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California Dreams Become Reality for Franchisees; Amended Franchise Relationship Law Passes

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The California State Assembly saw the seventh amended version of proposed changes to the California Franchise Relationship Act (CFRA)[1] introduced August 17, 2015, and a final version with additional amendments favorable to the industry passed both houses on August 24, 2015. This amendment is the product of industry negotiations that resulted from the realization that a bill was going to pass, whether or not franchisors agreed to the changes. Franchisors operating in California or considering operating in California after January 1, 2016 must prepare for the reality that the price of doing business in this consumer-rich market will be the limitations and costs imposed by the revised CFRA. Franchisees should likewise prepare for the reality that their costs of operating in California under the CFRA will rise, or that promising franchise concepts not currently operating in California will decide to operate in California through company stores, or not at all. The CFRA changes will apply to franchises entered into or renewed on or after January 1, 2016, and to franchises of an indefinite term that may be terminated without cause.

California Assembly Bill 525 ("the Bill") amends the substantive and procedural elements of the CFRA in an effort to reduce or eliminate the perceived arbitrariness of franchisor actions to enforce franchise agreements as written. As a result of the negotiations, there is better balance between protection of the brand and franchise system from poor performers at the expense of relatively long cure periods that will conceivably produce many unsatisfied customers in social-media-crazy California.

Termination Rights. The definition of good cause for termination or non-renewal remains very narrow. It is limited to failure of the franchisee to substantially comply with the franchise agreement, after notice and opportunity to cure. The opportunity for a good old-fashioned common law breach not enumerated in the franchise agreement as the basis for termination appears to be precluded. Although there is a market withdrawal concept included in the Bill (see below), the good cause provision and the market withdrawal provision are not well coordinated.

Under revised CFRA Section 20020, the franchisee will have at least 60 days and not more than 75 days to cure non-monetary defaults, and at least 10 days to cure regulatory violations, before a franchisor may terminate. The five-day monetary default cure period is retained. The bill preserves certain emergency termination rights, based on misconduct of the franchisee or external conditions such as foreclosure or eviction. The franchisor and franchisee may agree to terminate the franchise in writing, although it is unclear whether the practice of granting and reserving unilateral, mutual termination rights at specified intervals in the franchise agreement, which is common in the hotel industry, meets that standard. The franchisor can also terminate for repeated violations of the franchise agreement, whether or not a cure is effected, although the precise number of violations is not specified, and for a repeat violation of the same provision after the first violation is cured under the 60-75 day cure right.[2] Reading the two provisions together, a sensible interpretation would be three violations of the franchise agreement, which do not need to be the same violation. The Bill brings no clarity to these existing provisions.

However, the Bill brings new certainty to a long-standing practice in the hotel franchise industry, mutual termination rights. Under Section 20022 (f), the franchisees are free to agree in writing to terminate or not to

renew the franchise. On its face, the plain language should allow franchise agreements to reserve termination rights without cause, and to agree in advance that the franchise is not renewable. Coupled with the exclusion from the buyback obligation that applies if the franchisee is allowed to retain the place of business, these common practices in the hotel industry should not be challenged under the new law. Likewise, a narrow non-competition covenant that allows the franchisee to continue in business in the same place, to the extent otherwise enforceable in California, should survive a challenge.

Another provision that is not addressed in the Bill is the protection of felonious franchise owners. Existing law prohibits the franchisor from terminating upon a felony conviction unless the crime relates to the operation of the franchise. Given California's concern for privacy and protecting people from identity theft, it is surprising that they did not take this opportunity to include among the litany of horrible deeds that overrides good cause a conviction of identity theft or credit card fraud, if the franchise involved the collection and retention of personally identifiable information and the processing of credit card payments, even if the crimes were not committed in the operation of the franchise or upon the franchise's customers. In other states, termination would not likely be challenged under similar facts.

Buyback Obligations. Under new CFRA Section 20022, at termination or nonrenewal at the discretion of the franchisor, the franchisor must repurchase from the franchisee at the franchisee's depreciated value the inventory, supplies, equipment, fixtures and furnishings that are paid for under the terms of the franchise agreement or a collateral agreement by the franchisee to the franchisor or its approved suppliers or sources that are used in the franchised business. The franchisee is free to sell or retain the equipment, and no obligation arises if the franchisee retains control of the principal place of business. The last round of amendments addressed the issue of requiring the franchisee to deliver clear title to the assets, free from adverse claims of creditors and secured parties. There is no provision for equipment lease resolution if the equipment is leased rather than financed, even with a capital lease.

There is also a market withdrawal option that eliminates the need to repurchase the assets if the franchisor announces a geographic market withdrawal affecting the area where the franchise is located. However, the relevant geographic market definition is borrowed from the gasoline dealer statute and includes an entire standard metropolitan statistical area.[3] Given the huge size of SMSAs in California, a franchisor cannot easily fine-tune its markets within the large metropolitan areas once it commences selling franchises. Offset rights for amounts owed to the franchisor may be exercised. This right to sell avoids the possibility that the franchisee will be stuck with large amounts of tangible assets that it cannot use or must sell for liquidation prices. Personalized goods for a particular franchise are excluded.

A more subtle element is the attack on the supposedly higher costs attributable to supplier rebates and payments arising from tangible goods purchased from the franchisor or approved suppliers. A franchisor can reduce exposure under this section if franchisees are free to purchase a specified item from any supplier so long as the item meets standards. Fueled by the perception that source-restricted programs increase costs for franchisees and expose them to higher post-termination losses in asset value, this will cause franchisors to examine carefully whether source restrictions in California are worth the risk of repurchasing tangible assets of terminated franchisees that may be below recoverable market value. The price is based on depreciated value (price minus accumulated depreciation), rather than the Generally Accepted Accounting Principles (GAAP) formula of the lower of depreciated cost or market value. The franchisee gets to sell the assets for the higher price – the fair market value or the depreciated value. GAAP franchisors will realize an immediate loss if cost exceeds market price, so the accountants will be considering whether reserves or contra-accounts that offset revenues from approved supplier and tangible asset sales to franchisees are needed for California franchisors. Whether or not franchisors will be able to lay off some risk of this economic loss to approved suppliers will no doubt be the subject of negotiation.

Transfers. Under new CFRA Section 20028, franchisors must permit franchisees to transfer ownership of the franchised business or any portion of the franchisee's equity to any person who is qualified under the franchisor's then-existing and reasonable standards, as consistently applied to similarly situated franchisees operating within the franchise brand, for the approval of new or renewing franchisees. The franchisee is likewise prohibited from engaging in the sale if the franchisor's consent is not obtained because the putative buyer does not meet the standards, or the franchisee and buyer do not meet the conditions of the franchise agreement for effecting a transfer. This provision allows the franchisor to exercise a right of first refusal at the same price as the bona fide offer, and applies to asset and equity transactions. Franchisors will need to articulate and publish procedures for transfer that meet objective reasonableness standards, and do not create an opaque, mystical or arbitrary process for transferring some franchises and not others.

Franchisors that have used undisclosed evaluation criteria for franchise applicants will be forced to articulate their standards or admit all franchise candidates. If the standards have not been published, the franchisor must communicate them to the selling franchisee within 15 days after receiving a request to transfer. There are no articulated guidelines for what is "reasonable" and a new franchisor will be forced to take some risks if it does not consent to a proposed transfer transaction, since it does not have an internal frame of reference for what is reasonable. As the law of unintended consequences will no doubt apply, franchisors will be forced to set high standards and then rigorously apply them without regard to special circumstances, or give people a chance to succeed when their paper credentials are weaker than the norm. There is no protection for a franchisor that sets a bar for applicants as low as possible to comply with the statute and then experiences a high failure rate from unqualified or marginal candidates. The effect of this change may well lead to either high failure rates or foreclosed opportunities for entrepreneurs, with concomitant slower growth in jobs and business. There is no exception for programs designed to offer opportunities for disadvantaged entrepreneurs or veterans, so these laudable efforts of the franchise community may well be curtailed or cease entirely in California.

Transfer Procedures. New CFRA Section 20029 lays out in surprising detail the notice and time periods required for transfers governed by CFRA Section 20028. In a classic example of statutory micromanagement of business functions, the statute goes into great specificity about the content of notices, the delivery of relevant documents for the transaction, and the time period during which the franchisor must make its decision, no more than 60 days after delivery of all relevant documents. Any disapproval must be stated with reasons, and is subject to challenge by the franchisee in court or in an arbitration proceeding. In what may be the most curious provision of the Bill, the disapproval of a transfer is presumed to be a question of fact to be determined by the trier of fact, but the provision goes on to state that the issue can be decided at summary judgment if the reasonableness can be decided as a matter of law. Judicial management of disapproval cases will bear close scrutiny, as these potentially inconsistent directions are interpreted.

Election of Remedies. New Section 20035 provides a simple remedy for a franchisee if a franchisor allegedly violates CFRA in termination or non-renewal of a franchise. The franchisor can be made to pay the fair market value of the franchise plus damages. The Section also authorizes injunctive relief if violations can be arrested or reversed. Mitigation is possible under new Section 20036 for amounts owed to the franchisor and any recovery under Section 20022 for amounts paid to the franchisee, although it is unclear if asset sale proceeds by the franchisee from sales to parties other than the franchisor will be applied under the statute as an offset. There is no guidance on how to determine fair market value of the franchise, and whether other common law theories of recovery are available or foreclosed. A battle of the valuation experts will ensue in all cases.

The remedial provision is curious insofar as it may apply most effectively to a predatory non-renewal or termination, where the franchisor or an affiliate swoops into a strong market in place of the franchisee and effectively usurps whatever market equity the franchisee might have built up from its success. In contrast, the failing or marginal franchise is not necessarily helped because its market value will be low. This provision is in

essence a codification of common law damage theories for wrongful termination, so the last round of amendments made these changes more benign than earlier versions of the bill.

Bottom Line. Franchisors entering into or renewing franchise agreements with California franchisees after December 31, 2015, should think through how this legislation affects their options and obligations well before the law takes effect in franchise system management. Is this the end of franchising in California? The author believes that some franchisors will choose to take the risk given the riches offered by the robust market. Will more risk be priced into transactions through higher fees? Most likely. Will California consumers benefit from this legislation in the form of more choices, better meeting of their brand expectations and higher levels of consistent product and service quality? Not likely. Is this bill a trend that will influence state relationship law amendments under consideration in other states, a de facto norm of the industry? Stay tuned to these pages...

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[1] CA. Bus. Prof. Code Section 20020, et. seq.

[2] CA. Bus. Prof. Code Section 20021.

[3] Ca. Bus. Prof. Code Section 20999 (p).