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“If It’s Not Broken, Don’t Fix Break It”— The FTC Targets the Franchise Business Model

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Historically, the Federal Trade Commission (FTC) has shied away from regulating the substance of franchisor-franchisee relationships. A recent FTC press release, however, suggests this may soon change. If so, it is by no means clear that such a change would be beneficial for franchisors, franchisees, or consumers who patronize franchised businesses.

The FTC’s March 10, 2023 press release seeks public comment on “franchise agreements and franchisor business practices, including how franchisors may exert control over franchisees and their workers.” The relatively short time period for public comment (only 60 days) suggests that the FTC may already be contemplating significant new regulation of franchisor business practices and the terms of franchise agreements — as does some of the rhetoric of the press release. For example, the press release cites “growing concern around unfair and deceptive practices in the franchise industry.” It claims that “the promise of franchise agreements as engines of economic mobility and gainful employment is not being fully realized, and the unequal bargaining power inherent in these contracts is impacting franchisees, workers, and consumers.” Finally, the press release asserts that the FTC’s request for information “will begin to unravel how the unequal bargaining power inherent in these contracts is impacting franchisees, workers, and consumers.”

Regardless of just what changes the FTC may have in mind, franchising has certainly long been no stranger to FTC regulation. The FTC shares responsibility for civil antitrust enforcement with the U.S. Department of Justice Antitrust Division and also promotes consumer protection. Section 5 of the FTC Act empowers the FTC to regulate “unfair methods of competition” and “unfair or deceptive acts or practices.” 15 U.S.C. § 45. To the extent franchise agreements contain pricing or other provisions that are problematic under federal antitrust law, they may also constitute “unfair methods of competition” under Section 5 of the FTC Act. To the extent franchise systems engage in advertising claimed to be false or misleading, they may run afoul of FTC regulations that identify the circumstances in which advertising claims about a franchise system’s own goods and services (or those of a competitor) are “unfair” or “deceptive.”

Franchising itself has been specifically regulated by the FTC since 1979, when the original Franchise Rule (16 C.F.R. Part 436) took effect. It requires the disclosure of certain information in a prescribed

format — originally known as a Uniform Franchise Offering Circular (UFOC), now known as a Franchise Disclosure Document (FDD) — so that prospective franchisees can make an informed decision whether to invest time and money in the franchised business vis-à-vis competing opportunities. In other words, the FTC Franchise Rule takes a page (133 pages, to be exact) from the playbook of the securities laws after which it was modelled.

In contrast, the March 10, 2023 press release suggests the possibility of much more extensive FTC regulation of franchising, the result of which could be to invalidate contractual provisions that are common in franchise agreements. The clear implication of the FTC's press release is that franchisor "control over franchisees" is bad for franchisees (and possibly workers and consumers as well). Although reasonable people may disagree on this issue, most courts that have considered the franchise business model have reached the opposite conclusion. Earlier in the history of franchising, plaintiffs' lawyers routinely challenged franchisor control over franchisees as an unlawful restraint of trade, in violation of federal antitrust law. Ultimately, most such legal challenges were unsuccessful. In a 1964 landmark case involving CARVEL® ice cream franchisees, the Southern District of New York recognized (and the appeals court agreed) that "the cornerstone of a franchise system must be the trademark or trade name of a product," concluding that "uniformity of product and control of its quality and distribution . . . causes the public to turn to franchise stores for the product."[1] In 1980, the U.S. Court of Appeals for the Fourth Circuit similarly rejected an antitrust challenge to the controls imposed on McDONALD'S® restaurant franchise operators. The court observed that a franchisee "pays not only for the right to use a trademark but for the right to become a part of a system whose business methods virtually guarantee his success," stating that the franchisee's "business is identified with a network of stores whose very uniformity and predictability attracts customers."[2] According to the court, franchisees benefit from the uniformity and predictability that results from "pervasive franchisor supervision" over "all facets of the business, from the design of the menu board to the amount of catsup on the hamburgers, nothing is left to chance."[3]

To the extent there is empirical evidence on this subject, it does seem to bear out the courts' observations in the foregoing cases. A study in the late 1980s concluded that franchisees in systems whose franchisors exerted less control over franchisee operations were, on average, less profitable.[4] Another study, completed in 2010, found that franchised businesses were more likely to remain in operation than most independent businesses.[5] In short, it is entirely possible — and perhaps even likely — that weakening franchisors' control over their franchise systems could have the unintended consequence of harming the very franchisees that the FTC says it wants to help.

Regardless, any effort by the FTC to use its regulatory authority to reduce the control exercised by franchisors over franchisees risks running afoul of the federal trademark statute, the Lanham Act. By definition, a "franchise" subject to the FTC Franchise Rule involves a license to use or some other association with a trademark. As the owner of the trademark(s) licensed to franchisees, the franchisor has the absolute right — and in fact an affirmative duty — under Section 45 of the Lanham Act to control the quality and uniformity of the goods and services associated with its trademark.[6] Whether a federal agency can, by simply issuing a regulation, deprive franchisors of their intellectual property rights is debatable, to say the least.

The FTC's March 10, 2023 request for comments comes on the heels of its February 16, 2023 forum discussing a proposed sweeping federal ban on employee non-compete agreements, both retroactively and prospectively, in almost all circumstances. As it stands, the proposed federal ban on non-compete agreements would not yet extend to non-compete agreements outside the employment context (including non-competes in franchise agreements). The latest FTC request for public comments about franchisor "control over franchisees and their workers," however, may portend such

a change. For more on the FTC's proposed ban on employee non-compete agreements, read Foley's analysis here.

Non-Competes in Franchise Agreements Benefit Franchisees and Franchisors Alike

FTC regulation limiting the legality and enforceability of business-to-business non-compete agreements could negatively affect both franchisors and franchisees. Franchisors are not the only beneficiaries of non-compete agreements in franchise relationships. To be sure, non-competes are an important tool used by many franchisors to protect their confidential information, trade secrets and other intellectual property, and brand standards.[7] But franchisees can also derive substantial benefit from non-compete agreements with their franchisors. One of the primary benefits is preventing unfair competition from former franchisees that engage in "free riding" on the franchisor's training and investment by establishing competing businesses in current franchisees' areas of responsibility.[8] The arguably legitimate objectives of non-competes in franchising can thus include creating a stable and predictable business environment, reducing the risk of losing customers to unfair competition, and fostering a relationship of trust and cooperation between the franchisor and franchisee.[9] At bottom, non-compete agreements can help ensure that both the franchisor and franchisee are fully invested in the overall success of the franchise system, such that they can freely support and cooperate with one another to drive positive business results.

A wholesale ban on non-competes in franchise relationships would obviously negate these benefits, to the detriment of franchisees and franchisors alike. Although the FTC's latest request for comment neither mentions non-compete agreements nor takes a position on their utility in the franchise model, franchisors should pay close attention to the FTC's renewed focus on franchise regulation and how that focus may affect the enforceability of non-compete agreements in franchise systems.

If you would like to submit a public comment in response to FTC's latest request for comment, please contact the authors of this article for additional information.

FOOTNOTES

[1] *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed*, 381 U.S. 125 (1965).

[2] *Principe v. McDonald's Corp.*, 631 F.2d 303, 309 (4th Cir. 1980).

[3] *Id.*

[4] *See* Barbara Marsh, "When Franchisees Go Their Own Way—Dairy Queen Seeks to Rein In Unruly Empire," *The Wall Street Journal* (July 6, 1989).

[5] *See* "Franchise Success Rates and Statistics: What's Hot for 2023," afcfranchising.com (December 2, 2022).

[6] 15 U.S.C. § 1127. *See, e.g., Taco Cabana International, Inc. v Two Pesos, Inc.*, 932 F.2d 1113, 1121 (5th Cir. 1991), *aff'd*, 505 U.S. 763 (1992); *Oberlin v. Marlin Am. Corp.*, 596 F.2d 1322, 1327 (7th Cir. 1979); *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*, 549 F.2d 368, 387 (5th Cir. 1977); *Edwin K. Williams & Co. v. Edwin K. Williams & Co.-East*, 542 F.2d 1053, 1059-60 (9th Cir. 1976), *cert. denied*, 433 U.S. 908 (1977); *Power Test Petroleum Distribs., Inc. v. Calcu Gas,*

Inc. 754 F.2d 91, 97 (2d Cir. 1985).

[7] *See, e.g., Fitness Together Franchise, LLC v. EM Fitness, LLC*, 2020 WL 6119470, at *11 (D. Colo. Oct. 16, 2020) (recognizing protectable interest in franchisor goodwill, customers, market presence, and trade secrets); *South Bend Consumer Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209, 213 (N.D. Ind. 1983) (recognizing protectable interest in "the franchise itself," "customer contracts," and "goodwill"); W. Michael Garner, 2 Franch. & Distr. Law & Prac., § 8:53 (Dec. 2021).

[8] *See, e.g., Tantopia Franchising Co., LLC v. West Coast Tans of PA, LLC*, 918 F. Supp.2d 407, 418 (E.D. Pa. 2013) (noting franchisor interest increasing the marketability of the franchise to potential new franchisees and explaining that "[t]he presence of a competing tanning salon within the geographic area protected by the Non-Compete Covenant *reduces the value of the Tantopia Mark to a potential new franchisee who might consider opening a Tantopia business within the area*" (emphasis added)).

[9] *Id.*

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