Economic Mobility: Is the American Dream in Crisis?

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Chairman Cotton, Ranking Member Cortez Masto, and members of the Subcommittee and Committee, thank you for the opportunity to speak to you today. My name is Keith Miller. I am a 30-year franchise owner of Subway. Notice I use the term "franchise owner". While more commonly called a franchisee, and I will often use that term today, I prefer "franchise owner" reminding everyone that when you buy a franchise, you own something, you are an owner. I am a past president of the North American Association of Subway Franchisees (NAASF) and for 6 years, I was chair of the Coalition of Franchisee Associations (CFA), the largest franchisee-only organization in the country. I have long been an advocate for franchise owners. In 2018, I started a small business, the Franchisee Advocacy Consulting with the tagline, "Advancing franchisee causes through engagement and advocacy". I have been a voice in the industry for those that are not able to speak or are afraid to speak up.

With my background and expertise, today I will speak specifically about the franchise industry, the good, the bad, the ugly. I will talk about the opportunities the industry provides to realize the American Dream, and how that dream can turn into a nightmare. I will discuss about how the government has become an enabler for bad franchises, and finally, I will discuss oversight and transparency which I believe will clean up the industry and help rebuild some trust to help others realize the American Dream.

The franchise industry is large[i], and, over time has allowed many to realize their American Dream. The lodging industry, for example, is one that has allowed many early-generation immigrants to successfully own their own business and prosper. There are many examples of great brands that have provided these opportunities. The franchise business model itself is a brilliant business model, and one I support. However, because of little transparency and oversight, it is also an industry with far too many examples of predatory franchise companies that take advantage of prospective entrepreneurs and leave them overworked, despondent and broke. We hear the lure of the industry as it advertises to be your own boss, with proven business models, and no experience necessary. On top of that, the industry targets those most vulnerable; immigrants, veterans, and retirees. Remember, I am a small business owner myself, hardly one that advocates for an abundance of regulation. But, in the case of the franchise sector, the government provides inadequate oversight and access to money which can encourage fraud and lead to failed businesses and demoralized business owners.

Let's first talk about oversight. Most believe that this large sector is heavily regulated. The Federal Trade Commission (FTC) does regulate presale disclosure through the Franchise Rule. The FTC requires a prospective franchisee receive a Franchise Disclosure Document, or FDD. But I ask, how many of you knew that the FTC doesn't even collect the FDD, and on the first page of all FDDs it specifically states in bold print, "**Note, however, that no governmental agency has verified the information contained in this document**". The FTC permits franchisors to write terms into a contract that denies franchisees the right to buy goods from a lower-cost source, prohibit franchisees from organizing into an association and even bans them from sharing their experience with current and future franchise owners. It permits contracts that allow franchisors to provide fraudulent financial information outside of the FDD. The FTC allows contracts that force franchisees into arbitration which can make it easier for the franchise corporation to take the outlets of successful franchisees through minor infractions. I wouldn't call that heavily regulated.

Why is this important? Let's look at the securities industry for example. If you invest $100,000 in a stock, what is your risk? Well, worst case, you could lose your entire investment, so your risk is $100,000. Now let's look at a franchise, so I'll ask the same question, if you invest $100,000 in buying a franchise, what is your risk? No, it's not the $100,000 you invested; it's much more, it's all the assets you own! Personal guarantees are required in most franchise agreements, and often extend to the immediate family, so a separate

business entity provides little to no protection of personal assets. Yet here we have an industry with no governmental agency even reviewing the documents. In addition, once the ink is dried on the signed franchise agreement, there are no federal laws or regulations specific to the franchise industry to manage the relationship of that investment. There are 19 states that do have some level of relationship laws. This lack of oversight is vastly different from any industry I can think of when it comes to protecting the investors. Most laws and regulations are there to protect the investors first. Boards of directors have that fiduciary responsibility to protect those investors. In the franchise industry, the primary investor, as a class, is the franchise owners. However, the franchisees are not shareholders, they are considered stakeholders, therefore the franchise company has no such fiduciary responsibility to them or their investment.

Let's look at some numbers. Franchise Grade, a market research firm that analyzes franchisee investment risk published an article titled, "Can A Few Bad Apples Spoil the Industry Investment?"[ii] It looked at 1,900 franchise systems, using disclosure information from 2010 through 2014. In that 5-year period, they noted 168,585 new business units had opened, but also that 138,825 businesses had closed, for a net gain of only 29,760 businesses. Even more concerning was the difference between the top and bottom quartiles. While the bottom quartile accounted for 25% of the openings, it closed double the outlets opened and accounted for 61% of all closed outlets. With full disclosure and better oversight, very few of those failing stores would have opened and many entrepreneurs and employees would have been better off.

If this high level of failure were happening with private capital, it would be bad enough. But the Small Business Administration's loan guarantee programs enable failure and fraud. In 2013, the Government Accountability Office released a report (GAO-13-759) that showed during the previous 10 years, "SBA guaranteed franchise loans under its 7(a) program totaling around $10.6 billion. SBA made guaranteed payments on approximately 28 percent of these franchise loans, representing about $1.5 billion."[iii] This means that twenty-eight percent of franchise loans saw the owner not only lose their business, but all their assets. Franchise owners post significant collateral – their savings, their homes, other land or property they hold. When SBA loans are charged off, this means the franchise owner has already lost her or his collateral. Charge offs are paid for by higher fees charged to future borrowers and lenders and occasionally, the taxpayers. In fact, charge offs in the 7(a) program are so high now that the Trump Administration requested an appropriation of $99 million.[iv] Defaults should be rare, and for many franchise brands they are. But some franchise brands have very high levels of defaults, a fact that is very difficult for a potential franchise owner to learn.

Too many – the franchise corporations, the SBA, some in Congress -- only look at SBA funds showing how many businesses have opened, and how many jobs they created. Unfortunately, none of them stand up and count the businesses that fail, and the jobs that are lost. Failing franchisees cannot pay good wages. Some have nearly no employees; the franchise owners and family members work non-stop just to keep the business afloat. Franchise owners struggle to pay back the loan and meet the terms of a decades-long contracts.[v] Failing franchisees struggle to pay any wages and payroll taxes.

This concern is bipartisan. Ranking Member Cortez Masto recently sent letter outlining her concerns of four specific brands to the SBA and asking for loan performance information on these brands.[vi] In 2014, then Senator and Budget Ranking Member Jeff Sessions inquired about the "moral hazard" that was created by the SBA when banks can profit from poorly underwritten loans.[vii]

Let's look at some examples of the breakdown in this industry, and how dreams have been shattered. Amin Abdelkarim is an immigrant from Egypt, who moved to the Dallas area. He worked double shifts at the Dallas

Fort Worth airport and saved enough money to think about going into business, in search of his American Dream. He ended up purchasing a Dickey's Barbecue Pit franchise. He was given the FDD, and a spreadsheet showing estimated startup costs, and was provided assistance with applying for an SBA 7(a) loan. Unfortunately for him, the estimates given were grossly incorrect, and all his startup capital was spent getting the business open. He opened his business in August 2018, and Amin contacted me in September 2018, one month after opening, asking for help. He was already broke, he could not pay his SBA loan, and feared he would lose his home, rendering his family homeless. Dickey's idea of assistance was reminding him of the 60-month liquidated damages clause in his contract. His other option was to sell his business to a buyer Dickey's found, for pennies on the dollar. Either way, he knew his SBA loan was going in default, and he was going to lose all his assets. At one point he said to me, "in a few weeks, I will find myself, my disabled wife, and my 89-year old mother in law in the street, with no house, no car, and no money".

Some will argue, it's his fault, he didn't have the skills to be a business owner. This is what franchisors will always blame, the franchisee was not a good owner, so it's not the company's fault.

Here's the problem in the industry.

When a franchise is sold, both the franchise corporation and the franchise business should profit. However, the franchise corporations, brokers, and/or "consultants" make money up front. They earn a profit from the initial franchise fee, then the franchise corporation continues to make money on the ongoing royalties, most often based on revenue, not profit. The franchise corporation has little risk, while the franchise owners often struggle to make a decent living.[viii] The franchise owner has all the risk. The bank profits from the loan, a loan they often would not approve without the SBA's guarantee. In fact, banking regulators do not even consider government-guaranteed loans and do not get involved when those loans fail.

You may wonder why the SBA continues to guarantee loans when in fiscal year 2018, Dickey's started with 562 units, opened 72 new units, yet had terminations and ceased operations of 113, for a net loss of 41 outlets.[ix] Add in 44 transfers, many of them forced for pennies on the dollar, and you have a disorderly attrition rate of 28% of the total outlets in a single year. During the last 10 years, Dickey's took out 246 SBA loans, and 41, or 17% have been charged off. A recent survey of 201 of 336 Dickey's BBQ store operators representing 330 stores, found that 85% of current store owners would NOT open a Dickey's franchise. Of those 201 store owners, 84% said that buying a Dickey's franchise did NOT meet their expectations. These results do not include Amin and others like him who no longer have their store. And it's not just Dickey's - the SBA has a history of backing poor performing brands.[x]

Companies' pushes to sell more franchises has led to many franchisees that should not have been provided access to government-guaranteed loans. Again, many profit without risk. But take, for example, Experimac.[xi] This is a brand that started franchising in 2016. At the end of 2018, their disclosure document showed 101 franchised units in the United States. They started franchising just 3 years ago, yet have received 77 SBA approved loans, of which 23, or 30%, have already been charged off. Experimac is part of the United Franchise Group, which markets multiple franchises. They send prospective franchisees to a hand-picked loan broker. UnhappyFranchisee.com reported that this loan broker participated in a podcast in 2017 where he stated he had coordinated funding for 70 Experimac franchise owners, including facilitating SBA Express loans through Celtic Bank, 401k Rollover for Business Start-up (ROBS), and equipment leases. He further stated that financial projections are the biggest challenge but commented "I do that".[xii] This means he could provide financial projections that were not part of the FDD and would not be violating any kind of disclosure requirements.

Mark Shor retired from his IT job at a university and bought an Experimac franchise in Henderson, just outside of Las Vegas area. The franchisor directed him to the loan broker mentioned above that helped him apply for and obtain an SBA 7(a) loan from Celtic Bank. The loan broker provided him a projection spreadsheet that showed nearly $700,000 in profits for the first year, $995,400 the second year. The current FDD shows the highest volume franchised location at revenue of $822,375, with an average unit doing $410,639. I personally was contacted by this franchise group, and when I asked if I could expect to do revenue of at least $500,000, I was told in an email from a company representative that they have "locations in our Million Dollar Club". This of course is false. Mark has continued to work his business, still open while those around him have closed, but still bleeding cash. The only way he is surviving is by monthly dipping into his retirement to pay the SBA loan to keep it current. While he may be the exception and not default his loan, his retirement nest egg will be painfully depleted.

Complete Nutrition is a shocking story of abuse of franchise owners. At the beginning of March this year, the Complete Nutrition franchise notified franchisees that at the end of March, they would no longer be a franchise company. Franchisees could continue as a retailer for the nutrition company with no support from the company or could opt out of their contract for a $10,000 termination fee. On April 1, the Point of Sale system for franchisees was cut off, but not before the company data mined the customer information. A few days later, an email went out telling all customers that their local Complete Nutrition had been sold but not to worry, customers could order online 24/7. A few days after this, the company claimed that was a mistake, but is that really believable? Franchisees have told me that the company continues to market to their old customer base, selling products online significantly cheaper than they can in the brick and mortar location. Many of these franchisees recently bought into Complete Nutrition, at a price of $49,500, but now have a franchisor that has cut them off and is stealing their customer base. More than half the Complete Nutrition locations were financed using SBA loans. Before the recent actions, 12% have been charged off over the last 10 years.

Michael Hataway is a Complete Nutrition franchisee in Reno. Since the franchisor has pulled support, sent out the email that they have been sold, and aggressively marketed online sales, his sales have crashed. His finances and personal life are in shambles and he is heading towards default of his SBA loan. Jamie Stephens, a franchisee with 5 stores in North Dakota and one in Minnesota had 5 SBA loans totaling around $1.5 million when Complete Nutrition completely changed their business environment. But don't worry, the franchisor has kept their $49,500 franchise fees collected per outlet, some from the last few years.

Finally, Huntington Learning Centers. This brand, and the SBA lending to it, prompted an SBA Inspector General audit (Report No. 11-16) in 2011. The IG found that SBA 7(a) loans to Huntington Learning Center franchises had significantly inflated first year revenue projections.[xiii] Bob Spada from Connecticut was one such franchisee. He was given a loan consultant to work with and applied for a loan with Banco Popular. His first-year revenue projection given was just over $500,000, and he received a $300,000 loan. As he started to fail, he wondered why he was so short of projections. He found others opening at the same time were also far short of their projections. Then he found out that actual first year revenue numbers for an average center was really $249,000, less than half his projection. A mature location had average revenue in the low $400,000s. As he dug into the reasons for this projection, he discovered the devious means. To qualify for that $300,000 loan, he would need about a $75,000 profit that first year to meet the required debt service coverage ratio. To reach that profit level, and reverse engineering the numbers, you would need just over $500,000 in revenue. The numbers given to all these franchisees were false. It was clear that Huntington's consultant had reverse engineered the profit numbers just to qualify for the loans. And when the loan was funded, Huntington

Learning Centers collected a $60,000 franchise fee. Banco Popular sold these loans off on the secondary market for a nice profit. The only one really left with the liability was Bob, the franchisee. Bob was forced to file bankruptcy and lost everything. He's also an example of the true cost of to the economy. While the SBA claims the costs/losses are managed within the program, that is only true for the SBA loan amount. In reality, Bob, in an effort to make the business a success ran up huge credit card debt and got a home equity loan. The total losses of his mortgage, equity loan, and credit cards more than doubled the losses of the SBA loan. Who accounts for that loss to the economy?

Corrective Action Steps are Possible

When an industry tolerates deception and fraud, it is damaging to those entrepreneurs who see their dreams become nightmares. It is terrible for communities when stores close, jobs are lost, and homes are foreclosed. Here are some steps that need to be taken to rectify some of the issues in the franchise industry. Many are contained in the Coalition of Franchisee Associations' comments to the FTC of the Franchise Rule Review, which is attached. Some of those highlights are:

- Provide adequate resources and ensure staff will review compliance of the Franchise Rule, make the disclosure documents publicly available, and confidentially receive complaints so the franchisee is not subject to retaliation.
- Provide for a Private Right of Action. It is obvious the FTC does not have the resources nor the priorities to enforce their own Franchise Rule. A private right of action would provide damaged franchisees the right to sue for violations. Congress must legislatively make this change.
- Prevent FDDs from including disclaimers which allow franchisors to amend their policies outside the specific language of the franchise agreement. This is most often accomplished by including a statement that the franchisee must follow all policies in the most current Operations Manual. However, items often included in the Operations Manual are not operational issues, but contract changes. For example, including a section that limits how many outlets you can sell to a single buyer.
- Require the FDD be a binding contract for the term of the franchise agreement, which may be 5, 10, or up to 20 years. If the FDD is used as the part of the due diligence in purchasing the franchise, and the franchisor can change any of the practices that have been disclosed, then what value is the disclosure?
- Prohibit disclosures outside of the FDD, made both informally and by third parties.
- Make all FDDs publicly available on the FTC website.
- Increase disclosures on revenues, costs, loan repayment, defaults, and other data for both first year and mature units.

The next step is to require increased FTC disclosure of brands qualifying for SBA 7(a) loans. Any franchise owner receiving an SBA loan should get 1) disclosure of average first year revenues for franchised outlets and 2) disclosure of first year ceased operations and transfers. While opponents will claim that they do not want more government oversight on private business, they have no problem asking for government-guaranteed money to line their pockets. This change is not to curtail SBA lending, but to ensure more money is provided to viable brands at reduced fees and rates.

Finally, it is time for Congress to pass comprehensive franchise relationship legislation that protects franchise investors after the contract is signed. This legislation should include:

- Rights to association without interference or retaliation and an end to non-disparagement clauses that prohibit potential franchise owners from learning about the business from current franchise owners.
- Termination rights, to ensure fair due process is afforded to all franchise owners.
- Transfer rights, to ensure the right to transfer and monetize the equity the franchise owner has earned.
- Property rights to ensure the franchise owner is protected on the assets they have paid for.

Conclusion:

In summary, the franchise business model can be, and should be, a model for economic mobility, and realizing the American Dream for generations. However, leaving the industry to police itself is not working, and destroying many lives, while profiting a few individuals and corporate executives. There is no reason for this. Access to SBA money should be the model of transparency of the industry, one that ensures the best underwriting procedures. The industry forgets who the real investors are, the franchise owners, and their government fails in protecting those who invest, employ, support, and pay taxes in every community across this country.

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