



BUSINESS LAW SECTION
FRANCHISE LAW COMMITTEE
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PROPOSED NEW STATUTORY EXEMPTION FOR NEGOTIATED SALES
LEGISLATIVE PROPOSAL (BLS-2016-02)

TO: Office of Governmental Affairs
FROM: Business Law Section Franchise Law Committee
DATE: July 31, 2015
RE: Proposed New Statutory Exemption for Negotiated Sales (Amend Corporations Code § 31109.1)

SECTION ACTION AND CONTACTS

Date of Approval by the Executive Committee of the Business Law Section (the "Section"):
Approval Vote: August 7, 2015

For: 10 Against: 0

Section Contact:	Committee Contact:
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DIGEST:

This is a proposal to amend the existing statute, to facilitate negotiated sales of franchises (currently governed by California Corporations Code section 31109.1). This proposed revision would not affect the similar regulatory exemption contained in California Code of Regulations section 310.10.2.

PURPOSE:

The proposed revision would revise the existing statute to address practical problems that have been created by the current statutory scheme. As an additional benefit, the proposed changes will help to educate prospective franchise buyers about the sales process.

APPLICATION:

I. Current Law and Regulation; Business Background and Environment

Sales of franchises in California are governed by the California Franchise Investment Law, Cal. Corp. Code §31000 *et seq.* (the “CFIL”).

Similar in some regards to federal and state securities laws, franchises subject to the CFIL may only be offered or sold after compliance with various registration and disclosure obligations. In general, most franchises are sold pursuant to the terms of the franchise agreement drafted by the franchisor, which address the needs of the franchisor but may not contemplate requirements or needs of franchisees in special circumstances.

In some cases, prospective franchisees or their counsel may request changes to the franchise agreement or other terms of sale from those registered with the Department of Business Oversight. Depending on the circumstances, the franchisor may be willing to make some or all of the requested changes, and a negotiation process may ensue, which sometimes involves a degree of “give and take” by both parties.

The CFIL states that only a franchise agreement that is described in a disclosure document that has been registered with the Department of Business Oversight can be offered and sold to a resident of California or to a franchisee whose franchise will be located in California (absent any applicable definitional or other exemptions). As the CFIL was originally drafted, this led to a cumbersome procedure if a franchise agreement was changed as a result of negotiations between the parties. Specifically, the franchisor was required to amend its registration (on file with the predecessor to the Department of Business Oversight) before completing the sale. If the franchisor did not want to offer the same amended franchise agreement to all future franchisees in California, the franchisor then needed to re-amend its registration to return to the original document.

There have previously been two efforts to simplify this procedure. The first was a regulation adopted by the predecessor to the Department of Business Oversight (contained at Cal. Code of Regs. §310.100.2), which provided an exemption to the CFIL for “negotiated sales” that complied with the regulatory scheme. After that regulation was adopted, the legislature adopted a slightly different exemption for negotiated sales (*see* Cal. Corp. Code §31109.1). These two exemptions, which are discussed in more detail below, currently operate in parallel, allowing two different ways for franchisors and franchisees to negotiate changes to the registered franchise agreement.

A. California Code of Regulations §310.100.2

The first effort to allow franchisors to negotiate changes to a registered franchise agreement (without going through the cumbersome re-registration process) was enacted by the Department of Corporations (predecessor to the Department of Business Oversight) in 1989. The conditions for exemption in the regulation are:

1. The initial offer (the franchisor's disclosure document) must be registered;
2. Within 15 business days after consummating a negotiated sale, the franchisor must file a "Notice of Negotiated Sale" (on a specified form) with the Department. The "Notice of Negotiated Sale" lists, among other things, a description of the changes that were made by reference to the relevant section of the franchisor's registered disclosure document;
3. When a prospective franchisee receives the franchisor's disclosure document, he or she must also receive copies of all Notices of Negotiated Sale filed by the franchisor in the last 12 months;
4. After a negotiated sale occurs, but before selling any additional franchises, a franchisor must amend its franchise disclosure document to disclose that the terms of the franchisor's disclosure document have been negotiated with other franchisees, and must attach a copy of all Negotiated Sales Notices filed in California in the preceding 12 months; and
5. The franchisor must certify or declare in an appendix to its application for renewal that it has complied with all of the requirements of the regulation, if this exemption is claimed.

B. California Corporations Code §31109.1

In 2004, the legislature attempted to address the issue of negotiated sales through an amendment of the CFIL. That amendment added a new section (§31109.1) to the Corporations Code that exempts certain negotiated sales of franchises.

The statutory exemption eliminates the requirement that a franchisor must amend its franchise registration in connection with a negotiated sale if the following conditions are met:

1. The initial offer (the franchisor's disclosure document) is registered;
2. Within five (5) business days after a request by the prospective franchisee, the franchisor must provide to the franchisee:
 - A. A summary description of each material negotiated term that was negotiated by the franchisor for a California franchise during the previous 12 months; and

- B. A statement indicating that copies of the negotiated terms themselves are available upon written request, and the name, phone number, and address of a franchisor representative from whom the franchisee may obtain the negotiated terms.
- 3. The negotiated terms, on the whole, must benefit the prospective franchisee; and
- 4. The franchisor must certify or declare in an appendix to its application for renewal that it has complied with all of the requirements of the statute, if this exemption is claimed.

II. The Statute and Regulation Have Created Unintended Consequences

Both the regulation and the amendment of the CFIL were intended to facilitate the ability of franchisors to comply with requests for modification of franchise agreements, by eliminating the need to re-register before selling a negotiated franchise agreement. At the same time, however, there was some concern that some franchisees would get more favorable terms than others unless prospective franchisees could find out in advance what other negotiated changes had been made. The regulation and the prior amendments to the CFIL addressed this in different ways.

Under the regulation, a franchisor that takes advantage of the exemption for negotiated changes is required to make publicly available both the fact that the franchisor negotiated changes to its franchise agreement and the general nature of the changes (by filing copies of the Notice of Negotiated Sale with the Department of Business Oversight). While this requirement allows future franchisees to have greater information, franchisors here remained reluctant to negotiate the terms of any franchise agreement, out of concern that other franchisees would expect the same changes (even if those new franchisees were not situated similarly to the franchisee that first negotiated the change).

The prior amendment to the CFIL approached this issue in a slightly different way. A franchisor that uses this exemption is not required to make *public* disclosures about its negotiations, but if the franchisor is considering negotiating with a second (or subsequent) franchisee within 12 months after taking advantage of the exemption, the franchisor must deliver to those franchisees with whom it is willing to negotiate a summary description and copy of the terms that were negotiated with earlier franchisees. So long as a franchisor complies with the conditions of the statutory exemption for negotiated changes, the statute (unlike the regulation) does not require that the negotiated terms themselves be *publicly* disclosed – either through an amendment to the franchisor’s disclosure document, or through a filing with the Department of Business Oversight.¹

¹ Note that the statutory exemption for negotiated sales applies only to negotiated sales that occur within twelve months after a prior negotiated sale. Where a franchisor enters into only a single negotiated franchise agreement within any twelve-month period, it is not required under the statute to give notice of that sale to anyone.

These various requirements for disclosure were rooted in good intentions, but have resulted in unintended consequences. The idea was that full disclosure would promote fairness among franchises, and would help protect franchisees in a relationship that is frequently viewed as one-sided. The reasoning was that where one franchisee was savvy enough to negotiate the terms of her or his agreement, notice of the additional benefits and protections of the negotiated agreement should be made available to subsequent (and possibly less sophisticated) franchisees statewide.

In fact, however, both the statute and the regulation have created significant disincentives for franchisors to negotiate the terms of sales with franchisees. While virtually all franchisors are willing to negotiate with some prospective franchisees under some circumstances (the circumstances under which a franchisor will negotiate varies from franchisor to franchisor), the statute and the regulation actually serve to decrease the numbers of situations in which most franchisors are willing to negotiate with franchisees in California. At this time, California is the only state that currently imposes restrictions on the ability of franchisees and franchisors to negotiate—or that requires the disclosure of negotiated changes.

But if a franchisor negotiates with a franchisee in California (particularly if the franchisor takes advantage of the regulatory exemption for negotiated changes), then the results of that negotiation become publicly available, including to franchisees who are not even located in California. Many franchisors are concerned that this disclosure will cause the negotiated change to become a “new normal,” with future franchisees expecting to get not only every change that was negotiated in the past (whether or not they present circumstances similar to those that led the franchisor to negotiate before), but additional changes as well. To avoid this consequence, many franchisors refuse to negotiate any changes in California—even under circumstances in which they would be willing to negotiate with a similarly-situated franchisee in another state.

Franchisees generally are the parties initiating negotiations, seeking additional or different terms that will benefit them. The regulatory and the statutory exemption were designed to facilitate this process (and to benefit prospective franchisees by giving them access to information about the deals that the franchisor had previously made with others). As evidence of the law of unintended consequences, however, both of the existing exemptions created significant disincentives for franchisors to negotiate the terms of sales with California franchisees.

The business reasons that a franchisor may have to make a particular deal may not be (and usually are not) applicable to each and every franchise prospect. For example, a franchise may be granted to a Native American nation, with its own legal and operational requirements, to a university or college, or to an operator intending to do business on a military base or other unique venue, or to a multi-national corporation with related, but distinct, business units already in operation. Also, one prospect may offer more to the system (in terms of experience, capitalization, location, or other factors) than another, as is the case where the franchisee already has extensive experience under the business model to be franchised, or has a family member engaged in an occupation similar to the franchised business model. But the franchisor may fear that, if it makes a special deal for one franchisee, future prospects will demand the same deal and

be frustrated if they cannot receive it. Additionally, the franchisor may be concerned about making available business terms that it (and the franchisee who received the benefit of the negotiated sale) prefers to remain confidential.

In large measure, franchisors are refusing to negotiate any terms with California-based franchisees. Instead of protecting franchisees, the statute and the regulation have actually caused more harm to them by creating impediments to negotiating deals. For this reason, the Franchise Law Committee supports a revision to the existing statute, as detailed below.

III. Proposed Amendments to Corporations Code Section 31109.1

The proposed amendments to Corporations Code Section 31109.1 would address the existing unintended consequences problem. Under the proposed revision, franchisors would be permitted to negotiate changes to the franchise agreement provided the franchisor has made certain additional disclosures in its franchise disclosure documents that would provide prospective franchisees with more information about the negotiation and sales process.

Specifically, the Committee proposes that all franchisors selling franchises in California have an alternative to following the exemption currently existing under the regulation. Under this alternative approach, franchisors would notify prospective franchisees in California that negotiation of franchise agreements is permitted by law and that California law does not prohibit or compel negotiations. Each franchisor electing to pursue this option would be required to provide the notice to each prospective California franchisee at the same time that the franchisor delivers its disclosure document to the prospect. The disclosure would be contained in the franchisor's California addendum to the franchise disclosure document.

The notice will ensure that prospective franchisees will not be misled into believing that California law disallows negotiations. Prospective franchisees will have the benefit of better information about the negotiation process. Franchisees would be better-informed regarding the franchise relationship in general and its attendant risks, and (depending on the franchisor) they may have the opportunity to negotiate for themselves a deal on better terms than those in the registered offering.

The proposed statute would address the concern that current law creates disincentives for franchisors to negotiate deals, resulting in a situation in which California-based franchisees are, as a practical matter, deprived of an opportunity to negotiate, while franchisees of the same franchisor resident in other states may have such an opportunity. For all of these reasons, the Franchise Law Committee recommends that the proposed amendments to Corporations Code Section 31109.1 be presented to the legislature for its consideration.

ILLUSTRATION:

A franchisor that is registered in California offers to sell a franchise to a California resident (the "Prospect"). The Prospect finds several items in the franchise agreement that the Prospect wants to have changed to benefit him or her.

Prospect contacts the franchisor and asks to negotiate certain of the agreement's terms. Without the proposed new regulation, the franchisor is likely to notify the Prospect that, although franchisor would ordinarily be willing to negotiate, because the Prospect lives in California, the franchisor is not willing to change any of the agreement's terms.

Prospect asks the sales team why the franchisor will not negotiate. The franchisor responds by explaining that California law would require the franchisor to either file the negotiated changes, or make them available to subsequent prospects who want to negotiate with the franchisor. The franchisor indicates that, while Prospect has certain business experience that warrants special changes to the form franchise agreement, the franchisor does not want to make these changes known publicly because future prospects that do not have similar backgrounds would demand the same terms. Under existing law, the Prospect would face the choice to either: (a) walk away from the deal; or (b) accept the deal on terms that are less favorable to the Prospect than they would have been, had the Prospect been from a state other than California.

The proposed statutory amendment would offer a solution to this problem: the franchisor would be able to negotiate changes to the franchise agreement without the concern of making those changes public and known to later prospects. Also, Prospect would be informed through the disclosure document that California law permits a franchisor to negotiate.

DOCUMENTATION:

The Franchise Law Committee is not aware of any specific documentation to support the Committee's view that this is a problem. That said, a variety of franchise professionals have informed members of the Committee that California's laws on negotiated sales are a direct impediment and disincentive to negotiations between franchisors and franchisees. Moreover, in practice, members of the Committee (who represent both franchisors and franchisees) agree that the current statute and regulation do, in fact, cause the problem described above. Many Committee members have commented that the scenario illustrated above has occurred in their practice more than once.

HISTORY:

Originally, the CFIL did not contain any exemption for negotiated sales. As stated above, without an exemption, the only way for a franchisor to proceed with a negotiated sale was to register the revised, negotiated franchise agreement, which created an administrative burden on franchisors. To address this issue, the Department of Business Oversight first issued regulation §310.100.2, creating an exemption for negotiated sales that comply with the regulation's requirements. Subsequently, the statutory exemption was passed, creating an additional exemption and path for franchise companies to avoid the burden of a full registration for the negotiated document.

The Committee is not aware of any similar proposals considered by the legislature since the 2004 addition of §31109.1.

PENDING LITIGATION:

The Committee is not aware of any pending litigation that would be affected by the proposed amendments to the statute.

LIKELY SUPPORT & OPPOSITION:

Both franchisors and franchisees are likely to support the proposed statutory amendment. The Committee is comprised of both attorneys who primarily represent franchisees and those who primarily represent franchisors. Attorneys falling into both categories support the proposed amendment.

Only one member of the Committee, who primarily represents franchisees, opposes this proposed amendment. His objection is to striking subsection (a)(4) from Corporations Code Section 31109.1; specifically, that “[t]he negotiated terms, on the whole, confer additional benefits on the franchisee.” His concern is that removal of that subsection creates a pathway for unscrupulous franchisors to abuse the exemption by imposing upon franchisees unfavorable amendments that are not disclosed in the franchise disclosure document as a matter of course.

The other seventeen members of the Committee, who support this proposed amendment (and who include attorneys primarily representing franchisees), disagree. They feel that Corporations Code Section 31109.1(a)(4) needs to be stricken. If the language is retained, a franchisor relying on this exemption would be required to make a judgment call regarding whether the negotiated terms “on the whole confer benefits on the franchisee” in any situation where a credible argument can be made that any of the terms benefit the franchisor.

For this reason, the Committee believes that retaining Corporations Code Section 31109.1(a)(4) could result in franchisors remaining reluctant to negotiate changes in California. This is because negotiating franchisors could be forced to litigate whether the negotiated changes were beneficial to the franchisee. In other words, retaining that subsection could invite litigation, which is something the Committee would like to avoid.

Moreover, the Committee notes that: (a) the existing regulation at Cal. Code of Regs. §310.100.2 does not contain language like that in Corporations Code Section 31109.1(a)(4); (b) no other state currently imposes a similar requirement relating to negotiated changes, and the Committee is not aware of any specific examples of abusive behavior by franchisors during negotiations; and (c) in any event, franchisees remain free to refuse to sign agreements that vary from the form registered.

FISCAL IMPACT:

The Committee believes that the fiscal impact of the proposed amendments would be minimal. The Committee believes that the proposed amendments could have a positive net impact on the state’s economy. If more franchisors are willing to negotiate with prospects after the statute is revised, it stands to reason that more franchises will be sold, and businesses opened, within the state.

GERMANENESS:

The amendment to the statute requires the special knowledge, training, experience or technical expertise of the Section because the Section (and, particularly, the Franchise Law Committee) has the practical experience to understand how the CFIL affects franchise sales and negotiations in California.

DISCLAIMER:

This position is only that of the Franchise Law Committee of the Business Law Section of the State Bar of California. This position has not been adopted by the State Bar's Board of Trustees or overall membership, and is not to be construed as representing the position of the State Bar of California.

Membership in the Franchise Law Committee and in the Business Law Section is voluntary. Funding for Section activities, including all legislative activities, is obtained entirely from voluntary sources.

TEXT OF PROPOSAL:

Section 31109.1 of the California Corporations Code is amended to read as follows:

(a) There shall be exempted from the provisions of Chapter 2 (commencing with Section 31110) the ~~offer and~~ sale of a franchise registered under Section 31111, 31121, or 31123 on terms different from the terms of the offer registered thereunder if all of the following requirements are met:

(1) The initial offer is the offer registered under Section 31111, 31121, or 31123.

(2) The franchisor's disclosure document discloses that California law does not prohibit a franchisor from negotiating, or require a franchisor to negotiate, the standard franchise agreement contained in the disclosure document.

~~(2) The prospective franchisee receives all of the following in a separate written appendix to the franchise disclosure document:~~

~~(A) A summary description of each material negotiated term that was negotiated by the franchisor for a California franchise during the 12-month period ending in the calendar month immediately preceding the month in which the negotiated offer or sale is made under this section.~~

~~(B) A statement indicating that copies of the negotiated terms are available upon written request.~~

~~(C) The name, telephone number, and address of the representative of the franchisor to whom requests for a copy of the negotiated terms may be obtained.~~

(3) The franchisor certifies or declares in an appendix to its application for renewal that it has complied with all of the requirements of this section, in the event this exemption is claimed.

~~(4) The negotiated terms, on the whole, confer additional benefits on the franchisee.~~

~~(b) The franchisor shall provide a copy of the negotiated terms described in subdivision (a) to the prospective franchisee within five business days following the request of the franchisee.~~

(e) (b) The franchisor shall maintain copies of all material negotiated terms for which this exemption is claimed for a period of five years from the effective date of the first agreement containing the relevant negotiated term. Upon the request of the commissioner, the franchisor shall make the copies available to the commissioner for review. ~~For purposes of this section, the commissioner may prescribe by rule or order the format and content of the summary description of the negotiated terms required by subparagraph (A) of paragraph (2) of subdivision (a).~~