

Responsible Franchising: Policy Recommendations to Strengthen the Franchise Model

Today, there are **806,270** franchise establishments that generate nearly **3% of the U.S. Gross Domestic Product**. The franchise model creates unique business ownership opportunities – opportunities that allow higher percentages of women, veterans and people of color to own their own business than their non-franchise counterparts. The franchise model is comprised of **franchisors** (a brand that licenses to others the right to operate a business that uses its name and sells its products or services), **franchisees** (the individual business owners who license the right to operate a business under the franchisor’s brand), and **suppliers** (businesses and individuals that support the franchise system).

The International Franchise Association (IFA) is the world’s oldest and largest trade association representing franchising – franchisors, franchisees, and suppliers. **As part of its mission to protect, enhance, and promote franchising, IFA seeks to prevent the franchise business model from misuse and to promote responsible franchising by all stakeholders in franchising.** What follows are recommendations for all parties in franchising to foster responsible franchising and strengthen the franchise business model.



What is Responsible Franchising?

The sale of a franchise in the U.S. is governed by the [Franchise Rule](#), a federal regulation enforced by the Federal Trade Commission (FTC). The Franchise Rule, which is currently [under review by the FTC](#), requires a franchisor to provide a Franchise Disclosure Document (FDD). The FDD is an extensive pre-sale disclosure that is provided to a prospective franchisee. Broken into 23 “Items” or sections, the FDD contains information about the franchisor (including the franchisor’s corporate structure and leadership, litigation and bankruptcy history), the franchise opportunity being offered (including the fees and costs to develop and operate the franchised business, a franchisee’s obligations to the franchisor, and the franchisor’s obligations to the franchisee), how much other franchisees have earned, and other information about the franchise system. The FDD also includes a copy of the franchisor’s then-current form of franchise agreement, which governs the relationship between the franchisor and the franchisee.

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While this information is invaluable and necessary, [recent academic research](#) has shown that the **length and complexity of the language used in the document can be a barrier to some first-time business owners**. In fact, a recent [GAO Investigation](#) found many prospective franchisees did not read the disclosures and were unaware of tools available to conduct due diligence on a franchise opportunity. The IFA seeks to make these tools and other educational resources more accessible and better utilized by prospective franchisees.

IFA believes responsible franchising should be practiced intentionally and consistently among franchisors, franchisees, and suppliers to protect the integrity of the franchise model and the community of small business owners that are part of franchising, the workers franchising supports and the consumers franchised businesses serve.

IFA believes the core practices of responsible franchising include:

- ✓ **Setting clear goals and expectations** during the pre-sale period so that franchisors and franchisees are aligned as to terms of their long-term relationship
- ✓ **Connecting prospective franchisees with the right opportunity** through due diligence and validation of all parties in the franchise sales process
- ✓ **Ensuring that franchisors and franchisees commit** to their respective operational obligations to protect both the brand and the franchisee’s equity in their business
- ✓ **Focusing collectively on driving unit economics and profitability for all parties**
- ✓ **Embracing collaboration** among the franchisor and franchisees through open communication with franchise advisory councils and independent franchisee associations when modifying standards to respond to changing market forces and consumer preferences.



The Solution

In response to this need for greater clarity during the pre-sales process and clearer usability of the information provided, IFA assembled working groups comprised of representatives of the key stakeholders in franchising—franchisors, franchisees and suppliers (including seasoned franchise attorneys, consultants and third-party franchise sellers)—to develop recommended “Responsible Franchising” principles and best practices. We began by coming up with recommendations on how to improve pre-sale disclosures. These recommendations are rooted in IFA’s [Statement of Guiding Principles](#), which states:

Improved pre-investment disclosure will benefit both prospective franchisees and franchisors by enhancing the competition among franchisors for qualified franchisee candidates. By clearly communicating the terms contained in a franchise offering, prospective franchisees will be better able to evaluate and make investment choices among the wide range of franchise opportunities available to them and to choose from those that meet their goals, ambitions, financial and other requirements.

In short, IFA believes one of the most important ways to improve outcomes in franchising is to enhance the franchise sales process before a franchise agreement is signed. These collective recommendations are crafted with the goals of providing a prospective franchisee with key information necessary to conduct due diligence and directing a prospective franchisee to seek additional resources aligned with the significance of the investment before making a franchise purchasing decision.

To address these challenges and promote these goals, IFA proposes that the FTC and state legislators adopt the following suggestions regarding the pre-sale process.





The Role of the Franchisor

The Franchise Rules obligates franchisors to produce an FDD that supplies prospective franchisees with information about the franchisor, the franchise system and the agreements they will need to sign. All these disclosures are designed to make sure that investors make an informed investment decision.

However, prospective franchisees at times do not fully read and understand FDDs because the documents are long and complex. IFA believes franchisors can present the information currently required under the existing Franchise Rule in a more comprehensible manner.

Specifically, IFA recommends that franchisors present the information required in their FDDs in the following format:

- ▶ Shifting to a conversational, question-and-answer style of disclosure
- ▶ Adding an executive summary to facilitate an apples-to-apples comparison of franchise opportunities within an industry
- ▶ Restructuring sections containing cumbersome tables with illustrative examples and explanatory text
- ▶ Presenting information such as Initial Investment (Item 7), Financial Performance Representation (Item 19), Franchisee Information (Item 20), and Financial Statements (Item 21), better to tell the story of franchise system health
- ▶ Modernize the presentation of the FDD to enable the use of multimedia



The Role of the Franchisee

The franchise sales process can be daunting for an aspiring entrepreneur unfamiliar with franchising who may be considering many franchise opportunities and navigating the complexities of disclosure documents. In addition, many prospective franchisees are investing their life savings or, in some cases, putting up a home or retirement account as collateral for a loan. All are entering into long-term contractual relationships that span a decade or more with limited ability to exit the relationship. These contractual relationships can involve third parties like landlords, suppliers and lenders in addition to the franchisor.

Nevertheless, franchisees, like franchisors, have responsibilities in the pre-sale disclosure process. As Article 3 of IFA's [Statement of Guiding Principles](#) states:

Franchisees should clearly understand the franchise business model before investing. It is the responsibility of each prospective franchisee to conduct a thorough due diligence of the franchise system, to retain competent legal and other advisors, and to fully understand the terms contained in the Franchise Disclosure Document before signing any Franchise Agreement.

For these reasons, IFA recommends the following responsibilities for franchisees:

- ▶ Prospective franchisees need to fully investigate their investment in a franchise by comparing multiple brands, reading the FDD and retaining a franchise attorney.
- ▶ Prospective franchisees must validate any franchise opportunity (as well as the franchise seller presenting the franchise opportunity, as further discussed below) through interviews with existing franchisees.
- ▶ Prospective franchisees should understand the risks of business ownership generally and the obligations they will have to many other parties related to the operation of the franchised business, such as suppliers, landlords and lenders.



The Role of the **Supplier**

Third-party franchise sellers, one of the many supplier businesses in franchising, are individuals or companies that are engaged (whether directly or indirectly) in the business of offering franchises on behalf of a franchisor. Third-party franchise sellers may refer to themselves in different ways, including franchise brokers, franchise broker organizations, franchise sales organizations, business coaches, advisors, referral sources, franchise experts and sales consultants.

Often, a prospective franchisee engages with one or more third-party franchise sellers for weeks or months before engaging with the franchisor of a franchise opportunity being considered. Unlike some industries, like real estate and insurance, there are no mandatory disclosures about third-party franchise sellers required under federal or state law, nor are there any required certification, licensing or continuing education requirements that apply to third-party franchise sellers. Often the prospective franchisee does not even understand that the third-party franchise seller is independent of the franchisor of the franchise opportunity being presented. In recent years, third-party

franchise sellers—including broker networks and organizations, individual brokers and franchise sales organizations—have had an increasing role in the growth and expansion of franchise systems.

For these reasons, IFA recommends the following disclosures be adopted for third-party franchise sellers:

- **Recent professional experience**
- **Litigation history**
- **Services performed on behalf of franchisors and compensation received**
- **Industries represented and the number of brands represented within each industry**
- **Franchisees to whom franchises were sold during the prior calendar year**
- **Standardized information about the different categories of third-party franchise sellers and questions a prudent prospective franchisee may ask their third-party franchise seller**



What Happens Next:

IFA encourages policymakers to support the adoption of these recommendations as part of the FTC's ongoing review of the Franchise Rule.

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