FREE FRANCHISE ANALYSIS GUIDE

7 Red Flags Hidden in Every Franchise Disclosure Document

What your franchisor hopes you won't notice before you sign.

The FDD is a 200+ page legal document that every franchisor is required by the Federal Trade Commission to give you at least 14 days before you sign anything or pay any money. Most buyers skim it. The smart ones know exactly where to look.

Franchise Grade Systems

FranchiseGradeSystems.com

Built by a former franchise owner who learned these lessons the hard way. Now helping buyers protect their investment with the tools franchisors don't give you.

Before You Sign Anything

Buying a franchise is one of the biggest financial decisions you'll ever make. The average franchise investment ranges from $100,000 to $500,000, and many buyers commit based on a slick sales pitch, a few positive testimonials, and a document they barely read.

That document is the Franchise Disclosure Document (FDD). It contains 23 legally mandated items that the franchisor must disclose to you before you sign. The FTC requires it. And buried inside those 200+ pages are signals that separate healthy franchise systems from ones that will drain your savings.

The 7 red flags in this guide are the ones most buyers miss. They come directly from the FDD's 23 standardized items, cross-referenced with FTC guidance, franchise attorney recommendations, and real-world franchise outcomes. If you see even one of these in your FDD, slow down. If you see multiple, walk away.

Quick Reference: Where to Find These Red Flags

- Red Flag #1: Item 19 — Financial Performance Representations
- Red Flag #2: Item 20 — Outlets and Franchisee Information
- Red Flag #3: Item 3 — Litigation History
- Red Flag #4: Item 12 — Territory
- Red Flag #5: Items 5, 6, 7 — Fees and Initial Investment
- Red Flag #6: Item 2 — Business Experience of Leadership
- Red Flag #7: Items 17 — Renewal, Termination, and Transfer

RED FLAG #1

Missing or Vague Financial Performance Representations

FDD ITEM 19 — Financial Performance Representations

Item 19 is where franchisors can disclose how much their franchisees actually earn. According to the 2024 Annual Franchise Development Report by Franchise Update Media, approximately 86% of the 120 franchise brands surveyed include some form of financial performance representation in Item 19. However, that survey sample is self-selected from brands that attend franchise development conferences. Other industry estimates, including those from the American Association of Franchisees and Dealers, put the broader rate closer to 66% across all active franchisors.

Either way, a significant number of franchisors choose not to disclose financial data. They are legally permitted to leave Item 19 blank. When they do, they'll typically include a statement like: "We do not make any representations about a franchisee's future financial performance." That's legal. It's also a signal that you're being asked to invest six figures without knowing what existing owners actually earn.

Even when Item 19 is provided, watch for averages without context. A franchisor reporting "average gross revenue of $600,000" tells you nothing about profitability. It doesn't show operating expenses, owner take-home pay, the range between top and bottom performers, or how many locations are actually profitable. Medians and quartile breakdowns are far more useful than simple averages.

What to Do:

- ✓ Check if Item 19 is present. If blank, ask the franchisor directly why they choose not to disclose.
- ✓ If Item 19 exists, look for medians, ranges, and the number of locations included in the sample.
- ✓ Ask for net profit data, not just gross revenue. Revenue means nothing without knowing costs.
- ✓ Cross-reference Item 19 claims with what current franchisees tell you in your calls.

RED FLAG #2

High Franchisee Turnover in the Last 3 Years

FDD ITEM 20 — Outlets and Franchisee Information

Item 20 is the franchise system's report card. It shows, year by year for the last three years, how many franchise locations opened, closed, were transferred (sold by one franchisee to another), terminated by the franchisor, or ceased operations for other reasons. It also provides contact information for every current and former franchisee.

A few closures or transfers are normal. People retire, relocate, or sell profitable businesses. But if you see a pattern of 10% or more of locations closing annually, or a large number of terminations (where the franchisor ended the relationship), that signals serious problems: a broken business model, insufficient franchisor support, or franchisees who can't make money.

Pay special attention to the difference between "transfers" and "terminations." A transfer usually means a franchisee sold their business (often a positive sign). A termination means the franchisor ended the contract, which frequently involves a dispute, non-payment of royalties, or system non-compliance. A high termination count relative to total units is a major red flag.

What to Do:

- ✓ Calculate the closure rate: total closures + terminations + ceased operations divided by total units at the start of the year.
- ✓ Call at least 5 former franchisees (listed in Item 20) and ask why they left.
- ✓ Compare year-over-year net unit growth. A shrinking system is a warning sign.

RED FLAG #3

A Pattern of Lawsuits Against Franchisees

FDD ITEM 3 — Litigation

Item 3 discloses any litigation involving the franchisor, its officers, or directors from the past 10 years. This includes lawsuits filed by the franchisor against franchisees and lawsuits filed by franchisees against the franchisor.

Some litigation is normal, especially for large franchise systems with hundreds of locations. But look at the pattern. If the franchisor has filed dozens of lawsuits against its own franchisees for non-payment of royalties, that suggests franchisees can't afford to pay, which means the business model may not generate enough revenue to cover fees. If multiple franchisees have sued the franchisor alleging fraud, misrepresentation, or failure to deliver promised support, take that very seriously.

The FTC's own guidance on reviewing the FDD specifically warns: a franchisor that evades your questions about past litigation or tries to minimize its significance should give you pause. Transparency matters.

What to Do:

- ✓ Count lawsuits by type: franchisor-initiated vs. franchisee-initiated.
- ✓ Look for repeated allegations (fraud, misrepresentation, failure to support).
- ✓ If the list is long, ask the franchisor to explain the three most significant cases.

RED FLAG #4

No Protected Territory or Unreasonably Small Territories

FDD ITEM 12 — Territory

Item 12 discloses whether you receive an exclusive or protected territory and, if so, what rights and restrictions apply. Some franchise systems offer strong territorial protections that prevent other franchisees or company-owned locations from competing in your area. Others offer no territorial protection at all.

A lack of protected territory means the franchisor can open another location (or allow another franchisee to open one) right down the street from you. You could invest hundreds of thousands of dollars to build a customer base and then have the franchisor dilute your market by placing a competing unit nearby. This happens more often than you might think, particularly with rapidly growing franchise brands that prioritize total unit count over individual franchisee profitability.

Even if you have a protected territory, read the fine print carefully. The FTC notes that an "exclusive" territory may not protect you from all competition by the franchisor. For example, the franchisor may retain the right to sell the same products through its website, in catalogs, through other retail channels, or through a different brand it owns.

What to Do:

✓ Determine whether the territory is exclusive, protected, or neither.
✓ If territory is granted, ask if the franchisor can sell through e-commerce, catalogs, or other brands in your area.
✓ Ask current franchisees: Has the franchisor opened or approved nearby locations that impacted your revenue?

RED FLAG #5

Excessive or Poorly Explained Fees

FDD ITEMS 5, 6, AND 7 — Initial Fees, Other Fees, and Estimated Initial Investment

Item 5 discloses the initial franchise fee. Item 6 lists all other recurring fees, including royalties, advertising/marketing fund contributions, technology fees, training fees, transfer fees, renewal fees, and any other charges. Item 7 provides the estimated total initial investment, from the franchise fee through working capital needed to reach break-even.

Red flags include: a royalty rate at the high end of the industry range (above 8-10%) combined with a marketing/ad fund fee (typically 1-4%) that lacks transparency about how the money is spent, technology or software fees that seem disproportionately high, and required purchases from franchisor-designated suppliers where markups may be embedded.

Item 7 deserves special scrutiny. The estimated initial investment range is often presented as a wide range (e.g., $150,000 to $450,000). If the low end seems unrealistically optimistic, it probably is. The FTC advises buyers to compare Item 7 estimates with current franchisees in similar markets, because costs like build-out, rent, and local permitting vary significantly by location.

What to Do:

✓ Add up ALL fees from Items 5, 6, and 7 to calculate your true all-in cost for Years 1 through 5.
✓ Ask the franchisor for an itemized breakdown of how the advertising fund is spent.
✓ Ask current franchisees: Did your actual costs match the Item 7 estimates? What surprised you?

RED FLAG #6

Inexperienced or Unstable Leadership Team

FDD ITEM 2 — Business Experience

Item 2 identifies the franchisor's directors, principal officers, and key executives. It discloses their business backgrounds, experience in managing a franchise system, and how long they have been with the company.

A franchise's value lies in its proven system, and that system depends on the people leading it. Red flags include: a leadership team with no prior franchise management experience, high executive turnover (multiple C-suite departures in the last 2-3 years), or leaders whose backgrounds are primarily in franchise sales rather than franchise operations. A team that knows how to sell franchises but has never operated one may be building a system optimized for collecting franchise fees rather than supporting franchisee success.

Also check Item 4 (Bankruptcy). The FDD must disclose any bankruptcies involving the franchisor or its leadership in the last 10 years. A single personal bankruptcy from a decade ago may be irrelevant. A pattern of bankruptcies across leadership, or a corporate bankruptcy, is a serious concern.

What to Do:

✓ Look up each executive on LinkedIn. Verify their claimed experience.
✓ Check for executive turnover: have key leaders been replaced in the last 2-3 years?
✓ Ask the franchisor: What percentage of the leadership team has personally operated a franchise location?

RED FLAG #7

One-Sided Renewal, Termination, and Transfer Clauses

FDD ITEM 17 — Renewal, Termination, Transfer, and Dispute Resolution

Item 17 discloses the conditions under which the franchisor can terminate your agreement, what happens at the end of your franchise term (renewal), and whether you can sell (transfer) your franchise to someone else. This is where many buyers get hurt because they don't read the fine print until it's too late.

Red flags include: automatic termination for minor infractions without a cure period (meaning the franchisor can end your agreement without giving you a chance to fix the problem), non-compete clauses that prevent you from operating a similar business for years after termination, renewal terms that require you to sign a completely new agreement (potentially with higher fees or different terms), and transfer restrictions that give the franchisor the right to approve or reject any buyer, essentially controlling whether you can sell your own business.

The transfer clause is particularly important because it directly affects your exit strategy. If you build a successful franchise and want to sell it, restrictive transfer provisions can reduce its resale value or delay the sale significantly. Some agreements even give the franchisor the right of first refusal, meaning they can buy your franchise at the same price a third-party offers, potentially discouraging outside buyers from making offers.

What to Do:

✓ Identify the cure period for defaults. If none exists, negotiate one before signing.
✓ Review the non-compete clause: duration, geographic scope, and what activities it restricts.
✓ Understand the transfer process: approval requirements, transfer fees, and right of first refusal.
✓ Ask a franchise attorney to compare these terms to industry standards.

What to Do Next

Finding one or more of these red flags doesn't automatically mean you should walk away from a franchise opportunity. It means you need to dig deeper. Here's your next-step checklist:

■ **Request the FDD early.** You're legally entitled to receive it once the franchisor has your application. If they delay or resist, that's a red flag in itself.

■ **Read Items 19, 20, 3, 12, 5-7, 2, and 17 first.** These seven sections contain the information most likely to reveal problems. You can read the rest after.

■ **Call current and former franchisees.** Item 20 gives you their contact information. This is the most underused resource in franchise due diligence. Call at least 10 current owners and 5 former ones.

■ **Hire a franchise attorney.** Not a general business attorney. A franchise attorney who reviews FDDs regularly will spot issues you'll miss. The typical cost is $2,000 to $5,000, a fraction of your total investment.

■ **Run the numbers yourself.** Don't rely on the franchisor's projections. Use independent tools to calculate your real profit margin, ROI, and payback period based on actual data.

Free Tools to Run Your Own Numbers

Use these free calculators at FranchiseGradeSystems.com to stress-test any franchise opportunity before you invest:

→ **Franchise Profit Margin Calculator** — See your real take-home pay after every fee, royalty, and operating cost.

→ **Franchise ROI Calculator** — Calculate your return on investment, payback period, and compare to alternative investments.

This Guide Covers 7 Red Flags. The Full FDD Has 23 Items.

You've seen the 7 most critical warning signs. But the Franchise Disclosure Document contains 16 more items that directly impact your investment, your rights, and your exit strategy.

The FDD Deep Dive Guide

A complete, plain-English walkthrough of all 23 FDD items with:

✓ Red flags, yellow flags, and green flags for every item
✓ Exact questions to ask the franchisor (and how to interpret their answers)
✓ Side-by-side comparison worksheets for evaluating multiple franchises
✓ Real examples from actual FDDs showing what good vs. bad looks like
✓ A pre-meeting checklist for your franchise attorney review

Coming Soon at FranchiseGradeSystems.com

Questions? Reach us at FranchiseGradeSystems.com

Sources and References

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