



**BUSINESS LAW SECTION
FRANCHISE LAW COMMITTEE**

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PROPOSED NEW REGULATORY EXEMPTION FOR NEGOTIATED SALES

LEGISLATIVE PROPOSAL (BLS-2013-07)

TO: Office of Governmental Affairs
FROM: Business Law Section Franchise Law Committee
DATE: March 19, 2012
RE: Proposed New Regulatory Exemption for Negotiated Sales (Amend Code of Regs., § 310.100.2 and add Code of Regs., § 310.150)

SECTION ACTION AND CONTACTS

Date of Approval by Section Executive Committee (the "Executive Committee"): June 1, 2012
Approval Vote: For: 14 Against: 0

Executive Committee Contact:	Committee Contacts:
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DIGEST:

This memorandum is intended as a formal presentation to the California Commissioner of Corporations (the “Commissioner”) regarding the benefits of adopting a new exemption to facilitate negotiated sales of franchises (currently governed by California Corporations Code section 31109.1 and California Code of Regulations section 310.10.2).

PURPOSE:

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

APPLICATION:

I. Current Law and Regulation; Business Background and Environment

Similar in some regards to federal and state securities laws, franchises subject to the California Franchise Investment Law (Cal. Corp. Code §31000 *et seq.*) may only be offered or sold after compliance with various registration and disclosure obligations, absent any applicable definitional or other exemptions. 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 Corporations. 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 California Franchise Investment Law (CFIL) states that only a disclosure document and franchise agreement that have been registered with the Department of Corporations can be offered and sold to a person protected by the law. In the absence of a specific exemption, an agreement that has been changed as a result of negotiations between the parties would need to be registered under the CFIL before the sale can be consummated.

A “negotiated sale” under the CFIL and the applicable section of the Code of Regulations is the sale of a franchise on terms that are different from the terms set forth in the franchisor’s registered franchise disclosure document. *See* Cal. Corp. Code §31109.1; Cal. Code of Regs. §310.100.2 (the two laws that currently provide exemptions from the CFIL). In the absence of an applicable exemption, registration and re-disclosure of the terms of the negotiated sale would be required for any such sale. The current statute (Cal. Corp. Code §31109.1) and the related regulation (Cal. Code of Regs. §310.100.2) offer an alternative to this approach, so long as the franchisor can meet the conditions set forth in the applicable section.

A. California Corporations Code §31109.1

The statute exempts a franchisor from the requirement of re-registering (or amending) its franchise disclosure document in connection with a negotiated sale. To take advantage of the exemption, a franchisor is required, among other things, to make available to prospective franchisees with whom the franchisor desires to negotiate a summary description and copy of the terms that were negotiated with earlier franchisees. Specifically, for each negotiated sale that is made after the initial negotiated sale during any twelve-month period, the franchisor must comply with the following requirements:

1. The initial offer (the franchisor's disclosure document) must be 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.

So long as the above conditions are met, 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 a filing with the Department of Corporations.¹

B. California Code of Regulations. §310.100.2

The regulation provides for an alternative exemption for negotiated sales from an amendment or re-registration duty for franchisors. The conditions for exemption in the regulation, however, are markedly different from those in the statute. Those conditions are:

¹ The statute applies only to negotiated sales that occur within the twelve months after each 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.

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.

Unlike the statute, the regulation requires both the amendment of the franchisor's disclosure document and public filing of the Notice of Negotiated Sale with the Department of Corporations (making the negotiated changes publicly available). Also unlike the statute, the regulation does not require that the changes made, on the whole, benefit the franchisee. As a result, a franchisor that makes a negotiated sale where each and every term does not benefit the franchisee must make a judgment call as to whether it must comply with the regulation.

II. The Statute and Regulation Have Created Unintended Consequences

The statute and regulation were intended to promote fairness among franchises, and to help protect franchisees in a relationship that is frequently viewed as one-sided, as well as to facilitate the ability of franchisors to comply with requests for modification of franchise agreements. In other words, the reasoning has been that where one franchisee is 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. California is the only state that currently imposes restrictions on the ability of franchisees and franchisors to negotiate.

Franchisees generally are the parties initiating negotiations, seeking additional or different terms that will benefit them. The statute and the regulation were designed to facilitate this process, and to benefit prospective franchisees by giving them access to information about the deals the franchisor made with others. As evidence of the law of unintended consequences, 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.

While the statute does not require a franchisor making a negotiated sale to amend the franchisor's disclosure document or to make a filing with the Department of Corporations, the statute does require that the franchisor provide copies of the actual negotiated terms to subsequent franchisees with whom the franchisee is willing to negotiate. From the franchisor's perspective, this creates a significant problem: after making a negotiated sale, the franchisor must now provide the details of that sale to each subsequent franchisee with whom the franchisee is willing to negotiate. The franchisor may not want to give those same terms to every franchisee, and may have rational business reasons for not doing so.

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 an Indian 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) wants to remain confidential.

The regulation is even more troubling for franchisors, as negotiated changes must be disclosed even to prospective franchisees with whom the franchisor has no intention to negotiate. Under the regulation, a franchisor must create and file with the Department of Corporations a Negotiated Sales Notice every time it negotiates a special deal with a franchisee. Those terms then become publicly available, through the Department's online database or otherwise, even to prospective franchisees who are not otherwise protected by California law. In addition, the franchisor must attach each Negotiated Sales Notice to its disclosure document, which is made available to all subsequent franchisees for the stated time period.

While the statute and the regulation were intended to permit (or even facilitate) negotiation, the business and economic issues presented by the statute and the regulation have resulted in an unintended consequence: in large measure, franchisors are refusing to negotiate any terms with California-based franchisees. Because franchisors may be required to disclose all negotiated terms (depending on the exemption used), they are disinclined to provide a particular franchisee a special deal, in fear that subsequent franchisees will demand the same deal, regardless of whether the same circumstances are present that surrounded the initial

negotiated deal. Instead of protecting franchisees, the statute and the regulation have actually caused more harm to them by creating impediments to the negotiability of their deals. For this reason, the Franchise Law Committee supports a revision to the existing regulation, as detailed below.

III. Proposed Amendments To Regulation 310.100.2

The proposed amendments to regulation 310.100.2 would address the existing unintended consequence problem. Under the proposed revisions, franchisors would no longer be required to give negotiated sales information (including Notices of Negotiated Sale) to prospective franchisees. Instead, franchisors would be required to make certain additional disclosures in 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 would be required to provide prospective franchisees in California with notice that negotiation of franchise agreements is permitted by law. Each franchisor would be required to give a notice of this type to each prospective franchisee in California at the same time that the franchisor delivers its disclosure document to the prospect. This required disclosure, which would be contained in the California addendum to the franchise disclosure document, would state: (a) that California law does not prohibit or compel negotiations; (b) whether, as a general practice, the franchisor negotiates sales with prospective franchisees; and (c) the electronic and (if applicable) physical address for obtaining a copy of the informational pamphlet discussed below.

The proposed revisions include a tool that can be used by the Department of Corporations to enforce the regulation. Specifically, the Department is authorized to assess a monetary penalty of not more than \$10,000 per violation, which is consistent with the limits of authority contained in Cal. Corp. Code §31405. The Franchise Law Committee also considered, and rejected, the possibility of including separately enumerated enforcement mechanisms in the text of the proposed regulation. On this point, the Committee determined that the existing tools contained in other sections of the CFIL already provide certain powers to the Department of Corporations for dealing with violations of the regulation. *See, e.g.*, Cal. Corp. Code §§ 31400, 31403-31408.

The second component of the revised regulation would require the creation of an informational pamphlet about negotiated sales, which will be made available to prospective franchisees. The primary purpose of the pamphlet would be to inform a prospect about the sales and negotiation process and to combat the disinformation allegedly given by some franchise sales professionals.

The educational component means 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. Further, prospects will understand from the outset whether the franchisor is willing to negotiate with them, and can use that information in determining whether to buy a franchise. 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 regulation would address the concern that the 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 regulation 310.100.2 be presented to the Commissioner for his consideration and potential adoption.

IV. Proposed New Regulation 310.150

As part of this amendment, the Franchise Law Committee is also recommending the creation of a new provision, regulation 310.150, which would impose record keeping requirements for franchisors that use the new exemption under amended regulation 310.100.2. Specifically, franchisors that rely on 310.100.2 will be required to maintain copies of all material negotiated terms (together with such other records as are necessary to show that they have complied with the negotiated sales statute or the amended regulation) 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. This record keeping requirement would protect California franchisees against abuse of the exemption by franchisors who fail to comply with the requirements of the statute or the amended regulation.

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 the 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 regulation 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. Prospect will have had the opportunity to read the informational pamphlet using the directions disclosed in the disclosure document, and would as a result be better educated about the negotiation and sales process as a whole.

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 would be to register the revised, negotiated franchise agreement, which created an administrative burden on franchisors. To address this issue, the Department of Corporations first issued regulation §310.100.2, creating an exemption for negotiated sales that comply with the regulation's requirements. Subsequently, the statute 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 Commissioner in the past.

PENDING LITIGATION:

The Committee is not aware of any pending litigation which would be impacted by the proposed amendments to the regulations.

LIKELY SUPPORT & OPPOSITION:

The proposed regulations have been supported by Committee-member attorneys who primarily represent franchisees and those who primarily represent franchisors.

FISCAL IMPACT:

The Committee believes that the fiscal impact of the proposed amendments would be minimal. The proposed amendments, if enacted, would require the creation of an informational pamphlet (which the Committee could assist in creating). This pamphlet would largely be disseminated via the Internet, but would also be available in printed form by a prospective franchisee's request directed to the Department of Corporations. The Committee also 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 regulation is revised, it stands to reason that more franchises will be sold, and businesses opened, within the state.

GERMANENESS:

The amendments to the proposed regulations require 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 statute and regulation have affected 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 and funding for section activities, including all legislative activities, is obtained entirely from voluntary sources.

TEXT OF PROPOSAL:

Section 310.100.2 of Title 10 of the California Code of Regulations would be amended, to read as follows:

310.100.2 Negotiated Sales

~~(a) General.~~ The offer or sale of a franchise on terms different from the terms of the offer registered under Section 31111, 31121, ~~or 31123~~ or 31125 of the Law is exempt from the registration requirements ~~of Section 31110 of the Law~~ under the Law, if all of the following conditions are met:

(1) The initial offer is the offer registered under ~~to Section 31111, 31121, or 31123 of the Law~~ or 31125, or is exempt under the Law.

(2) ~~When the prospective franchisee receives the offering circular, he or she also receives copies of all Notices of Negotiated Sale of Franchise filed with the Commissioner within the last 12 months, if any. The franchisor's disclosure document discloses that:~~

(A) California law does not prohibit a franchisor from negotiating, or require a franchisor to negotiate, with a prospective franchisee for the purpose of making changes to the standard franchise agreement contained in the disclosure document;

(B) Whether, as a general practice, the franchisor is willing to negotiate the terms of its standard franchise agreement with a prospective franchisee; and

(C) The uniform resource locator address where a prospective franchisee can download the informational pamphlet on negotiated sales entitled "[INSERT TITLE]," as well as a physical address to where the prospect can write to request a hard copy of the pamphlet.

~~(3) Before selling another franchise, the franchisor amends its registered offer to disclose: "The terms of Item(s) _____ of this Offering Circular have been negotiated with other franchisees. A copy of all Negotiated Sales Notices filed in California in the last twelve months is attached as Exhibit _____." This disclosure should be made in the UFOC Item that was negotiated or in an appendix to the UFOC. This disclosure must be made if the negotiated sale occurred within twelve months of the offering being made. An amendment making only this disclosure is effective when filed. 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 Notice of Negotiated Sale of Franchise in the form set forth in subsection (b) is filed with the Commissioner within 15 business days after the negotiated sale is consummated.~~

~~(5) The franchisor certifies or declares in an appendix to its application for renewal that all notices have been filed with the Commissioner as required by paragraph (a)(4) (see Section 310.122 of these rules).~~

~~(b) The Notice of Negotiated Sale of Franchise required by subsection (a)(4) of this rule shall be filed on the following form:~~

Section 310.150 of Title 10 of the California Code of Regulations would be added, to read as follows:

310.150. Record Keeping

(a) In addition to the other books, records, and accounts of sales required to be maintained by Section 31150 of the Code, each franchisor that sells a franchise on terms different from the terms of the offer registered under Section 31111, 31121, 31123 or 31125 of the Law shall maintain copies of all material negotiated terms (together with such other records as are necessary to show compliance with Section 31109.1 of the Law or Section 310.100.2 of this regulation) 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 such copies available to the Commissioner for review.

(b) The Commissioner may address violations of this regulation in accordance with the provisions of Sections 31405, 31406, 31407, or 31408(b) of the Law.