PUBLICATION

SBA Changes the Game

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On November 22, 2016, the Small Business Administration released SOP 50 10 5(I) (the "SOP"), which is administrative speak for new standard operating procedures affecting loans to businesses involved in franchising. The well-trodden paths to franchise lending using the Franchise Registry and the forms of SBA Addenda to franchise agreements worked out by franchisors were largely obliterated with the figurative stroke of a pen. The franchise world was taken by surprise and now must adjust its thinking and procedures, effective with SBA loan applications submitted on and after January 1, 2017. The goal was to provide guidance on what was and wasn't affiliation between the franchisee and its franchisor. Here's what the changes mean and how the world of SBA financing will be reset:

- The SBA has a standard form addendum to franchise agreements that must be signed verbatim by the franchisor and the franchisee. The language is substantially the same as the form demanded by the SBA for several years, but the negotiated nuances of individual franchisors will disappear.
- The SBA will not review franchise and license agreements for provisions that constitute "affiliation" or excessive control of franchisee decision-making by the franchisor.
- The SBA will discontinue the separate lists of franchises that either do or don't create relationships that constitute affiliation. This ends the Franchise Registry and the SBA Franchise Findings List.
- The SBA imports the definition of a franchise from the Federal Trade Commission Franchise Rule, 16 CFR Part 436.1(h) and the related commentary and guidance to determine what qualifies as a franchise for purposes of the SOP. Franchises governed by the Petroleum Marketing Practices Act and exempt from FTC Franchise Rule disclosure are covered by the SOP.
- The SBA loan eligibility criteria are limited to applicants that are independently owned and operated small businesses and not dominant in their field of operation, with the right to profit from their efforts and bear the risk of loss commensurate with ownership. There are no interpretations or metrics that accompany this language.
- The SBA will not finance master franchise or development agreements that do not grant the franchisee/developer the right to develop outlets because they are passive investments and/or inherently speculative. However, area development agreements that contemplate the outlet development and operation will be eligible for financing.
- In a nod to political correctness, the SBA will no longer finance businesses that restrict patronage on any basis other than capacity. That means gender-restricted businesses such as single sex health clubs and fitness centers cannot be financed.
- Although couched in terms of collateral evaluation, the efforts of franchisors to use real estate covenants, subordinations and other indirect property controls that effectively limit the use of SBA-financed assets to a single use or franchise system will be prohibited for SBA financing. Property must be capable of being sold without restriction.
- The simplified SBA Addendum requires that the franchisor (i) not unreasonably withhold consent to transfer, (ii) not exercise a right of first refusal for transfers involving existing owners, (iii) not hold the right to purchase real estate owned by the franchisee (a lease for the balance of the franchise term at market rent is permitted), (iv) not restrict post-franchise use of the franchise site owned by the franchisee, and (v) not directly control (hire, fire, schedule) franchisee employees. Simple, right?

Will the new SBA Administrator nominee, Linda McMahon, reverse or change this SOP if she is confirmed? No indication has been published at this writing. Will this approach simplify borrowing for franchisee borrowers? Yes, most likely. Will lenders get squeamish about unconventional franchise agreement terms and franchise service programs that reduce franchisee discretion and risk? Yes, most likely. Has the franchise world heard the last word on this SOP? Not likely.