat. 237, 5 U.S.C. § 500 et seq.

[6] Dissenting Statement of Commissioner Andrew N. Ferguson, at 1. He elaborated: "The Policy Statement suggests that a franchisor violates Section 5 by merely including a non-disparagement, goodwill, or confidentiality clause in its franchise agreement without a disclaimer that the clause cannot apply to the reporting of legal violations to the government. But it is not plausible that a franchisor violates Section 5 merely by putting in a franchise agreement a clause as simple as "Franchisee shall not disparage Franchisor." That some franchisees might misinterpret that clause to prevent the reporting of legal violations to the government is not a Section 5 violation" (footnotes omitted).

[7] Staff Guidance on the Unlawfulness of Undisclosed Fees Imposed on Franchisees, https://www.ftc.gov/system/files/ftc_gov/pdf/Franchise-Staff-Guidance.pdf (accessed April 9, 2025).

of the five Commissioners, either individually or as a body. The Staff Guidance has its own disclaimer:

> *This document represents the views of FTC staff and is not binding on the Commission.*

Compared to a Policy Statement, Staff Guidance perhaps should be viewed more as a yellow caution than a red warning light, because any staff enforcement or rulemaking initiative based on conduct discussed in the Staff Guidance would have to go through the Commission first. Having said that, we can assume that a Staff Guidance document would not be issued if the leaders of the FTC's Bureau of Consumer Protection thought it to be inconsistent with the current views of the Commission.

The July 12, 2024 Staff Guidance is short but packs a lot into a page and a half. First, it cites multiple forums raising "the issue of franchisors imposing and collecting fees from franchisees that were not disclosed in their FDDs." This suggests (but not conclusively) that the staff senses a "pattern or practice" that the agency requires as a predicate for exercising its enforcement or rulemaking authority.

Second, the Staff Guidance refers to the guidance being released as "guidance regarding the *unlawful* imposition of undisclosed fees" (emphasis added). Use of the italicized term suggests a value judgment has already been made about the subject. Is it always unlawful? Why isn't it stated as "guidance regarding the imposition of previously undisclosed fees" – which may or may not be unlawful? Perhaps it is just loose wording, but that seems unlikely, because any FTC document destined for public posting is reviewed many times with a fine-toothed comb. However, at the end of the document, the staff is careful to say that any determination of a law violation "will be fact specific, and the staff is not taking a position on whether any particular company is currently violating the Franchise Rule or Section 5."

Third, the Staff Guidance specifically targets new fees. It starts with a simple reminder that "if a franchisor fails to disclose [certain types of] fees in the FDD, such failure is a violation of the Franchise Rule and Section 5 of the FTC Act." This much is unremarkable, but the Staff Guidance also anticipates the argument that the FDD could not have disclosed (and therefore did not deceptively fail to disclose) a fee that did not exist at the time of FDD delivery. The staff adds a statement that does <u>not</u> depend on the Franchise Rule or a deception theory: "If a franchisor imposes or collects a new fee, through its operating manual or otherwise, that was not disclosed in the FDD and included in the franchise agreement, the franchisor may be engaging in an *unfair* act or practice in violation of Section 5 of the FTC Act."[8]

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[8] *Id*. (emphasis added). Under the FTC Act, "An act or 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." 15 U.S.C. § 45(n).

It should be noted that the precedent relied on in the Staff Guidance, *FTC v. Orkin Exterminating Co.*,[9] is neither a franchise case nor one that involved a "new" fee. In *Orkin*, the defendant had entered into consumer contracts that specified a fixed annual fee for renewal of lifetime termite protection. Orkin did not attempt to introduce a new fee that did not previously exist. Rather, Orkin attempted to increase the existing fee, in the face of contact language permitting adjustment of the fee in only one specific circumstance and absent any other contract language permitting increases. As the Staff Guidance correctly describes, the Commission found no deception by Orkin but concluded that the unilateral *breach of contract* was an unfair practice. *Orkin* certainly supports the proposition that a franchisor may not state a specific fee in its franchise agreement, with no provision for changing the fee, and then increase the fee later. That, too, is a unilateral breach of contract. However, it is less clear that implementing a new fee through the operations manual would be a breach of contract or that *Orkin* applies to that situation.

C. Issue Spotlight[10]

The Issue Spotlight is not a position document or guidance document of any kind. It is a report in which the FTC staff summarizes "areas of concern" about franchising drawn from a variety of sources, including the comments submitted in response to the FTC staff's March 10, 2023 RFI. The Issue Spotlight so far is the only FTC document reporting on the results of the RFI.

The Issue Spotlight confirms that the RFI received 5,291 comments, that the FTC posted 2,216 of them on the public docket, and that the remainder were unresponsive. The Issue Spotlight does not explain, and to our knowledge the FTC has never explained, why more than 3,000 comments – 58% of the total submitted – were deemed unresponsive.

The Issue Spotlight does provide some other statistics, however. It states that a little over half of the commenters identified themselves as franchisees and fewer than 10% identified themselves as franchisors, trade groups, attorneys and suppliers.[11] Comments were submitted by franchisees and franchisors associated with 154 different franchise brands.[12]

Part III of the Issue Spotlight lists the top 12 issues of concern identified by franchisees in their RFI comments. Franchisor-imposed fees turn up in two of the listed categories: #3 Fees and Royalties and #9 Franchise Disclosure Document Issues. According to Section #3, many franchisees commented on the high level of fees (particularly credit card processing and technology fees); some described "surprise fees" that had not been properly disclosed; some discussed new fees for which no new services were provided; and one referred to "junk fees."[13] The Issue Spotlight does not specifically confirm

[9] 108 F.T.C. 263 (1986), *aff'd*, Orkin Exterminating Co. v. FTC, 849 F.2d 1354 (11th Cir. 1988)
[10] Issue Spotlight: Risks to Small Business Success in Franchising, https://www.ftc.gov/system/files/ftc_gov/pdf/Franchise-Issue-Spotlight.pdf (accessed April 9, 2025).
[11] *Id*. at 3. Presumably, these statistics are based on the 2,216 comments placed on the public record, although the Issue Spotlight does not specify.
[12] *Id*.
[13] *Id*. at 7.

whether all of these fees were paid to the franchisor as opposed to unaffiliated third parties. It does note some other franchisee comments describing fees as being fair and stable. Again in Section #9, the report notes franchisee comments complaining about new fees that should have been disclosed in the FDD.[14]

D. Re-Opened Comment Period

As noted above, another action taken by the FTC on July 12, 2024 was to re-open the RFI comment period. The FTC received 573 additional comments before the comment window closed again on October 24, 2024.[15] A search for the word "fees" on this database of comments gets 175 hits. A review of randomly selected comments in this group shows them to be similar to the comments summarized in the Issues Spotlight under #3 of the Top 12 list.

E. Other FTC Activity on Franchising

Franchise Rule Review. By its own calendar, the FTC is supposed to review all of its regulations on a ten-year cycle. The purpose of the review is to consider whether changes in the industry, the economy, the law, or other factors call for amending or even rescinding a regulation.

The FTC commenced a periodic review of the Franchise Rule on March 13, 2019 – long before the RFI or any of the other events described above in this paper.[16] The March 2019 solicitation resulted in 39 comments, all supporting continuation of the Franchise Rule but several proposing changes to the rule. Eighteen months later, the Commission decided to seek additional information about the proposed changes raised by the commenters.[17] The agency scheduled an online public workshop for November 10, 2020, identifying as topics the FDD format, Item 19, and the use of disclaimers. Fee disclosures were not called out as a topic. Submission of public comments followed the workshop. Then, crickets until the RFI.

F. Other FTC Activity on Fees

Junk Fees Rule. Franchising stakeholders naturally focus on the FTC's activities specific to franchising, but they should always remember that these activities are going on in a larger policy context. Other, non-franchise activities on the FTC's agenda can be informative as to where franchise regulation might be headed. Sometimes franchising initiatives are only once piece of a broader theme.

For purposes of this paper, the FTC's new "Junk Fees" rule is relevant, because it demonstrates that the Staff Guidance is far from the agency's only expression of concern

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[14] *Id*. at 15.
[15] The comments can be found at https://www.regulations.gov/document/FTC-2023-0026-2219/comment.
[16] Disclosure Requirements and Prohibitions Concerning Franchising, 84 Fed. Reg. 9051 (March 13, 2019).
[17] Public Workshop Examining Franchise Rule, 85 Fed. Reg. 55850 (Sept. 10, 2020).

about proper disclosure of fees.[18] The Junk Fees rulemaking began in November 2022[19] and proceeded to a Notice of Proposed Rulemaking a year later.[20] In the NPRM, the Commission stated that it had "reason to believe that certain unfair or deceptive acts or practices involving fees are prevalent, specifically: 1) misrepresenting the total price of goods and services by omitting mandatory fees from advertised prices, and 2) misrepresenting the nature and purpose of fees."[21] The proposed rule would have applied to all businesses and it generated over 60,000 comments to the FTC. Ultimately, the FTC issued a significantly narrowed final rule in December 2024 that applies only to the sale of live-event tickets and short-term lodging.[22] The final rule, scheduled to take effect on May 12, 2025, requires ticketing and hotel sites to include a clear and conspicuous disclosure of the total price whenever a price offer is made. It also affirmatively prohibits misleading fees, including misrepresentation of the nature, purpose, amount, or refundability of any fee or charge.

The comments about undisclosed and unexpected fees submitted by franchisees in response to the RFI are reminiscent of the types of comments submitted by consumers to the FTC in the Junk Fees rulemaking. In that light, the timing of the Staff Guidance regarding undisclosed fees should not be surprising. The FTC's attention to complaints about undisclosed fees in franchising fits into a larger policy initiative. As of this writing, we have not yet seen a clear signal whether that initiative will continue under the new Administration.

II. FTC Rule Requirements for Fee Disclosures

With FTC's focus on fees in context, we turn to the actual FTC disclosure requirements relating to fees charged to franchisees. Again, our focus is on the fees required to be disclosed in Item 6 of the FDD, not initial franchise fees.

The FTC Franchise Rule instructions for disclosing fees are short and probably quite familiar to everyone attending this workshop:

> ***Item 6*** *: Other Fees. Disclose, in the following tabular form, all other fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party. State the title "OTHER FEES" in capital letters using bold type. Include any formula used to compute the fees.*[3]

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[18] Trade Regulation Rule on Unfair or Deceptive Fees, 90 Fed. Reg. 2066 (January 10, 2025). The official name of the Junk Fees rule is the "Rule on Unfair or Deceptive Fees."

[19] Request for public comment: Unfair or Deceptive Fees Trade Regulation Rule, Commission Matter No. R207011, 87 Fed. Reg. 67413 (Nov. 8, 2022). The FTC received over 12,000 comments on this Advance Notice of Proposed Rulemaking.

[20] Notice of proposed rulemaking; request for public comment: Trade Regulation Rule on Unfair or Deceptive Fees, 88 Fed. Reg. 77420 (Nov. 9, 2023).

[21] *Id*. at 77431.

[22] Trade Regulation Rule on Unfair or Deceptive Fees, 90 Fed. Reg. 2066 (January 10, 2025).

> *[3] If fees may increase, disclose the formula that determines the increase or the maximum amount of the increase. For example, a percentage of gross sales is acceptable if the franchisor defines the term "gross sales."*[23]

These brief instructions leave some questions open:

Does Item 6 require disclosure relating to ongoing purchases of supplies from the franchisor or an affiliate?

The term "fee" is not defined in the amended Franchise Rule, nor in its 2007 Statement of Basis and Purpose (the "SBP")[24], nor in the FTC Compliance Guide.[25] Presumably the term was considered so obvious as to not need definition. The Merriam-Webster dictionary definition of "fee" is "a fixed charge" or "a sum paid or charged for a service." This is a broad definition, but not necessarily all-encompassing – in particular, it does not seem to cover the price paid for products. However, both the SBP and the Compliance Guide refer more broadly to "payments" made to the franchisor. In practice, some state examiners have required Item 6 disclosure of at least some payments for ongoing purchases of supplies from the franchisor.

Does Item 6 apply only to *required* fees, or does it apply to *all* fees paid to the franchisor and affiliates, whether for required items or optional items?

The Franchise Rule does not use the word "required" but it refers to fees that the franchisee "must pay" to the franchisor or its affiliates. If a fee is for a voluntary program or service, we cannot say the franchisee "must" pay the fee; however, if the franchisee chooses to participate and the service is provided by the franchisor or its affiliate, then the franchisee "must" pay the franchisor or affiliate. Looking again to the SBP and the Compliance Guide, neither of them makes a distinction between required fees and optional fees – it is the destination of the payment that matters.

What exactly does "*impose or collect . . . for a third party"* mean?

Note that the FTC does not always use the terms "impose" and "collect" in the same way, and not always together. Both the SBP and the Compliance Guide refer to "payments . . . *collected* by the franchisor or affiliate for the benefit of a third party," leaving out the word "imposed." The Compliance Guide twice states that Item 6 must address whether the fee "is imposed *and* collected by the franchisor," not imposed *or* collected as in the Franchise Rule itself. None of these sources elaborate on what "impose" means (although "collect" seems clear enough). The one thing the sources do make unmistakably clear is that Item 6 does not apply to fees or payments made directly by a franchisee to third parties. In fact, the FTC Staff Report supporting issuance of the amended Franchise Rule

[23] Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5(f).

[24] Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444 (March 30, 2007) (the "Statement of Basis and Purpose" or "SBP").

[25] Franchise Rule Compliance Guide, https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf (last accessed April 9, 2025).

recommended that such payments be included in Item 6, and the Commission specifically rejected that recommendation, concluding that the Item 7 and Item 8 disclosures were "more than sufficient" to address direct payments to third parties.[26]

The authors read "impose" consistently with its dictionary meaning: "to establish or apply by authority" – specifically, by the contractual authority of the franchise agreement or related agreement. The franchisor or affiliate establishes an obligation to make a payment by designating a third party as the source of a service to the franchisee. However, to "impose" the fee or payment by itself is not enough, because the FTC has made it clear that Item 6 does not apply if the fee or payment goes directly from the franchisee to the third party.

As a practical matter, the Franchise Rule instructions must be read as "imposed *and* collected," like the two statements in the Compliance Guide. Item 6 applies if the franchisor both (1) establishes the fee or payment *obligation* (not necessarily the amount, which might be controlled by the third party), and (2) collects the fee or payment (in whole or in part) for the third party.

Does footnote 3 of Item 6 apply *only* when the fee disclosure and the underlying contract *expressly reserve* the right to increase the fee?

Early experience with 2025 state filings verifies that if an Item 6 disclosure expressly reserves the right to increase a stated fee, state examiners are going to enforce the obligation to disclose the formula that determines the increase or the maximum amount of the increase.

What if the Item 6 disclosure simply states that "currently" the fee is $X? Potential ambiguity arises, because "currently" can be read in two ways. The franchisor might mean (1) this is our "current" fee for franchisees who sign a franchise agreement after receiving this FDD; we may have a different "current" fee in a future FDD, but the future change will not apply to franchisees who received this FDD. More likely, the franchisor means (2) that franchisees who sign a franchise agreement after receiving this FDD "currently" will pay the stated amount but might have to pay a different amount during the life of their contract. If the latter meaning is intended – or if state examiners think this meaning is implied – then the "formula or maximum" comes into play.

If a fee disclosure in Item 6 is silent about future increases to the fee, the prospective franchisee's legitimate assumption likely will be that the fee cannot increase during the life of the contract. This is, effectively, the *Orkin* situation described in Section I.B above; unilaterally changing a fee without having reserved the right to change it is likely to be a breach of contract and, in the Franchise Rule context, a disclosure violation as well.

[26] SBP at 15485-86.

Does footnote 3 require the franchisor to state the maximum amount that the fee can ever be?

To be precise, the footnote doesn't say to disclose the "maximum amount of the fee" – it says to disclose the "maximum amount *of the increase*." In some cases, this is a distinction without much of a difference. In particular, if the number of increases is inherently limited, disclosing the maximum amount of the increase also effectively defines the maximum amount the fee can ever be. For example, if the fee is $100, and it can be increased up to 10% per year, and it's a 10-year contract, the maximum amount of the fee in year 10 is $236 (assuming a 10% increase every year, rounded to the nearest dollar). If the maximum increase is $10 per year, and it's a 10-year contract, the maximum amount of the fee in year 10 is $190 (assuming a $10 increase every year).

If the potential fee increases are not annual or tied to another periodic cycle, this calculation is more difficult. Suppose the contract and the Item 6 disclosure state that the franchisor may increase the fee at any time on 90 days' notice. While it's feasible to calculate the maximum number of consecutive 90-day notice periods within the life of the contract, which would provide a theoretical maximum of what the fee could be during the contract, it probably would not be meaningful disclosure in terms of reflecting what the franchisee is actually likely to experience.

Footnote 3 clearly states that if the fee is stated as a percentage of gross sales, no further disclosure is needed even though, in principle, there is no dollar limit on how much the fee might be in the future. The dollar amount of the fee will be determined by the level of gross sales, which does not have a limit. But both the footnote and the Compliance Guide state that this formula – dollar amount of gross sales multiplied by the stated percentage of gross sales – is an acceptable formula as long as "gross sales" is defined.

While it appears that there is no requirement to state the maximum amount the fee can ever be, voluntarily doing so would be one way to satisfy the disclosure requirement. For example: *The annual conference fee is currently $500 per person. We have the right to increase the conference fee up to a maximum of $1,000 per person.* This approach substitutes information about the maximum *amount* for information about the size of interim *increases*. This approach is helpful in cases where it may be difficult for the franchisor to use a formula or to estimate future changes in external costs affecting the fee. However, choosing the maximum dollar level could be challenging. If the past few years have taught us anything, it's that unexpected supply chain disruptions, volatile inflation, and unpredictable tariff policies can make it very difficult to guess at what costs might be in the future. To protect against the uncertainties, franchisors using this approach might have to give themselves a cushion by disclosing maximum fees significantly above what they might otherwise prefer.

How does footnote 3 apply to fees "that the franchisor or its affiliates impose or collect in whole or in part for a third party"?

Suppose a franchisor imposes a requirement on franchisees to use a designated customer relationship management system and the franchisor negotiates (or the CRM provider insists on) central collection of payment from franchisees so that the provider does not have to bill them directly. The fee or payment charged to franchisees may be a straight pass-through of the vendor charge or it may include a mark-up to the franchisor to cover its costs of centralized billing and perhaps deliver a profit.

Presumably, third parties remain free to adjust their own fees, even if collected by the franchisor. If the CRM vendor can increase its fees, but the franchisor does not control the vendor's increases, what is the franchisor's disclosure obligation under footnote 3? The answer is not clear, but it seems unreasonable to require the franchisor to disclose a formula or maximum increase in these circumstances, unless maybe the franchisor's arrangement with the CRM provider expressly covers future increases. Otherwise, for fees that are collected and passed through in whole or in part to third parties, the "maximum amount of the increase" disclosure arguably should apply only to the portion (if any) of the fee retained by the franchisor.

How can a franchisor avoid the concerns in the FTC Staff Guidance about imposition of new fees?

The Staff Guidance states that the franchisor may be engaging in an unfair act or practice in violation of Section 5 of the FTC Act if the franchisor imposes a new fee that was not disclosed in the FDD. At the same time, many franchisors believe they need flexibility to introduce new fees in the course of the franchise relationship to respond to events or trends that could jeopardize the brand's competitive position. But not knowing what these future fees might be needed for or how they would be structured, the franchisor cannot disclose them in the FDD with any specificity.

Suppose (1) the franchise agreement expressly reserves the right to impose a new fee, (2) Item 6 discloses that the franchisor has reserved this right, and (3) five years later, the franchisor introduces a fee in the subject area where it has reserved its rights. The amount and frequency of the fee are not known to the franchisee until the fee is introduced. In these circumstances, would the FTC view the new fee as one that was "not disclosed" in the FDD issued five years earlier? If the purpose of the disclosure is to put prospective franchisees on notice of costs they will occur in the operation of the franchise, the original disclosure arguably accomplishes the purpose, even though the amount of the fee is not known (and is therefore not capable of being disclosed) at the outset.

This is not different in nature from other FDD disclosures of future changes that might affect the franchisee's operations. For example, Item 8 disclosures routinely advise prospective franchisees that the franchisor may designate new vendors that franchisees are required to use. Neither the identity of those vendors nor the amounts they charge are known at the time of the disclosure. Yet regulators have not taken the position that

the appointment of a new vendor five years later is a potential disclosure violation as to those who received the FDD five years earlier.

III. States

A. NASAA 2008 Disclosure Guidelines

The North American Securities Administrators Association ("NASAA") is the oldest organization dedicated to international investor protection.[27] "NASAA is an association of state securities administrators who are charged with the responsibility to protect consumers who purchase securities or investment advice."[28] As such, while NASAA itself does not have direct regulatory authority over franchising in the U.S., its protection of investors includes through the coordination and promotion of best practices among state franchise regulators. Since the 1980s NASAA's Franchise and Business Opportunity Project Group has facilitated regulators addressing franchise issues, including through interpretive commentaries.[29] NASAA members often adopt and implement at the state level securities laws advocated by NASAA, and commentaries. "The Federal Trade Commission ("FTC") and states that regulate franchising have historically given great weight to the recommendations, commentaries, and policy initiatives of NASAA's Franchise Project Group and, in many cases, states have specifically incorporated them into their franchise laws."[30]

In March 2007, the FTC amended its Trade Regulation Rule known as the "Franchise Rule." The purpose of the amendment was to "streamline the Rule, minimize compliance costs, and to respond to new technologies and market conditions in the offer and sale of franchises."[31] Following the adoption of the amended Franchise Rule, NASAA swiftly prepared interim guidelines and recommended that, as of July 1, 2007, Registration States allow franchisors to file disclosure documents prepared under NASAA's 2007 Interim Guidelines.[32] As of July 1, 2008, NASAA recommended that Registration States permit franchisors to file disclosure documents prepared under the NASAA 2008 Franchise Registration and Disclosure Guidelines.[33] NASAA cautioned

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[27] *See* www.nasaa.org.
[28] *Id.*
[29] *See* N. AM. SEC. ADM'R ASS'N, NASAA FRANCHISE AND BUSINESS OPPORTUNITIES PROJECT GROUP RESPONSE TO SOLICITATION FOR PUBLIC COMMENTS ON PROVISIONS OF FRANCHISE AGREEMENTS AND FRANCHISOR BUSINESS PRACTICES DOCKET ID FTC-2023-0026, June 8, 2023, https://www.nasaa.org/wp-content/uploads/2023/06/NASAA-Franchise-PGComment-Letter-re-FTC-RFI-Docket-FTC-2023-0026_6-8-2023.pdf.
[30] Bethany Appleby & Abhishek Dube, *Complying With New Prohibitions of Questionnaires and Acknowledgements While Protecting a Franchisor's Legitimate Interests*, ABA 46TH ANNUAL FORUM ON FRANCHISING W-14, at 13 (2023).
[31] Federal Register / Vol. 72, No. 61 / Friday, March 30, 2007 / Rules and Regulations, 15444 https://www.ftc.gov/sites/default/files/070330franchiserulefrnotice.pdf.
[32] https://www.nasaa.org/industry-resources/uniform-forms/franchise-registration-and-disclosure-guidelines/.
[33] *Id.*

franchisors to check with individual states as to whether the state had any specific filing requirements.[34]

The NASAA 2008 Franchise Registration and Disclosure Guidelines (the "2008 Guidelines") are seventy-four pages long, including forms and appendices of tables.[35] The 2008 Guidelines state very little with respect to fees. NASAA adopted specific instructions for the preparation of the Franchise Disclosure Document ("FDD"). Those include:

> 1. Disclose all required information clearly, legibly, and concisely in a single document using plain English. Plain English means the organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information, where possible. It avoids legal jargon, highly technical business terms, and multiple negatives.

…

> 11. Separate documents (for example, a confidential operations manual) must not make representations or impose terms that contradict or are materially different from the disclosure in the Franchise Disclosure Document.
>
> 12. Use 8½ by 11 inch paper for the Franchise Disclosure Document and other forms submitted to the Franchise Filing States. The text of the Franchise Disclosure Document must be clearly readable and presented in at least 11 point type. Tables in the Franchise Disclosure Document and separately attached documents not prepared by the franchisor may be presented in less than 11 point type as long as the text is clearly readable.[36]

At the time, some of the key items of interest to franchise lawyers were: the requirement that franchisors add a statement to the Receipt to reflect state laws, for which the 2008 Guidelines provided sample language; questions as to the issuance date for the FTC Cover Page, which the 2008 Guidelines clarified; the idea that brokers were no longer required to be disclosed in Item 2, which the 2008 Guidelines addressed with a requirement that a legend be included on the State Cover Page if the franchisor utilizes third-party franchise brokers to offer the franchise; questions about Item 17, for which the 2008 Guidelines provided a sample; and whether and which states would permit franchisors to use unaudited financial statements or balance sheets, because while the 2008 Guidelines were identical to the Amended Franchise Rule, it remained up to the states to decide how they would proceed and that was not immediately clear.[37]

The 2008 Guidelines included a copy of the requirements for the preparation of an FDD under those Guidelines, which "are substantively equivalent to the requirements

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[34] *Id.*
[35] *NASAA 2008 Franchisee Registration and Disclosure Guidelines (Amended and Restated UFOC Guidelines)*, July 1, 2008 ("2008 Guidelines"), https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf.
[36] *Id.* at Section IV.A.
[37] *See* Dale Cantone, Lee J. Plave, Craig Tregillus, & Will K. Woods, *Advanced Disclosure Issues Under the Amended FTC Rule*, ABA 31ST ANNUAL FORUM ON FRANCHISING W-1 (2008).

adopted" by the Amended Franchise Rule.[38] There, the 2008 Guidelines addressed fees, as follows:

(e) Item 5: Initial Fees

Disclose the initial fees and any conditions under which these fees are refundable. If the initial fees are not uniform, disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount. For this Item, "initial fees" means all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sum or installments. Disclose installment payment terms in this section or in Item 10.

(f) Item 6: Other Fees.

Disclose, in the following tabular form, all other fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party. State the title "OTHER FEES" in capital letters using bold type. Include any formula used to compute the fees.[3]

Footnote 3: If fees may increase, disclose the formula that determines the increase or the maximum amount of the increase. For example, a percentage of gross sales is acceptable if the franchisor defines the term "gross sales."

Item 6 Table
OTHER FEES

Column 1	Column 2	Column 3	Column 4
Type of fee	Amount	Due Date	Remarks

(1) In column 1, list the type of fee (for example, royalties, and fees for lease negotiations, construction, remodeling, additional training or assistance, advertising, advertising cooperatives, purchasing cooperatives, audits, accounting, inventory, transfers, and renewals).
(2) In column 2, state the amount of the fee.
(3) In column 3, state the due date for each fee.
(4) In column 4, include remarks, definitions, or caveats that elaborate on the information in the table. If remarks are long, franchisors may use footnotes instead of the remarks column. If applicable, include the following information in the remarks column or in a footnote:
(i) Whether the fees are payable only to the franchisor.
(ii) Whether the fees are imposed and collected by the franchisor.
(iii) Whether the fees are non-refundable or describe the circumstances when the fees are refundable.
(iv) Whether the fees are uniformly imposed.
(v) The voting power of franchisor-owned outlets on any fees imposed by cooperatives. If franchisor-owned outlets have controlling voting power, disclose the maximum and minimum fees that may be imposed.[39]

[38] 2008 Guidelines, *supra* note 9 at Section VII.
[39] *Id.* at 38-39.

Elsewhere, the requirements set forth in the 2008 Guidelines noted that in Item 7 the total initial investment should incorporate "ranges of fees, if used"[40] and that Item 8 should disclose "Any fees and procedures to secure approval to purchase from alternative suppliers."[41] In Item 8, the franchisor was guided to "Include obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice." In a footnote, the requirements explained, "Franchisors may include the reason for the requirement. Franchisors need not disclose in this Item the purchase or lease of goods or services provided as part of the franchise without a separate charge (such as initial training, if the cost is included in the franchise fee). Describe such fees in Item 5. Do not disclose fees already described in Item 6."[42]

B. Commentary on 2008 Disclosure Guidelines

In June 2008, the NASAA Franchise and Business Opportunities Project Group published its Commentary on 2008 Franchise Registration and Disclosure Guidelines (the "2008 Commentary").[43] On April 27, 2009, NASAA adopted the 2008 Commentary. The 2008 Commentary was "intended to provide practical guidance about the disclosure requirements and instructions adopted under NASAA's 2008 Franchise Guidelines."[44] States including New York, adopted the 2008 Commentary.[45]

The 2008 Commentary is over thirteen pages of material in a question and answer format. The supposed frequently asked questions in the 2008 Commentary address Cover Pages, Items 1, 2, 3, 8, 17, 19 and 20. Item 6 is not covered in any of the Q and A; it is absent from the 2008 Commentary.[46] Indeed the word "fee" or "fees" appears only once in the 2008 Commentary.[47] In the context of the FTC Cover Page, the question is asked, "On the FTC Cover Page, regarding the disclosure of the total investment necessary to begin operation, may the franchisor adjust the actual totals from Items 5 and 7 to reflect the fact that some franchisees may not incur some specified fees or expenses?"[48] The Answer given is: "No. Franchisors must use the actual total amounts from Items 5 and 7 without alteration, adjustment or explanation."[49]

As franchisors navigated the new FTC Rule, franchise counsel began recognizing common concerns or issues. The order of the day was "Read and Follow" the 2008 Commentary.[50] Even though some states did not require all of the forms in the 2008

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[40] *Id.* at 40.
[41] *Id.* at 41.
[42] *Id.* at 41, n. 4.
[43] *Commentary on 2008 Franchise Registration and Disclosure Guidelines* ("2008 Commentary"), https://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.
[44] *Id.* at i.
[45] *See* https://ag.ny.gov/sites/default/files/regulatory-documents/2008_FDD_Commentary.pdf.
[46] 2008 Commentary, *supra* note 17.
[47] *Id.* at 1.
[48] *Id.*
[49] *Id.*
[50] Leonard D. Vines, Halima M. Madjud & Dale E. Cantone, *Best Practices for State Franchise Registration*, ABA 32ND ANNUAL FORUM ON FRANCHISING W-8, at 8, 11 (2009).

Guidelines, "All states should be following the NASAA Guidelines. Even if a state has not affirmatively promulgated the NASAA Guidelines, the state should be following them…"[51] Franchise counsel noted that "The Amended FTC Rule specifically states 'Do not include any materials or information other than those required or permitted by part 436 or by state law not preempted by part 436.'"[52] Therefore, franchisors were advised to avoid adding introductory paragraphs at the beginning of Item 2 and Item 6.[53] With respect to fees, it was noted that changes in fees required disclosure in the quarterly updates required by the Amended FTC Rule.

> As a practical matter, the areas that most frequently require updating are increased costs in establishing or operating the franchise, franchisee turnover through termination and nonrenewals, mergers and acquisitions involving the franchisor, new litigation or arbitration or significant developments in existing cases, changes in the franchise program, **changes in fees**, changes in franchisor's obligations, changes in franchise personnel involved in franchise activities, and adverse changes in the franchisor's financial status or competitiveness.[54]

Best practices were to closely follow the 2008 Commentary, which meant that franchisors did not have to focus heavily on the disclosure of fees. The 2008 Commentary did instruct franchisors that "All revenues a franchisor (or its affiliates) derives from purchases and leases of products and services to franchisees must be disclosed."[55] It also clarified that in Item 8, "disclosure is required if rebates are paid by designated or approved suppliers or by suppliers who comply with the franchisor's specifications."[56] But the 2008 Commentary, and franchise commentary and scholarship at the time generally, were not focused on the chance that a franchisor might impose fees that were not disclosed in the FDD. That came later.

C. Washington Franchise Act Interpretive Statement FIS-09

On November 1, 2023, the Washington State Department of Financial Institutions published its Franchise Act Interpretive Statement FIS-09 regarding Disclosure of Franchise Fees ("FIS-09").[57] FIS-09 was published after the regulators became aware of reports that some franchisors charged franchisees fees that were not disclosed in the FDD, "including fees that were imposed through their inclusion in an operations manual."[58] FIS-09 points out that "The operations manual is not typically provided to potential franchisees before executing the franchise agreement."[59]

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[51] *Id.* at 8.
[52] *Id.* at 8 *citing* 16 CFR 436.6(d).
[53] *Id.* at 11.
[54] *Id.* at 21 (emphasis added).
[55] 2008 Commentary, *supra* note 17, at 6.
[56] *Id.*
[57] Washington State Department of Financial Institutions, *Franchise Act Interpretive Statement – FIS – 09*, (Nov. 1, 2023), https://dfi.wa.gov/franchise-act-interpretive-statement-fis-09.
[58] *Id.*
[59] *Id.*

FIS-09 sets out the relevant statutes and rules related to disclosure of fees, specifically 16 CFR 436.5(e) (franchisors must disclose "all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens"), 16 CFR 436.5(f) (franchisors must disclose "all other fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party."), and the rule regarding the disclosure of the computation of a fee as set forth in the FTC Franchise Rule Compliance Guide of May 2008, at 46 ("Any formula used to compute the fee must be disclosed as well. If a fee may increase, franchisors must disclose the maximum amount of the increase or the formula used to determine the increase").

Under Washington law, FIS-09 reminds franchisors, "it is unlawful to make any untrue statement of material fact or omit a material fact necessary in order to make the statements made…not misleading."[60] FIS-09 defines "material fact" using a 1986 case. "A material fact is a fact to which a reasonable person would attach importance in determining their choice of action in the transaction in question."[61]

FIS-09 cautions franchisors that:

> Because the operations manual is typically only provided after the franchise agreement is executed, the imposition of fees in the operations manual that were not disclosed in the FDD prior to the execution of the franchise agreement, or any payment to the franchisor or an affiliate in connection with the proposed franchise sale, violates both state and federal law.[62]

Franchisors must disclose "all fees, including prospective fees" in the FDD. "Failure to disclose a fee or payment required by the franchisor" is an unlawful omission of fact under Washington law.[63] "A franchisor cannot impose a fee through the operations manual or otherwise, without pre-sale disclosure in the Franchise Disclosure Document as required by 16 CFR 436.5(e) and (f) and RCW 19.100.170(2)."[64]

D. California FAQ

As in Washington, the regulators in California also took up the question of whether a franchisor can impose fees through changes to the system imposed by the operations manual. There too, the answer based on the Amended FTC Rule and California law, is "No."

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[60] *Id. citing* RCW 19.100.170(2).
[61] *Id. citing Morris v. International Yogurt Co.*, 107 Wn.2d 314, 322-23, 729 P.2d 33 (1986).
[62] *Id.*
[63] *Id. citing* RCW 19.100.170(2).
[64] *Id.*

<u>May a franchisor impose fees through its operations manual or otherwise that were not disclosed in the Franchise Disclosure Document?</u>

No. CA and federal law both require the franchisor to disclose all fees, including prospective fees, to a prospective franchisee in the Franchise Disclosure Document ("FDD") before the franchise agreement is signed or the receipt of any payment by the franchisor or any of its affiliates in connection with the proposed franchise sale. The Operations Manual is typically provided to the franchisee after the franchise agreement is signed. Failure to disclose a fee or payment required by the franchisor before the franchise agreement is signed constitutes an unlawful omission of fact under California Corporations Code Section 31201. A franchisor cannot impose a fee through the operations manual or otherwise, without pre-sale disclosure in the FDD as required by 16 CFR 436.5(e) and (f) and California Corporations Code section 31201.
Initial fees include "all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens." See 16 CFR 436.5(e) and Item 5 instructions in the CA Guidelines for Franchise Registration. In addition, franchisors must disclose "all other fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party." See 16 CFR 436.5(f) and Item 6 instructions in the CA Guidelines for Franchise Registration. "Any formula used to compute the fee must be disclosed as well. If a fee may increase, franchisors must disclose the maximum amount of the increase, or the formula used to determine the increase." See FTC Franchise Rule Compliance Guide, at 46 (May 2008).[65]

IV. Case Law Involving Fee Disclosures

There is little case law regarding fee disclosures, especially when compared to the amount of cases involving false earnings claims. The authors could only identify one case in which the FTC brought an enforcement action involving undisclosed fees. The case arose prior to the Amended FTC Franchise Rule and was not an action to enforce Item 6 requirements, but rather to enforce the requirement that franchisors disclose conditions related to transfers. In addition, for decades, state agencies have had the ability to enforce state franchise laws, and while some states have regularly initiated enforcement actions, few such actions are based on undisclosed fees. Most claims related to undisclosed fees are found in private litigation. NASAA and others have explained that "private remedies serve as a necessary supplement to governmental regulation and enforcement efforts."[66] In those cases, franchisees face challenges based on timeliness, waiver, and the clear language of their franchise agreements.

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[65] California Department of Financial Protection & Innovation, *Franchises – Frequently Asked Questions and Answers*, https://dfpi.ca.gov/regulated-industries/franchises/franchises-frequently-asked-questions-and-answers/ (last visited April 6, 2025).

[66] *The FTC's Franchise Rule: Twenty-Three Years After Its Promulgation* (June 25, 2002), https://www.nasaa.org/886/the-ftc%E2%80%99s-franchise-rule-twenty-three-years-after-its-promulgation/#:~:text=The%20states%20have%20a%20broad,protected%20only%20through%20governmental%20action.

A. FTC Cases

The FTC historically has not been active in bringing enforcement actions against franchisors for violations of the FTC Rule.[67] Compared to the number of cases in which the FTC takes action against defendants who have violated the Franchise Rule by making false income or earnings claims, there are extremely few FTC enforcement cases for franchisors' failure to disclose fees. In *FTC v. Minuteman Press*, decided before the enactment of the Amended FTC Rule, the franchisor failed to make required disclosures of transfer fees typically charged upon the sale of a franchise.[68] There, the court held that the franchisor unlawfully failed to disclose "the conditions under which the franchisee may sell or assign all or any interest in the ownership of the franchise, or of the assets of the franchise business."[69] Thus, the court ruled that the franchisor violated Franchise Rule 436.1(a)(15)(ix), then in effect, and not Franchise Rule 436.1(a)(7) or (8), which then required disclosure of "the total funds which must be paid by the franchisee" and "any recurring funds required to be paid." The court found the corporate and individual defendants in the case liable for any consumer redress with respect to the undisclosed transfer fees charged by the franchisor.

More often, the FTC enforcement actions are based on alleged violations of the current Section 436.1(b) of the Rule, 16 C.F.R. § 436.1(b)(2), which "states that if a franchisor makes any representation to a prospective franchisee regarding 'a specific level of potential sales, income, gross or net profit for that prospective franchisee, or which states other facts which suggest such a specific level,' then the franchisor must have a 'reasonable basis' for the representation which must be disclosed.[70]

Prior to the enactment of the Amended Franchise Rule, FTC enforcement actions involving false income or earnings claims also far exceeded those involving failure to disclose fees. For example, before *Minuteman Press*, in *FTC v. Jordan Ashley, Inc.* the defendants violated Section 5(a) of the old FTC Rule when they made false income claims to induce individuals to purchase franchises.[71] The case was often cited for the standard that a violation of the Franchise Rule was considered a <u>per</u> <u>se</u> violation of Section 5 of the FTC Act.[72] In 2002, in *FTC v. Accent Marketing, Inc.*, the court held that "the failure to make the mandatory disclosures renders several of the defendants' representations, including particularly its representations concerning earnings and potential earnings,

[67] *See* Martin Cordell, Theresa Leets & Warren Lee Lewis, *Responding to Franchise Enforcement Actions*, ABA 43RD ANNUAL FORUM ON FRANCHISING W-12, at 9 (2020).
[68] *See Fed. Trade Comm'n v. Minuteman Press*, 53 F. Supp. 2d 248, 257 (E.D.N.Y. 1998) (7. Defendants did not Disclose Mandatory Transfer/Training Fees This subject was discussed in the Court's opinion of February 4, 1997 which addressed Haber's motion, made pursuant to Rule 52(c), for judgment as a matter of law. In that opinion, it was held that the transfer fee typically charged upon the sale of a franchise was required to be disclosed by defendant corporations under Franchise Rule 436.1(a)(15)(ix),7 and was not. The relevant portion of that earlier decision, (see pp. 9–11), is incorporated by reference and constitutes the Court's findings of fact.)
[69] *Fed. Trade Comm'n v. Minuteman Press*, 53 F. Supp. 2d 248, n. 7 (E.D.N.Y. 1998).
[70] *F.T.C. v. Tashman*, 318 F.3d 1273, 1278 (11th Cir. 2003)(holding that the "defendants' many representations…lacked any reasonable basis in fact" and remanding for judgment in favor of the FTC).
[71] *Jordan Ashley*, 1994-1 Trade Cas. at n 3.
[72] *Jordan Ashley*, 1994-1 Trade Cas. at n 3.

unfair and deceptive."[73] In 2006, in *FTC v. USA Beverages*, the defendants made earnings claims to prospective franchisees, but did not make the disclosures required by the prior rule, nor, at any point, did they provide the required earnings disclosure document.[74] To protect consumers, the court banned the defendants from selling business ventures or franchises[75] and held them jointly and severally liable for over $2.5M in damages.[76]

The same court was called on again in *FTC v. Transnet Wireless Corp.*, where it held that business ventures sold by the defendants were franchises as defined in Sections 436.2(a)(1)(ii), (a)(2), and (a)(5) of the Franchise Rule, 16 C.F.R. § 436.2(a)(1)(ii), (a)(2), and (a)(5).7, that the defendants provided some prospective customers with a Franchise Disclosure Document, and that in those FDDs the defendants made earnings claims within the meaning of the Rule Sections 436.1(b), (c), and (e). The court held that, "The Franchise Disclosure Documents provided by Defendants were deficient in several ways, thereby violating the Franchise Rule or Business Opportunity Rule."[77] The court noted that the defendants "did not disclose the names and business experiences of current directors and officers for the previous five years…. did not disclose any names, addresses, and telephone numbers of other business ventures as required by the Rule…did not disclose the range of time that had elapsed between the signing of the franchise agreement and site selection… did not include or provide a "reasonable basis" for their earnings claims made to prospective purchasers during the oral sales presentations, in the written solicitations, or through the required disclosures in the Franchise Disclosure Document."[78] The court stated, "Defendants also did not disclose the number of prior purchasers known to have achieved the same or better results."[79] "These failures constitute further violations of the Franchise Rule. 16 C.F.R. §§ 436.1(b), (c), and (e)."[80] The decision is silent with respect to disclosures regarding fees or funds required to be paid by franchisees.

And notably, the FTC recently brought an enforcement action against franchisor Burgerim, including for its failure to disclose its financial performance representations in its FDDs "despite being required to do so" leading to the issuance of a permanent injunction.[81] There are also cases where franchisors denied they were franchisors and sold franchises with no disclosure whatsoever.[82] But, the authors were not able to find

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[73] *Fed. Trade Comm'n v. Accent Mktg., Inc.*, No. CIV.A. 02-405-CB-M, 2002 WL 31257708, at *2 *citing* 16 C.F.R. § 436.2.
[74] *F.T.C. v. USA Beverages, Inc.*, 2006 WL 8432509, at *13 (S.D. Fla. June 28, 2006).
[75] *Id.* at *15.
[76] *Id.* at *16.
[77] *F.T.C. v. Transnet Wireless Corp.*, 506 F. Supp. 2d 1247, 1269–70 (S.D. Fla. 2007).
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *United States v. Burgerim Group USA, Inc.*, No. CV 22-825-DMG (PDX), 2024 WL 661189, at *4-5.
[82] *See e.g. F.T.C. v. Tiny Doubles Int'l, Inc.*, 76 F.3d 385 (9th Cir. 1996) ("Friedman's sole defense to the FTC's complaint alleging violations of the Franchise Rule was that Tiny Doubles studios were not franchises. The district court found otherwise and, after a review of the record, we agree. There is no genuine issue of material fact that Tiny Doubles studios fall within the definition of a franchise as defined in 16 C.F.R. § 436.2(a). The district court appropriately granted in part the FTC's motion for summary

any cases where the FTC brought an enforcement action based specifically on a franchisor's failure to make required Item 6 disclosures.

B. State Enforcement Actions

State franchise laws afford the state the authority to conduct investigations, and state enforcement actions offer a variety of remedies including, cease and desist orders, registration revocation, injunctions, financial penalties, or criminal prosecution, which the state can employ in combination, against franchisors and their principals or franchise sellers, to protect its residents. Criminal convictions are rare, but have been sustained.[83]

"The states regularly initiate enforcement actions for violations of their state disclosure laws."[84] For example, in Maryland about 28 enforcement orders entered annually over the last ten years.[85] California has a searchable database[86] as well as a page listing recent enforcement actions by month.[87] Wisconsin has a similar page of enforcement administrative orders[88] as does Washington.[89] Minnesota has a database of enforcement actions.[90] Indiana also permits Administrative Action Searches, which can be narrowed to franchise entities, and further by date range and other criteria.[91] South Dakota maintains a webpage listing administrative actions for securities regulation with links to orders.[92] Virginia makes selected case information available to the public.[93]

Reviewing such state resources reveals that actions based on Item 6 or its equivalent or other fee disclosures or omissions are rare. Indeed, reviewing enforcement administrative orders issued by the Wisconsin Department of Financial Institutions reveals no such actions, although actions were taken with respect to failure to register and other disclosure violations of the Wisconsin Franchise Investment Law. Likewise, reviewing orders issued in Washington the authors found no actions based on false or misleading fee disclosures, although actions were frequently taken when franchisors allegedly sold unregistered franchises, failed to provide FDDs, failed to make proper Item 2 or Item 3 disclosures, and made false or misleading financial performance

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judgment on the liability issue, denied Friedman's cross motion for summary judgment, and entered a permanent injunction.")

[83] *People v. Carter*, 454 N.E.2d 189 (Ill. 1982), appeal dismissed sub nom. Carter v. Illinois, 465 U.S. 1055 (1984) (defendant was convicted of four counts of violating the Illinois Franchise Disclosure Act; evidence was sufficient to find defendant guilty beyond a reasonable doubt).

[84] Martin Cordell, *supra* note 41 at 10.

[85] https://www.marylandattorneygeneral.gov/Pages/Securities/index.aspx#InplviewHash39b5c39f-d976-4642-9cec-995d5666aa57=WebPartID%3D%7B39B5C39F--D976--4642--9CEC--995D5666AA57%7D.

[86] https://dfpi.ca.gov/actions_and_orders/?s=undisclosed&letter=.

[87] https://dfpi.ca.gov/about/what-we-do/summary-of-actions-and-orders-listed-by-month/.

[88] https://dfi.wi.gov/Pages/Securities/RegistrationOfProfessionals/EnforcementAdministrativeOrders.aspx.

[89] https://dfi.wa.gov/securities-enforcement-actions/securities2024.

[90] https://www.cards.commerce.state.mn.us/enforcement-actions?documentClass=ENFORCEMENT_ACTIONS.

[91] https://securities.sos.in.gov/admin-actions-search/. Note, "The Administrative Action Search is not an exhaustive list of all Administrative Actions that have been issued by the State of Indiana." *Id.*

[92] https://dlr.sd.gov/securities/admin_actions.aspx.

[93] https://www.scc.virginia.gov/docketsearch.

representations or falsely stated in the FDD that it made no such representations. In California, orders also entered where franchisors allegedly failed to meet the requirement in California's Franchise Investment Law and Rule 310.111.2 that financial statements filed with the franchise registration applications be audited by either an independent certified public accountant or independent public accountant.[94] And, although Indiana initiated fewer enforcement actions overall, the results there were the same - no actions based on undisclosed fees, and actions and orders entered based on alleged sales of unregistered franchises, failure to make proper Item 2 and Item 3 disclosures, and false or misleading FPRs. Virginia is similar.

Since 2000, Minnesota engaged in over 150 enforcement actions in the franchise industry; almost all such enforcement actions in Minnesota are based on allegations that the respondent sold unregistered franchises in Minnesota.[95] In South Dakota, enforcement actions are not frequently commenced against franchise sellers. Burgerim's registration was revoked in 2020 based on orders issued in other states[96] and in 2024 two consent orders entered related to the sale of unregistered business opportunities.[97]

In a very thorough search of state enforcement actions, the authors found only two matters involving disclosure of fees. Both are described below. More often, the states' enforcement actions involve the sale of unregistered franchises, incomplete Item 3 disclosures, failure to comply with previous orders or cease and desist notices, or false earnings claims.

In Maryland, on October 4, 2019, franchisor Tasty Baking Company entered into a Consent Order. According to the Order, Tasty Baking violated the three provisions of the Maryland Franchise Law. It sold unregistered franchises in violation of §14-214 of the Maryland Franchise Law; it failed to comply with disclosure requirements in violation of §14-216 of the Maryland Franchise Law; and it required distributors to pay fees for assigning their rights to others in violation of §14-223 of the Maryland Franchise Law. The Consent Order required Tasty Baking to cease and desist from the offer and sale of franchises in violation of Maryland Franchise Law, offer rescission to franchisees and

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[94] *See e.g.*, *Commissioner v. Stretchmed Franchise, LLC*, Consent Order, Oct.18, 2023, https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/10/StretchMed-Franchise-Consent-Order-Final.pdf; *Commissioner v. MD Hydration Franchise Inc.*, Consent Order, Sept. 19, 2022, https://dfpi.ca.gov/enforcement_action/md-hydration-franchise-inc/; *Commissioner v. Pet Wants Franchise System, LLC*, Consent Order, Dec.13, 2021, https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/12/Pet-Wants-Franchise-System-LLC-Consent-Order.pdf; *Commissioner v. Tru Bowl Superfood Bar Franchise, LLC*, Consent Order, Sept. 9, 2021, https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/09/Tru-Bowl-Superfood-Bar-Franchise-LLC-Consent-Order-FINAL.pdf.
[95] https://www.cards.commerce.state.mn.us/enforcement-actions?documentClass=ENFORCEMENT_ACTIONS.
[96] https://cbs4indy.com/news/state-of-indiana-bans-burger-franchise-from-opening-new-locations-business-under-investigation/.
[97] https://dlr.sd.gov/securities/admin_actions.aspx.

return the administrative fees charged for the distributors' assignments, and pay a $500 civil monetary penalty.[98]

More recently, in California, franchisors in the Xponential Fitness system allegedly made material misrepresentations and omissions in disclosures that included, first among ten alleged failures, "Understating aspects of the estimated initial investment and costs provided in Item 7 of the FDDs."[99] The franchisors did not admit nor deny the Commissioner's findings, but based on the Commissioner's opinion that they violated California Corporations Code sections 31200, 31201, and 31110, agreed to desist and refrain from further violations of the Code, pay a $450,000 administrative penalty, and attend franchise law compliance education.

Although certain states initiate enforcement actions for violations of their laws frequently, the likelihood of an enforcement action based on fee disclosures remains small. However, franchisors should understand that state regulators typically have a few years after the franchisor's alleged act or omission within which to bring an enforcement action,[100] and, in California, there is no limitations period.[101] With the current focus on so-called hidden or junk franchise fees, it is possible that enforcement actions based on undisclosed fees may increase.

C. Private Litigation

For now, franchisees who believe they are victims of undisclosed or junk franchise fees are likely left to consider a private civil action or arbitration against the franchisor. As with enforcement actions, more civil actions arise from allegations that franchisors provided false financial information or unlawful financial performance representations. "The Federal Trade Commission Franchise Rule (FTC Rule) does not provide a private right of action, but its detailed disclosure standards are a siren call for franchisees looking for a good cause of action. In the fifteen states with state franchise disclosure laws providing a private right of action, franchisees generally assert claims under those

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[98] *In the Matter of Tasty Baking Company*, Case No. 2019-0086. https://www.marylandattorneygeneral.gov/Securities%20Actions/2019/Tasty_Baking_Company_Consent_Order_100419.pdf.

[99] *Commissioner v. Xpotential Fitness, Inc.*, Consent Order, Nov. 1, 2024, https://dfpi.ca.gov/wp-content/uploads/2024/11/Consent-Order-Xpotential-Fitness-Inc.pdf.

[100] *See, e.g.,* HAW. REV. STAT. § 482E-10.5(b) (five years "subsequent to the date of the violation or two years subsequent to the discovery of facts constituting the violation, but in no event shall any civil action be brought later than seven years subsequent to the date of the violation."); IND. CODE § 23-2-2.5-30 (three years "after discovery by the plaintiff of the facts constituting the violation"); MICH. COMP LAWS § 445.1533 (four years after the act or transaction "constituting the violation"); MINN. STAT. § 80C.17, Subd. 5 (three years after the "cause of action accrues"); N.Y. GEN. BUS. LAWS § 691 (three years after the act or transaction "constituting the violation"); and VA. CODE ANN. § 13.1-571(b) (four years "after the cause of action"); *See* Anthony Marks, Dawn Newton & Gerald Wells, *Oh No, They Did What?! What Do We Do Now?*, ABA 41ST ANNUAL FORUM ON FRANCHISING W-16, at 22-24 (2018).

[101] CAL. CORP. CODE, TIT. 4, DIV. 5 §§ 31400-31403. There is a four-year statute of limitations on actions brought by California regulators for civil penalties. *Id.* at § 31405.

statutes."[102] Because there is no private right of action for violation of the FTC Franchise Rule, "virtually all states have enacted some version of the FTC Act, modelled on the Uniform Deceptive Trade Practices Act or Uniform Consumer Sales Practices Act."[103] "However, aggrieved franchisees will usually seek recourse under both state statutory law, if available, and common law claims of fraudulent inducement or concealment."[104] They may also claim that the franchisor breached the parties' franchise agreement.

Historically, these cases are not easy for franchisees to prevail. In 1986 in *Thompson v. Atlantic Richfield Co.* a Washington federal district court held that the Washington Franchise Investment Protection Act did not require a franchisor to initially disclose that upon renewal the franchisee would be required to pay a specific renewal fee. Relying on the federal law then in-effect, the court held that a disclosure was sufficient because it made it clear that the franchise was "not automatically renewable and, if renewed, the franchisee will be required to execute an agreement in accord with the company's current franchise policy."[105]

Cases where franchisees allege violations of state franchise registration or sales laws are often dismissed as time-barred.[106] For example, in *Kinnard v. Shoneys Inc.* the plaintiff franchisees claimed that the defendant franchisor collected hidden franchise fees in violation of the Indiana Deceptive Franchise Practices Act. The claim was time-barred under that Act and the franchisor was granted summary judgment on that claim.[107] In that case, many of the plaintiffs' claims relating to their licensing agreements were also released through various agreements they executed with the franchisor.[108]

A claim that a franchisor wrongfully failed to disclose its fee policy prior to executing franchise agreements was deemed released by virtue of a release contained in franchise transfer agreements in *DNB Fitness LLC v. Anytime Fitness LLC*.[109] There, the court held that a franchisor's failure to disclose a fee prior to charging the fee is a one-time breach and not an ongoing violation. "Consequently, Anytime's failure to disclose does not give rise to a new cause of action each month."[110] The franchisor's motion to dismiss was granted due to the release.

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[102] Bethany L. Appleby, Robert S. Burstein & John M. Doroghazi, *Cause of Action Alchemy: Little FTC Act Claims Based on Alleged Disclosure Violations*, FRANCHISE LAW JOURNAL Vol. 36, No. 3 (Winter 2017).
[103] Adrian K. Felix & W. Michael Garner, *Tricks of the Trade: Navigating Deceptive and Unfair Trade Practice Statutes in Franchising*, ABA 47TH ANNUAL FORUM ON FRANCHISING W-5, at 3 (2024).
[104] Marshall T. Kizner, *Unreasonable Reliance – Defending a Claim for an Alleged Item 7 Misrepresentation*, FRANCHISE LAW JOURNAL Vol. 42, No. 4, at 421 (Fall 2023).
[105] 649 F. Supp. 969 (W.D. Wa. 1986).
[106] *See e.g., Picktown Foods, LLC v. Tim Hortons USA, Inc.*, Case No. 17-21072-CIV-ALTONAGA/Goodman, 2017 WL 9854073 (S.D. Fla (Nov. 8, 2017); *Bayit Care Corp. v. Tender Loving Care Health Care Services of Nassau Suffolk, LLC*, 843 F. Supp. 2d 381 (E.D.N.Y. 2012); *Kinnard v. Shoney's, Inc.*, 100 F. Supp. 2d 781, 799 (M.D. Tenn. 2000).
[107] *Kinnard*, 100 F. Supp. 2d at 799.
[108] *Id.* at 793.
[109] *DNB Fitness LLC v. Anytime Fitness LLC*, No. 11-cv4892, 2012 WL 1952662 (N.D. Ill. May 30, 2012).
[110] *Id.* at *3.

In cases involving Quizno's, franchisees were reminded that, "In the face of the UFOC and Franchise Agreement disclosures, it was not reasonable for the plaintiffs to rely on representations directly contradicted by the contract terms."[111] Courts dismissed not only federal civil RICO claims, Sherman Act Claims, and state antitrust claims, but state common law fraud claims as well. On the other hand, a more recent decision denying summary judgment on plaintiff franchisees' claims of fraud and fraudulent inducement contains the following finding, provided by the judge, "in hopes of focusing the parties at trial": "the disclaimer provisions in the franchise agreement do not make Plaintiffs' reliance on Defendants' alleged misrepresentations unreasonable as a matter of law but instead may be relevant to the reasonableness of Plaintiffs' reliance."[112]

Franchisees can also maintain claims for violations of state unfair trade practices acts where the franchisor unilaterally begins to withhold a royalty absent from the FDD and franchise agreement.[113] But, under many states' laws, franchisees face challenges when pursuing claims that the franchisor's imposition of fees violates a state unfair or deceptive trade practices acts. One challenge is that often such state laws require an actual or potential public impact in order for the franchisee to maintain the claim, and that also stymies franchisees' claims.[114] And in some instances, where no provision of the state law incorporates the requirements of the FTC Franchise Rule, a franchisee cannot recover under the state law.[115] Even where a state act might afford franchisees some rights against the franchisor, the state may not recognize claims for fraudulent practices based on representations relating to future events, like future costs or profitability.[116] The economic loss rule may also prevent franchisees from successfully pursuing claims for misrepresentations in franchise documents other than for breach of contract.[117]

Even so, sometimes, franchisees make headway with a breach of contract claim. In *Valpack Direct Marketing Systems, Inc. v. Triple O Partners, Inc.*, a franchisee alleged that the franchisor breached the franchise agreement based on a mandatory fee imposed by the franchisor that the franchisee claimed was not disclosed in the UFOC, which the

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[111] *Siemer v. Quizno's Franchise Co. LLC*, No. 07 C 2170, 2008 WL 904874, at *5 (N.D. Ill. March 31, 2008). *quoting Westerfield v. Quizno's Franchise Co.*, 527 F. Supp. 2d 840, 849 (E.D. Wis. 2007).
[112] *Cluck-U Chicken, Inc. v. Cluck-U Corp.*, 358 F. Supp. 3d 1295, 1311 (M.D. Fla. 2017).
[113] *Family Wireless #1, LLC v. Automotive Technologies, Inc.*, 15-CV-1310 (JCH, 2016 WL 183475, at *8 (D. Conn. Jan. 14, 2016) (denying motion to dismiss claims for violation of Connecticut Unfair Trade Practices Act).
[114] *See e.g., Colorado Coffee Bean, LLC v. Peaberry Coffee Inc.*, 251 P.3d 9 (Colo. App. 2010), *as modified on denial of reh'g* (Apr. 1, 2010), *cert. denied*, No. 10SC284, 2010 WL 4400079 (an actual or potential public impact did not exist, as required in order for franchisees to maintain a private cause of action under Colorado Consumer Protection Act).
[115] *Yumilicious Franchise, L.L.C. v. Barrie*, 819 F.3d 170, 176 (5th Cir. 2016) (no provision of Texas or federal law declares violations of the Franchise Rule are actionable deceptive trade practices under the Texas Deceptive Trade Practices Act and franchisee's claim dismissed because it failed to plead other elements required by the Texas law).
[116] *See e.g., Yogo Factory Franchising, Inc. v. Ying*, Civil Action No. 13-630(JAP)(TJB), 2014 WL 1783146, at *9 (D.N.J. May 5, 2014; *Aylin & Ramtin, LLC v. Barnhardt*, No. 19 C 3402, 2024 WL 325384, at *12 (N.D. Ill. Jan. 29, 2024) *citing Bixby's Food Sys., Inc. v. McKay*, 193 F. Supp. 2d 1053, 1062 (N.D. Ill. 2002) (citing Cont'l Bank, N.A. v. Meyer, 10 F.3d 1293, 1298-99 (7th Cir. 1993); *Barrington Press, Inc. v. Morey*, 752 F.2d 307, 310 n. 1 (7th Cir. 1985)).
[117] *See e.g., Yumilicious Franchise, L.L.C. v. Barrie*, 819 F.3d at 177-78.

franchisee claimed was incorporated by reference in the franchise agreement.[118] The franchisor argued to the contrary and further that the franchisee's claims did not state a breach of contract claim because the franchisee's claims were based on a breach of a provision in the franchisor's operations manual and other policies and procedures of the franchisor. The court denied the franchisor's motion to dismiss referring to multiple sections of the franchise agreement and noting that the franchisor required the franchisee to acknowledge that the franchisee read the UFOC, permitting the court to "assume the Franchise Agreement does incorporate the Offering Circular."[119] However, although the court denied the motion to dismiss the breach of contract claim, the court also noted that the franchisor "is authorized to periodically amend, modify, replace and supplement the policies and procedures." The court did not specify whether it believed the imposition of new fees undisclosed in the UFOC might be included in the policies and procedures the franchisor was authorized to amend. On the other hand, in *Lady of America Franchise Corp. v. Arcese*, the franchisee claimed that she did not contemplate termination fees in the form of future royalties because future royalties were not disclosed in Item 6 and Item 17 of the UFOC. That court determined that whether the franchisor complied with the UFOC Guidelines did not have any impact on whether the franchisee contemplated paying future royalties for a breach based on the plain language of the franchise agreement.[120]

In *Bird Hotel Corp. v. Super 8 Motels, Inc.*, the franchisor attempted to make changes to its customer loyalty program, the effect of which was allegedly an additional 5% fee payable by franchisees on gross room sales to TripRewards members.[121] The court found that the franchisor could not unilaterally impose a fee greater than what was provided in the franchise agreement (2%) and thus, the franchisor breached the agreement by requiring franchisees to pay a total fee of 7% for participation in the TripRewards program. The court noted that although it did not rely on the parol and extrinsic evidence offered by the franchisee in support of its claim,

> Franchisors are required under federal law to disclose to prospective franchisees in detail all the fees that a franchisee must pay to the franchisor and its affiliates as well as the formula used to compute the fees. The regulations specifically provide that "[i]f fees may increase, disclose the formula that determines the increase or the maximum amount of the increase. For example, a percentage of gross sales is acceptable if the franchisor defines the term 'gross sales.' " In accordance with these regulations, Super 8 represented to class members and to the Federal Trade Commission that "Recurring fees are limited to a royalty of 4% of gross room revenue, payable to Super 8 Motels, Inc. and 2% of the gross room revenue payable to the Super 8 Advertising and Reservation Fund. There are no other royalties or fees." It is the Court's view that Super 8's disclosure pursuant to these regulations indicates that the parties did not anticipate

[118] *Valpack Direct Mktg. Sys., Inc. v. Triple O Partners, Inc.*, No. 8:08-CV-1841-T-17EAJ, 2009 WL 10670750 (M.D. Fla. Aug. 24, 2009).
[119] *Id.* at *5.
[120] *Lady of Am. Franchise Corp. v. Arcese*, No. 05-61306-CIV, 2006 WL 8431025, at *6 n.8 (S.D. Fla. May 26, 2006) (in addition the court would not address whether the UFOC violated Florida's Unfair and Deceptive Trade Practices Act for its failure to plainly state that the franchisee was required to pay future royalties upon termination.).
[121] *Bird Hotel Corp. v. Super 8 Motels, Inc.*, No. CIV 06-4703, 2010 WL 572741 (D.S.D. Feb. 16, 2010).

> that Super 8 would be permitted under the terms of the Agreement to impose an additional recurring fee equal to 5 percent of gross room sales to TripRewards members.[122]

Still, civil actions are an uphill climb for franchisees claiming violations of the fee disclosure requirements of the FTC Rule. Franchisees must keep in mind that various limitations in statute and in contract may apply to their claims. In a climate rife with discussion about rebates and "kickbacks," it is also important to bear in mind the difference between fees paid to the franchisor and fees the franchisor receives from suppliers.[123]

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[122] *Id.* at *8, n.4.
[123] *Assoc. of Independent BR Franchise Owners v. Baskin Robbins Franchising, LLC*, Civil Action No. 16-10963-WGY, 2017 WL 4314607 (D. Mass. Sept. 27, 2017).