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2024 Recap of Franchise Developments and 2025 Trends To Watch

There were a number of important and potentially impactful developments in 2024 that we predict will continuing developing and trending in 2025. Some of these topics are also discussed in other articles in this annual update. The below lists a few additional trends from 2024 to watch that will impact franchise law.

Amendment to the FTC Franchise Rule and Related Franchise Relationship Issues and Disputes

The Federal Trade Commission's (FTC) efforts to amend the FTC Franchise Rule (the Rule) will continue in 2025. While we continue to expect some changes to the current disclosure requirements, and we suggested some changes to the FTC in response to its request for information (RFI), we anticipate focus in 2025 to be on efforts to add federal regulations governing relationship issues and not just to make changes to the existing disclosure requirements. After a long comment process in which the FTC showed its interest in multiple relationship issues, in July 2024 the FTC issued a report (the Report) with a request for additional comments on certain relationship issues and an extension of the comment period through October. The FTC board also issued a policy statement and FTC staff issued guidance on relationship issues that show the direction and likely areas of focus.

In its Report on its findings to date, which it stated were based on some of the comments received in response to its RFI, the FTC listed several relationship issues that it found to be the most prevalent potential needs for rulemaking. Two of the top three issues related to system changes and new or increasing fees that are often imposed by franchisors through changes to the operations manual. The FTC described complaints from franchisees and its concerns with franchisors adding fees for new technology and new services when those services and fees were not disclosed in the Franchise Disclosure Document (FDD) or provided for in the franchise agreement. We, too, have found that this is a growing tension in many systems and predict that franchisors and operators will experience much more activity navigating disputes in 2025, and that this will be a continued focus of the FTC and in states with existing franchise relationship laws.

In the staff guidance issued on the same day as the Report, FTC staff stated that they

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interpreted the existing FTC Act as preventing franchisors from imposing fees on franchisees that were not disclosed in the franchisor's FDD and provided for in the franchise agreement. The staff provided this guidance in direct response to the above-noted franchisee reports of ever-increasing fees, including processing and technology fees and fees for training, marketing, property improvement and other product or added services required by the franchisor. The staff guidance opines that it is illegal for franchisors to impose such undisclosed fees — what the FTC calls junk fees — and the staff repeated several times its concern that such new undisclosed fees may raise costs and be the difference between a profitable franchise and an unsustainable one.

The challenges of meeting consumer demands and competition through innovation and technology, which are essential to staying competitive but also add costs and fees, will be a major issue in 2025. This tension in many systems is mounting as brands incur the research and development costs necessary to employ much-needed new technology and upgrades and then attempt to mandate it to franchisees with some level of corresponding fees to pay for the costs by the operators and franchisees. Franchisees often want the technology and new services, but not the added fees hitting their operating costs. While the expectation often is that the added service or technology will increase revenue as much or more than the increase in fees and costs, that is not always the case, nor is the revenue as immediate as the added costs and fees. Who should pay the higher costs and added fees necessary to keep up with competitive pressures and customer demands? This will remain, and we predict grow as an issue in 2025. The FTC communications, if not direct actions, in 2025 will enhance the immediate nature of this growing tension.

In addition to the FTC's issuing the Report and reopening the comment period, and the FTC staff providing the staff guidance, the FTC board also issued a policy statement warning that franchisors' use of contract provisions, including non-disparagement clauses and clauses that prohibit franchisees from engaging in conduct that harms the brand's goodwill, violate the FTC Act if used to stifle franchisee communications to the FTC and other government bodies. The statement emphasized that franchisee reports and voluntary interviews are a critical part of FTC investigations, and franchisees' reluctance or inability to file reports and discuss their experiences may hamper the agency's work to protect franchisees. The board also reiterated that threats of retaliation against a franchisee for reporting potential law violations to the government are unlawful.

These statements coupled with the topics on which the FTC requested comments demonstrate an interest to add the Rule's relationship issues.

Additional franchise relationship issues and trends that we anticipate will continue and increase in 2025 include claims and disputes over the estimated initial costs in Item 7 and over renewal conditions. We saw both of these relationship issues rise with an increase in the number of claims and disputes between franchisees and franchisors. The FTC included renewal conditions in its top 12 list of key issues raised by franchisees, as well.

Noncompete Covenants

The enforceability of noncompete covenants is a front-and-center legal issue for 2025. 2024 saw substantial legislative and administrative rulemaking activity at the federal and state levels. With a new administration and states continuing to consider changes, there is likely more to come on this front.

While the focus is generally on employer-worker relationships, the franchise relationship is not immune from the ongoing efforts to make enforcing noncompete covenants more difficult. Indeed, many decisions addressing noncompete covenants in franchise agreements look to case law on non-competes in varying contexts when determining

whether to enforce a noncompete covenant against a franchisee or former franchisee. Thus, changes in existing laws and adding laws necessarily impacts noncompete covenants in franchise agreements.

Generally, the law in most states historically has been that a noncompete covenant is enforceable when it is intended to protect legitimate interests, for example, confidential information or trade secrets, and is reasonably tailored to the necessary geographic limits, duration and prohibited conduct to protect the legitimate interest. However, in recent years, multiple states have tightened the enforceability in the employment context and, generally, these state statutes only carve out minimal exceptions for the sale of the business and sometimes highly compensated individuals. Some states have even added criminal penalties for an employer's including or attempting to enforce a noncompete covenant in violation of the new law. States with recently enacted laws preventing or greatly limiting the enforcement of noncompete covenants include Colorado, Illinois, Maine, Maryland, Minnesota, New Hampshire, Oregon, Rhode Island, Virginia and Washington. Several other states are considering new legislation and some states' courts have greatly reduced the enforceability of noncompete covenants, including California, which added to its statute in 2024. Where and how a franchise agreement covenant not to compete fits into the employment-oriented noncompete law is often uncertain and unpredictable.

The FTC got involved at the federal level with a lot of activity in 2024. It published a proposed rule in the Federal Register on Jan. 19, 2023, that would have greatly limited the enforceability of noncompetes in the employment context. While in the proposed rule the FTC stated that the rule was not intended to cover franchise relationships, it invited comments on whether to include franchise relationships — and in the above-referenced Report, it referenced concerns regarding noncompete covenants — and some suggested during the comment period that the rule should be expanded to cover franchisees.

Overall, the FTC received 27,000 public comments and has spent more than $500,000 and 6,000 hours on the rule. The FTC approved the new rule banning noncompetes on April 23 to take effect in 120 days. However, multiple lawsuits to enjoin the rule followed, and a Texas court enjoined the rule by order on Aug. 20 in the case of Ryan, LLC v. Federal Trade Commission. For now, the new rule will not take effect.

In yet another development, the North American Securities Administrators Association (NASAA) just issued "guidance" on post-term non-compete provisions in franchise agreements in January 2025. That guidance statement focused on the "reasonableness" of noncompetes in franchising, in which NASAA reiterated that "[p]ost-term non-competes should be narrowly drawn and reasonable in scope, duration and territory," such that the non-compete protects the franchisor's legitimate interests while sufficiently narrow to minimize harm to the former franchisee. This is in essence a recitation of the current law in most states to enforce a non-compete; but may signal a new item some state administrators will begin reviewing.

Misclassification

Recent years have seen substantial activity in the standard applied to claims that an employer misclassified a worker as an independent contractor as opposed to an employee. If misclassified, a worker has claims to greater benefits and related claims. As the standard has changed, the question of whether a franchisee meets the definition of an employee rather than an independent contractor remains. Indeed, efforts to make the standard easier to find employment status have substantial impact on the franchise model and relationships.

Over time, at least three standards have emerged: the “economic realities test,” the “ABC Test” and a two-factor test set forth during the first Trump administration for Fair Labor Standards Act (FLSA) claims, which focused on

1. The employer’s degree of control over the work and;
2. The worker’s opportunity for profit or loss.

In 2024, the Department of Labor (DOL) attempted to change the standard to the economic realities test for FLSA claims. The DOL published its final version of the rule on Jan. 10, effective March 11. As such, under the FLSA, the DOL employs a non-exhaustive six-factor test (the economic realities test) to determine whether an individual is classified as an employee or an independent contractor. This new rule rescinded the rule issued under the Trump administration, which never went into effect.

The Rule’s Non-Exhaustive List of Factors:

- Worker’s opportunity for profit or loss;
- Investments made by the worker and potential employer;
- Degree of permanence of the work relationship;
- Degree of control an employer has over the work;
- Extent to which the work performed is integral to the employer’s business;
- Use of a worker’s skill and initiative.

The big question is whether and, if so, when the DOL under the new Trump administration will attempt to go back to its prior proposed two-factor rule.

Meanwhile, the ABC Test remains in place in several states. This includes California, where Assembly Bill 5 went into effect Jan. 1, 2020, for determining whether a worker is an independent contractor or an employee under California employment law.

Under the ABC Test:

- A worker is an employee, not an independent contractor, unless the hiring entity can show all of the following:
    - The worker is free from control and direction;
    - The work is outside the usual course of the hiring entity’s business;
    - The worker is engaged in an independent trade.
- A worker is presumed to be an employee, rather than an independent contractor, unless all parts of the test are met.

Recent cases suggest uncertainty will remain for some time. 7-Eleven franchisees, as well as franchisees in the cleaning industry and other lower startup-cost systems, have continued to advance claims that the franchisees are entitled to employment benefits from the franchisor. The FTC even filed an amicus brief in favor of such a claim by 7-Eleven franchisees.

There are several takeaways for franchise relationships given this uncertainty. The new DOL test only applies to claims under the FLSA, but state-specific classification tests (like the ABC Test for California, Illinois, Massachusetts and New Jersey) are still applicable to state law claims. Thus, classification under state law might not be the same as under the DOL’s new independent contractor test. Further, depending on the franchise system, some of the factors are more likely to weigh in favor of the franchisee being an independent contractor, such as the investment by the worker and the opportunity for profit or loss depending on skill. But unfortunately, some of the factors, such as whether the worker relies on training provided by the company, whether the company uses

technological means to supervise the worker, whether the company prevents the worker from working for someone else and the extent that the work is integral to the company's business, could be argued to be present in almost all traditional franchise models. In light of this new test and its factors, franchisors may find they are misclassifying their franchisees as independent contractors and therefore face increased liability under the FLSA for not providing the required benefits to franchisees, such as minimum wage and overtime pay. Remedies under the FLSA include liquidated damages and attorneys' fees, as well as potential injunctive relief and civil or criminal penalties.

Joint Employer

The seesaw, or pendulum, regarding the standards for a finding of joint employment in the franchise context continued to go up and down, or back and forth, in 2024 and likely will not be settled in 2025. On Oct. 27, 2023, the National Labor Relations Board (NLRB) published its final rule revising the standard to determine whether multiple entities jointly employ certain employees under the National Labor Relations Act (NLRA). The previous test, established by rule in April 2020, required a showing of ***direct and immediate*** control over employees before an entity could be considered a joint employer. That rule was then rescinded and replaced with a new rule that would make it easier to establish joint employment. Under that proposed new standard, entities would be considered joint employers if they ***directly or indirectly share or codetermine those matters governing employees' essential terms and conditions of employment***, such as wages, benefits, supervision and direction, work and scheduling, hiring/ discharge, and workplace health and safety.

On March 8, U.S. District Judge J. Campbell Barker of the Eastern District of Texas vacated the NLRB's new rule. Judge Barker had previously stayed the joint employer rule until March 11. On May 7, the NLRB filed a notice of appeal to the Fifth U.S. Circuit Court of Appeals and Congress also passed a law to go back to the more traditional standards, but President Joe Biden vetoed that law. The NLRB has now withdrawn its appeal, so the old direct and immediate test is back for now and presumably will remain for at least the next four years under the NLRA. The test for joint employment under the FLSA has also been shifting. In 2020, the U.S. Department of Labor (DOL) under the Trump Administration issued a rule adopting a four-factor test for joint employment under the FLSA.

That test would have considered four factors: whether the potential joint employer

1. Hires or discharges employees;
2. Supervises or controls work schedules;
3. Sets pay rates; and
4. Maintains employment records.

This test focuses on the actual control over the relationship and is generally a higher standard to meet. Seven states and the District of Columbia filed suit against the DOL in the U.S. District Court for the Southern District of New York, asserting that the Trump-Era Rule violated the Administrative Procedure Act (APA) because it conflicted with the provisions of the FLSA. Seven months later, on September 8, 2020, the district court vacated substantial portions of the Trump-Era Rule. The Trump Administration and others appealed to the Second Circuit. In March 2021, the Biden Administration's DOL rescinded the Trump Administration's rule. The Second Circuit then dismissed for mootness.

The takeaways for joint employment include that legal standards vary by statute and court. The primary focus is "control": Does the franchisor control certain actions of the franchisee and the franchisee's employees' manner and means of how the franchisee runs its

business or the essential terms and conditions of employment (hiring, firing, discipline, supervision, direction, assignments)? As noted, some courts and agencies also consider indirect control, reserved right to control and control over other aspects of the franchised business, e.g., brand standards.

Vicarious Liability Claims and Direct Liability Claims

We anticipate that claims against franchisors by both customers and employees of franchisees will remain prominent in 2025. In our experience, these claims are on the rise and have seen an increase in third-party efforts to find not only vicarious liability under theories of agency and apparent agency, but also direct liability against the franchisor under claims of negligent supervision, training or assumption of duty and similar theories. These theories of direct liability essentially claim that if a franchisor imposes certain requirements that result in bodily harm or property damages to the customer or employee, the franchisor is directly liable.

Summary of Recommended Practices To Reduce Risks of Misclassification, Joint Employment and Vicarious Liability

Regardless of theory, each of the above areas of potential liability boil down to questions of control or the right to control. As such, some recommendations follow best practices to limit claims or reduce risk of adverse findings, including:

- Clear documentation disclaiming authority to control a franchisee's employees.
- Review agreements and other documentation, including manuals and handbooks, for evidence of actual or reserved control regarding a franchisee's employees.
- Make clear that franchisees are solely responsible for all employment and personnel matters, including the hiring, firing, supervising, disciplining, scheduling, compensating and managing of their own employees.
- Expressly disavow in writing any right to control these employment matters.
- Include that language regarding a franchisee's personnel matters or policies should be phrased as optional recommendations, when possible, that the franchisee alone may decide whether and how to implement.
- To the extent limited requirements are necessary, such requirements should be described in the context of maintaining objective operational brand standards, such as having ethical and courteous employees trained to provide a certain level of service and accommodate customer needs.
- Avoid actual or reserved control over franchisees' employment/ personnel decisions.
- Franchisees should handle administrative functions regarding their employees (payroll, etc.).
- Designate third-party suppliers to provide HR services (employee screening, etc.).
  „ Focus interactions with franchisees' employees on brand standards.
- Do not supply mandatory employee handbooks to franchisees.
- Ensure customers and franchisees' employees know a franchisee is an independent business — signage, contracts, applications, signed acknowledgment, etc.
- Provide indemnification and insurance.
- Include an arbitration clause with a class action waiver.

Broker Registration and Disclosure

A significant issue in franchise registration and disclosure laws relates to proposals for broker registration and disclosure. This is a trend we expect to see addressed in several states and at the FTC in the coming year. As described in a separate article in this update, California amended its Franchise Investment Law, effective 2026, to add annual

registration and presale disclosure requirements for franchise brokers.

In addition, as part of the FTC's current review of the Rule, many in the industry are advocating for the revised rule to include certain disclosures by third-party franchise sellers, which would include: recent professional experience; litigation history; services that the seller performs on behalf of franchisors and the compensation received; the industries and number of brands the seller represents; franchisees to whom franchises were sold during the prior calendar year; and a uniform disclosure regarding the different type of franchise sellers and some basic questions a prudent prospective franchisee may ask.

Stay tuned for more action on this front in 2025.

Corporate Transparency Act

The big news as of January 23, 2025 is that the U.S. Supreme Court lifted the injunction blocking the enforcement of the Corporate Transparency Act (CTA) (in the case of Texas Top Cop Shop, Inc., et al., v. Garland, No. 4:24-cv-478 (E.D. Texas, Dec. 3, 2024). Despite this ruling, reporting obligations under the CTA remain on hold due to a separate nationwide injunction issued on January 7, 2025, issued by a different federal judge in Texas in Smith et al v. United States Department of the Treasury et al., 6:24-cv-00336 (E.D. Texas, Jan. 7, 2024).

Previously during the period when the CTA was subject to a nationwide injunction, FinCEN indicated that filings could continue to be made on a voluntary basis. We encourage reporting companies to continue their compliance efforts so as to be in a position to file should the injunction be lifted and to watch closely for updates from either courts or FinCEN – as there will be additional developments.

The CTA, if it were to go into effect in the future, would require most companies to report personal direct and indirect beneficial ownership and control information pertaining to businesses operating in the U.S. This includes personal identifying information (PII), including name, date of birth, physical home address and photograph. That PII would have to be reported for all natural persons owning, directly or indirectly, 25% or more of any class or category of economic interest in a business entity, or who have or may assert, directly or indirectly, "substantial control" over a business entity.

There are a number of issues regarding whether franchise agreements may attribute "substantial control" of a franchisee's business to the franchisor and its control persons, necessitating reporting of such franchisor person's PII on their franchisees' CTA reporting.

There are some exemptions, including certain regulated business entities, such as publicly traded companies, insurance businesses, banking businesses, 501(c) federally tax-exempt nonprofit entities, and governmental and quasigovernmental organizations, and a large operating entity exemption that applies to companies that operate from a physical commercial street address in the U.S., have 21 or more full-time U.S. employees and generate more than $5 million in annual U.S. gross receipts as reported on the business entity's prior year's federal tax filing. There is also a wholly owned subsidiaries exemption, which provides that if a parent corporation is an exempt entity and wholly owns a subsidiary entity, that subsidiary entity would also be exempt from CTA reporting.

Failure to comply created substantial liability — fines of $591 per day up to $11,820 per incident and possible jail time (up to two years) for those failing to timely and properly comply with the CTA.