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TESTIMONY BEFORE THE HOUSE SMALL BUSINESS SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

HEARING ON "*Enabling Success: Examining the Competitive Landscape for Small Businesses*"

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Chairman Meuser, Ranking Member Landsman and members of the Subcommittee, thank you for the opportunity to appear before you today to share my perspective on the competitive landscape for small businesses.

I appear before you on behalf of myself and the members of the International Franchise Association (IFA). IFA is the world's oldest and largest organization representing franchising worldwide. For over 60 years, IFA has worked through its government relations, public policy, media relations and educational programs to advocate for the protection, promotion and enhancement of franchising and the approximately 790,000 franchise establishments that support nearly 8.4 million direct jobs, $825.4 billion of economic output for the U.S. economy, and almost 3 percent of the Gross Domestic Product (GDP). IFA members include franchise companies in over 300 different industries, individual franchisees, and companies that support franchising in marketing, technology solutions, development and operations.

I have experienced firsthand the remarkable impact that franchised businesses can have on local economies and communities, including their ability to create jobs, develop a skilled workforce, and foster economic growth.

I graduated from USC in 2005 and come from a legacy family that helped establish the USC School of Dentistry. It was expected I return to USC for medical school and carry on the family tradition, however, I found myself spending more hours writing more business plans than I did in hospitals. Therefore, I decided to break from the family tradition and chase my entrepreneurial dreams without any support.

Looking back on it now, I am amazed I was brave enough to develop and pitch a business plan that detailed changing the relationship between wireless carriers and retailers. Shockingly, T-Mobile endorsed the plan which laid the foundation for what is known as the TPR-I program. This program defines T-Mobile's main distribution channel through private retailers today. As one of the founders of the program, I was fortunate to participate in it after my partner and I raised $60k to open the first T-Mobile TPR-I retail location in Fullerton, California.

Over ten years, we grew from 2 locations to 40, from San Luis Obispo to San Diego. I owe our growth and success to our team. We had an extremely strong culture. When we walked into events with our team leaders, the entire crowd would start chanting our company name and cheering us on. The development and management of our company culture was the result of our commitment to our team over profit.

Once we hit our 10-year anniversary, T-Mobile started to change the program so my partners and I decided it was our time to exit. It was one of the hardest decisions I had ever made, but we sold in 2018. After selling, I made the decision to venture into food and began researching many different concepts before choosing Jimmy John's as the next venture. Having started one successful business, I thought that being in business “for myself, but not by myself,” sounded pretty good.

I picked Jimmy John’s because of the culture, love for quality ingredients, fresh baked bread, and speed. Also, because I love sandwiches. To me, a sandwich is the perfect meal. After setting my sights on Jimmy John’s, I opened my first store in Pittsburgh, Pennsylvania. After receiving an SBA loan, for the next year, I flew back and forth from California to Pennsylvania while sleeping at the store and working day and night to learn the business. My team and I hit the ground running, and before we knew it, we had gained the knowledge necessary to open 4 more in Pittsburgh and the rights to open 24 in California – which was almost the beginning of the end.

We were overly confident and began opening stores at a rapid pace in California. Some months we were opening two at a time with blind faith that we had the skills to make it work. Unfortunately, we underestimated how competitive California was and the stores opened at half the sales volume we were expecting. At the time, we thought we were too deep to adjust the trajectory of the business and the ship would sink. Bank commitments had been made, leases signed, debt had been taken on, and personal guarantees all over the place. I had no family and was willing to take on the burden of turning the company around.

I will never forget, I called a bankruptcy attorney, since I was sure that the end was imminent. He told me, "James: First, you couldn't afford me. Second, all those stories you hear about people going bankrupt and hiding money elsewhere are not true. They will come and take all your assets. The best thing to do is, take the money from the sale of your T-Mobile's, invest in yourself, and turn around the company." So that's what I did.

Looking at the numbers, I could see the business was on the upward trend, but needed time. So, I came up with a Hail Mary. Buy cash-flowing businesses to offset the losses in California and dig in with the team to run lean while keeping the faith. We called every Jimmy John's franchisee in the entire system to ask if they would be interested in selling. If someone was even the slightest bit interested, I was on the next flight to see them.

Slowly but surely, after making several minor acquisitions and after closing 14 stores in California, we started to become profitable. On the day Tom Hanks announced he had COVID we had turned California into the fastest growing market for Jimmy John's in the Nation and I was on my last few hundred bucks. I was sure this moment was the end of the Jimmy John's story for me as all the COVID mandates continued to rollout. But thankfully, our government had the foresight and grace to provide programs that most restaurants relied on to make it through.

As things stabilized, we continued inching forward and making progress. Because of the strength of my team and their devotion to our vision, we are now on a path to owning and operating 100 Jimmy John's in 6 states.

Entrepreneurs are unsung heroes. There are not enough of us to make our voice heard against the masses and we cannot leave our teetering business to engage in playing a consistent active role in regulatory matters.

Yet, most businesses are small businesses. If it were not for the passion I have for creating and building while providing the income for people to support their families and dreams, I would not recommend for anyone to become an entrepreneur. The current political climate is making it too difficult, litigious, and expensive to operate. People expect a return on the investment of their time and money - when the investment no longer matches the return, people move on to other things. In this case, that means people stop establishing businesses or innovating which, for me, is what the American Dream is all about.

The Unique Franchise Business Format

Franchising is perhaps the most important business growth strategy in American history. The first franchises started in the colonies by Ben Franklin, and over the centuries, this system has served as a core American model of opportunity and entrepreneurism. In 1731, Ben Franklin entered into a partnership with Thomas Whitemarsh, who franchised his printing business – *The Pennsylvania Gazette*. Later, Whitemarsh would introduce the first "franchised" newspaper of South Carolina, the *South Carolina Gazette*.

Franchising has contributed to robust job creation and provided foundational skills development for small business owners and workers. Today, there are more than 790,000 franchise establishments, which support nearly 8.4 million jobs[1]. Many people, when they think of franchising, focus first on the law. While the law is certainly important, it is not the central thing to understand about franchising. At its core, franchising is about the relationship that the franchisor has with its franchisees—how the franchisor supports its franchisees, the franchisor's brand value and how the franchisee meets its obligations to deliver the products and services to the system's brand standards.

Franchising is often confused with "big business" when it is in fact the exact opposite. A franchise is first a local business, distinguished from other local businesses because it licenses the branding and operational processes of a franchisor while operating independently in a defined market. The local owner, or franchisee, is responsible for hiring staff, organizing schedules, managing payroll, and all daily operational tasks as well as local sales and marketing. The value of franchising lies in a strategic balance in the relationship between a franchisor and franchisee: the independence of a franchisee to manage its day-to-day operations and connections with its employees, consumers and the local community balanced with the franchise system giving aspiring small business owners a head start toward becoming their own boss, with a proven business model that can set up new business owners for success and easier access to lines of credit than a traditional business.

The value of franchising is supported by empirical data. A recent study by Oxford Economics found that franchising offers a path to entrepreneurship for all Americans, but especially for minorities and women. Around 26% of franchises are owned by people of color, compared with 17% of independent businesses generally. In addition, franchising offers the opportunity for business ownership that would not otherwise be available, especially to women, people of color, and veterans. Franchised businesses also perform better and provide better pay and benefits than their non-franchised counterparts. On average, franchises report sales 1.8 times as large and provide 2.3 times as many jobs as non-franchised businesses. Sales and jobs in franchised businesses exceed non-franchised businesses across all demographic cuts, including gender and race. For example, Black-owned franchised firms generate 2.2 times as much in sales compared to Black-owned non-franchised businesses, on average[2].

Despite how it is often characterized, franchising is not an industry. Franchising is a business growth model used *within* nearly every industry. More than 300 different sectors are represented in franchising, and franchised companies offer a huge range of products and services from lodging to fitness, home services to health care, plumbing, pest control, restaurants, security, and lawn care.

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[1] Franchiseeconomy.com (2021).

[2] The Value of Franchising. Oxford Economics

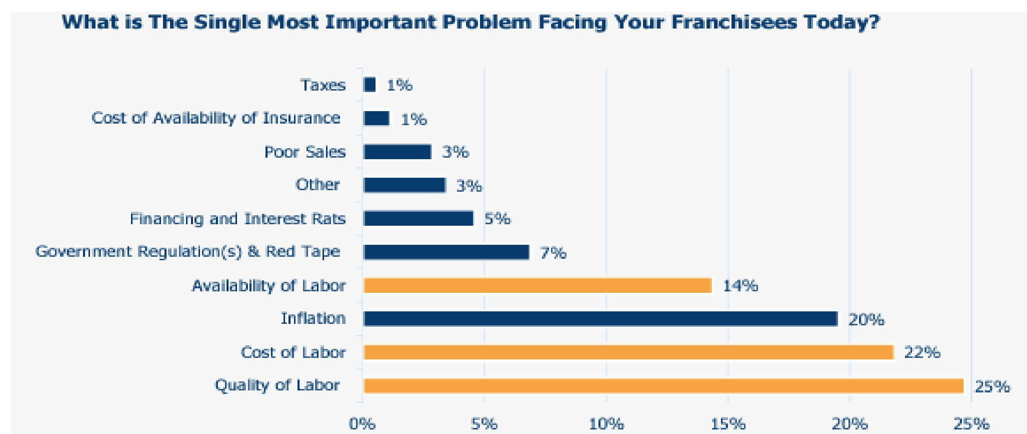
Further, despite popular misconceptions, franchising consists of far more than merely the "fast food" industry. In fact, 63% of companies that franchise are not in the food services at all, and 83% are not in fast food.[3] As you can see in the graphic below, there are far more local (50% of all franchised brands) and regional brands (34% of all franchised brands) whose names you might not recognize than the fast food giants that garner the most attention.

There are two principal explanations given for the popularity of franchising as a method of distribution. One is that it "was developed in response to the massive amounts of capital required to establish and operate a national or international network of uniform product or service vendors, as demanded by an increasingly mobile consuming public."[4] The other is that franchising is usually undertaken in situations where the franchisee is physically removed from the franchisor, giving autonomy to the franchisee to run their own day-to-day business operations. These two motivations are consistent with a business model in which the licensing and protection of the trademark rests with the franchisor, and the capital investment and direct management of day-to-day operations of each franchise unit are the responsibility of the franchisee who owns, and receives the net profits from, its individually owned franchise unit.

It is typical in franchising that a franchisor will license, among other things, the use of its name, its products or services, and its operational processes and systems to its franchisees. The turnkey nature of operating a franchised business is why I and so many of my fellow franchisees purchased a franchise. Franchisees look to the franchisor to protect the trade names, trademarks and service marks (collectively the "Marks") and brand by establishing and enforcing standards on all franchisees in a system. Such standards are essential for protection of franchisees' equity in their businesses and consumers of the brand. These standards allow franchisors to maintain the uniformity and quality of product and service offerings and, in doing so, to protect their Marks, the goodwill associated with those Marks, and most importantly, consumer confidence in the Marks and brand. Because a core principle of franchising is the collective use by franchisees and franchisors of Marks that represent the source and quality of their goods and services to the consuming public, action taken to control the uniformity and quality of product and service offerings under those Marks is not merely an essential element of franchising, it is an explicit requirement of federal trademark law under the Lanham Act.

Staffing challenges

As I mentioned earlier, I am working day in and day out to grow my business, but there are headwinds. One of those is the ongoing difficulty of finding staff.



According to the U.S. Bureau of Labor Statistics (BLS), the unemployment rate edged down to 3.5%, one of the lowest in history. Demand for labor far exceeded the supply, resulting in a wage growth of 9.0% in 2022. The wage growth tapered down in the fourth quarter of 2022 to 6.4%. ADP Research projects wage growth in 2023 of approximately 3%, which is higher than pre-pandemic norms. Quality and cost of workforce remains the biggest challenge for almost all franchised businesses. According to the IFA/FRANdata 2023 labor survey of franchisors and franchise portfolio companies, 81% of franchised brands experienced constrained growth due to labor challenges, a continuation from 2022. Nearly identical to last year, 87% of franchisees have had difficulty filling in positions for unskilled labor, skilled labor, or both (88% in 2022).

In 2023, the franchise labor market is even more competitive than it was in 2022. According to the IFA/FRANdata 2023 labor study, 85% of the franchisors surveyed reported an increase in store-level wages in the past six months, and 43% of franchised businesses reported benefit increases. Almost 60% of the franchisors surveyed anticipate an increase in labor wages in the next six months. FRANdata expects that the rebalancing of the labor market will likely take some time, and franchisees will continue to face labor related challenges at least in the first half of 2023.

Tax Policy and the Deductibility of Interest

Another headwind is a particular aspect of tax policy – the limitation on the deductibility of interest imposed by the expiration of a provision in the Tax Cuts and Jobs Act. While I understand the rationale for wanting to discourage undue leverage, for small businesses, it hinders our growth, and at the beginning of last year, it got worse.

Prior to January 1, 2022, businesses' interest expense deductions were limited by section 163(j) to 30% of their earnings before interest, tax, depreciation, and amortization (EBITDA). Interest deductions are now limited to 30% of earnings before interest and tax (EBIT) – a stricter limitation. This change, combined with rising interest rates, is proving to make incremental investments by small businesses much more expensive.

On average, a restaurant affected by the change could see a three-fold increase in its incremental tax burden, facing both higher interest rates when financing improvements and a very high tax rate.

Restaurants famously offer low barrier to entry jobs with high upward mobility potential. One in three Americans begins their career in a restaurant. The EBITDA-based interest limitation would allow us to keep creating jobs and open this opportunity for countless more Americans seeking flexible entry-level positions.

In the Jimmy John's system, we're constantly hearing from franchisees who want to delay remodels or new restaurant openings because they'll be penalized by the tax code for their growth. This is hurting not only restaurant job creation, but jobs in construction, contracting, supply chain, etc.

According to an EY study, the permanent stricter EBIT-based interest expense limitation before market adjustment would cost **467,000 U.S. jobs, $23.4B in lost wages, and $43.8B in GDP over 10 years.** Two dozen OECD countries have earnings-based limitation. We are *the only country* with EBIT-based limitation; the others all include depreciation and amortization.

Reps. Adrian Smith (R-NE), Joe Morelle (D-NY), Kevin Hern (R-TX) and Brad Schneider (D-IL) have introduced bi-partisan legislation (H.R. 2788) to permanently preserve the EBITDA standard and

ensure that the tax code does not penalize job-creating investments. In addition, H.R. 3938, the Build It in America Act includes a retroactive extension through 2025 and was approved by the Ways & Means Committee earlier this year.

I would urge Congress to take either of these approaches to addressing this critical issue as soon as possible, but certainly before the end of 2023.

SBA Lending

I started my first Jimmy John's location with an SBA loan, and the SBA's lending programs and the access to capital they provide are a big part of the franchise success story. About 20% of SBA lending goes to franchising. In 2022, about 7,000 loans were approved in the 7(a) and 504 programs representing more than $5 billion of loan volume and supporting more than 100,000 jobs.

Earlier this year, the SBA finalized a number of changes to its affiliation rules, including elimination of the concept of affiliation by control, which also resulted in elimination of the Franchise Directory.

The IFA supports efforts to streamline government-supported lending programs and recognizes this was the intent of eliminating the principle of affiliation by control in the SBA size standards, which in the case of a franchise is currently based on franchise agreements. Those determinations required, by their very nature, subjective assessments of contract language. As such, consistency of those determinations, delays in approvals created by occasionally lengthy reviews, and the back and forth with franchisors to reach acceptable agreement language all were impediments to franchisees being able to access the capital they needed to grow. We commend the SBA's desire to address these issues and believe this is a good effort to do so.

However, as part of the affiliation review and use of the Franchise Directory, the SBA conducted an eligibility review, an effort to help lenders from an efficiency standpoint. Unlike other businesses, in franchising there is a set of agreements between a franchisor and the small business franchisees who borrow using SBA-guaranteed loans. In essence, it is a one-to-many review. One-time eligibility review decisions eliminate the need for each lender to review the sometimes lengthy and complicated agreements to assess eligibility. Importantly for franchisors, such reviews avoided the problem encountered years ago where they got inconsistent and often conflicting decisions and requirements from various lenders.

IFA's understanding of the affiliation change now shifts this burden to lenders. This shift may create an inefficiency that will put many franchise brands at a disadvantage. IFA is particularly concerned about access to capital for emerging brands (of which there are hundreds each year) and smaller, regional brands. Will a community bank be willing to make a loan to a franchisee associated with a brand that requires the banker to wade through multiple franchise documents to determine eligibility? Most franchise loans are relatively small, averaging under $400,000. The economics for lenders doing only one or a few franchise loans may drive them away from franchise lending completely.

Now that this rule is final, we will have to wait and see how lenders react, absent action from Congress. We appreciate the Committee's interest in and oversight of these changes and would be happy to be a resource as it considers what, if any, action to take.

Joint Employer

Finally, I would like to highlight an issue that has the potential to completely undermine the franchise business model. Any day now, the National Labor Relations Board (NLRB) is planning to issue a final rule on a joint employer standard that would reverse its course back to the harmful 2015 version.

The NLRB's proposal largely reestablishes the broad Obama-era standard of joint employment, under which one company may be deemed the joint employer of a second company's employees not only where it directly or immediately exercises control over the second company's workforce, but where the first company's putative control is indirect, or even simply reserved but not ever actually exercised. This puts franchisors at risk of being sued for things they never did and had no power to stop. Moreover, it risks wiping away the equity that I have spent my life and career building in my businesses and ultimately makes me a middle manager of my brand. The joint employer standard created by the NLRB in 2015 led to a nearly doubling of litigation against franchised businesses, cost franchising $33 billion per year, and preventing the creation of 376,000 new jobs in the four ensuing years. Small businesses will not survive a similar consequence in the current labor market.

The NLRB's proposed changes to the joint employer rule will take away the equity and independence of franchise small business owners and would put their success and livelihoods, including mine, in jeopardy. Franchisors will naturally move to hire numerous attorneys to oversee employment issues and claims across its network of independently owned franchised businesses over which the franchisor has no control. Ultimately, the additional costs to the franchisor would translate into additional costs to independent owners like me, and that would make the franchise business model untenable.

In fact, research released last week by Oxford Economics based on a July 2023 survey of franchisees shows that franchise owners are bracing for more harm from the new NLRB joint employer rule as it injects uncertainty in the franchisor-franchisee relationship and threatens standards enforcement across franchise systems. Overall, 43% of franchisee respondents expected a change in the franchisor/franchisee relationship as a consequence of the NLRB's joint employer rule, although there is uncertainty among franchisees regarding the responses from franchisors. Approximately 20% of respondents expected franchisors to increase control over their operations while another 20% expected franchisors to distance and reduce operations and compliance support.

Approximately 40% of franchisees did not know what to expect, and the remaining 20% expected no change. This uncertainty about franchisor responses to the new joint employer rule brings with it significant concern among franchisees, with 74% of franchisees expressed a high level of concern at the prospect of increased franchisor control, and 55% a high level of concern with reduced franchisor support.

The Oxford Economics report is also expected to identify increased costs for franchisees as a result of responses by franchisors to mitigate risk under the new joint employer rule. These include the heightened risk of litigation (i.e., 70% of franchisees expected increased litigation) and increases in legal and advisory fees, as well as higher insurance and operations costs. Meanwhile, the new rule may reduce the attractiveness to being a franchisee with respect to operating an independent business and lead to fewer franchises (i.e, 66% of franchisee respondents expected

the new standard to raise barriers to entry into franchising).

This report confirms that franchisees have significant concerns about their ability to do business if the NLRB moves forward with its proposed joint employer rule. A majority of franchisees are highly concerned about both increased franchisor control and decreased franchisor support, demonstrating that franchising currently has the right balance in the franchisor-franchisee relationship. Unnecessary, expanded joint employer liability will hurt franchised businesses – just as it did in 2015.

I urge Congress to reject this unnecessary and over-reaching rule via the Congressional Review Act.

Mr. Chairman, thank you again for the opportunity to testify. I am happy to answer any questions you may have.