New Federal Franchise Bills Seek to Bring Balance to Relationship

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Two bills introduced in Congress on July 23, 2015, aim to give franchisees "more information and more say in the businesses they run," according to the bills' sponsor, Rep. Keith Ellison (D-MN). The Small Business Administration Franchise Loan Transparency Act (H.R. 3195) and the Fair Franchise Act (H.R. 3196) would require franchisors to provide more accurate financial information before a franchisee invests, as well as more transparency in business operations and more protections against unfair practices. The bills offer the potential for a federal standard for franchise agreements, establishing baselines for renewals, transfers, and terminations.

If passed, the SBA Franchise Loan Transparency Act and the Fair Franchise Act would change the way franchising operates. In this article, we consider the implications of each Act and assert that both represent a step in the right direction because they seek to balance the scales that have for so long weighed in franchisors' favor.

The full text of each bill is available through the Library of Congress at http://thomas.loc.gov.

SBA Loan Transparency Act

The SBA Franchise Loan Transparency Act would set "minimum standards of disclosure" by franchisors whose franchisees use loans guaranteed by the SBA. H.R. 3915 § 2(b). The Act would ensure transparency in the loan process, reduce fees and rates charged to franchisee borrowers, help ensure lower default rates, and prohibit "hidden" discussions between franchisors and lenders. *Id.* § 2(b)(1)–(4). Franchisors (other than those in the lodging sector) would be required to disclose the average first-year revenue of each franchise location for the preceding five years of operation; the number of franchise locations that went out of business or were sold by franchisees during the first year of operation for each of the preceding five years; and average revenues for all locations for each of the preceding five years, aggregated to show the top 25 percent, middle 50 percent, and bottom 25 percent of revenue. *Id.* § 3(a)(1)–(3). In addition, franchisors would have to give franchisees any financial information relating to the performance of any location provided to the lender for purposes of qualifying for the loan. *Id.* § 3(b).

To explain the need for such measures, the Act cited a study by the U.S. Government Accountability Office (GAO) showing that in the decade from 2003 to 2012, of 32,323 SBA loans to franchisees, totaling $10.6 billion, 28 percent required guarantee payments, totaling $1.5 billion. *Id.* § 2(a)(6) (citing GAO, Review of 7(a) Guaranteed Loans to Select Franchisees, GAO-13-759). The report concluded that potential franchisees should include first-year revenue estimates in their SBA applications but noted that "this information is not necessarily available to potential franchisees" in the FDD. *Id.* Further, citing audit reports by the SBA Office of Inspector General, the Act noted that certain franchise brands had "exceptionally high default rates," *id.* § 2(a)(5) (citing Report No. 13-7), and that first year revenue projections for Huntington Learning Center franchisees have been "significantly inflated." *Id* at § 2(a)(4) (citing Report No. 11-16). The type of financial disclosures required by the Act may indeed reduce litigation over misleading or misstated financial representations, in that the misleading statements commonly relate to initial profitability and the potential for an immediate return on investment.

The requirements of the Transparency Act are consistent with a franchisor's obligations under the Amended FTC Rule with respect to the dissemination of financial performance representations. In our experience, however, franchisors, through their sales representatives, frequently make additional representations that are inconsistent with the limited information provided in Item 19 and do not strictly comply with the disclosure requirements. Given the lack of a private right of action available to franchisees and the use of merger and integration and disclaimer clauses to bar actions based on oral financial performance representations, these franchisors have been able to sidestep the disclosure requirements of the Amended FTC Rule. If passed, the Act would reinforce franchisors' current obligations and permit franchisees a viable cause of action where franchisors fail to comply with the statute. Franchisors may claim that requiring such financial

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disclosures is impractical because they do not have access to revenue data. But the SBA Loan Transparency Act correctly notes that "franchise companies most often collect royalties based on gross revenue; therefore, revenue data on each franchise outlet is readily available." H.R. 3195 § 2(a)(7).

Fair Franchise Act

The Fair Franchise Act is intended to rectify "a profound imbalance of contractual power in favor of the franchisor." H.R. 3196, § 2(a)(5). The legislation focuses on three areas of concern: franchise sales and pre-sale disclosures; unfair practices; and renewal, transfer, and termination.

Franchise Sales and Pre-Sale Disclosures: Numerous franchisees have sued franchisors over false or misleading financial performance representations made during the sales process. Some lawsuits have been defeated by franchisors based on merger and integration clauses in the franchise agreements. *See, e.g. Steak n Shake Enters., Inc. v. Globex Co., LLC et al.,* 2015 WL 3883590 (D. Colo. June 23, 2015).

The Fair Franchise Act would prohibit franchisors and their agents from failing to provide a franchisee with historical financial performance data, including sales, expenses, and profitability, and from making oral or written statements that are inconsistent with the FDD. H.R. 3196, § 3(a)(2)(C). The Act would give franchisees a statutory cause of action against franchisors that use such sales tactics and would reduce or eliminate the effectiveness of merger and integration clauses as a means to avoid liability for false or misleading representations. *Id.* § 5(c).

Unfair Trade and Business Practices: The Fair Franchise Act would identify and prohibit deceptive and discriminatory practices already prohibited by some state laws. *Id.* § 3(b). Among other things, the legislation would bar franchisors from:

- Prohibiting, or penalizing franchisees for forming or participating in, franchise associations;
- Discriminating against franchisees by imposing conditions on some franchisees but not others;
- Imposing unreasonable and excessive renewal fees;
- Enforcing mandatory arbitration clauses or prohibiting class or mass actions;
- Terminating, cancelling, or refusing to renew franchise agreements based on franchisees' failure to participate in promotional campaigns, sell services and products at a specific price, or meet sales quotas;
- Collecting liquidated damages in excess of average monthly royalties for the previous calendar year multiplied by six months or the number of months remaining in the franchise agreement, whichever is less; and
- Refusing to provide, free of charge, physical copies of all records and accountings of marketing, rewards programs, advertising funds, and fees paid by franchisees for suppliers.

Id. §§ 3(b), 5(b).

The Act expressly acknowledges that franchise agreements impose duties of good faith and due care on franchisors, *id.* § 4(a)-(b), and would give franchisees a statutory cause of action against franchisors that violate those duties. *Id.* § 5. The Act also would prohibit franchisors from obtaining non-disparagement clauses as part of a waiver or release. *Id.* § 5(a)(3).

Renewal, Transfer, and Termination: Franchisees make a substantial investment when they purchase a franchise. To protect this investment, the Fair Franchise Act contemplates a statutory regime for transfer, renewal, and termination of franchise agreements. *Id.* §§ 6–9.

For example, the Act would allow franchisors to condition a transfer upon completion of a training program, payment of a transfer fee, and payment of all amounts then due. *Id.* § 6(d). But it would not allow franchisors to condition the transfer upon the transferee making capital improvements greater than those required under the current franchise agreement. *Id.* § 6(e). The Act would permit franchisees to transfer time remaining on their franchise agreements and would not allow franchisors to require a transferee to enter into a franchise agreement on terms materially different than those in the current agreement. *Id.* § 6(f). Finally, the Act would prohibit franchisors from enforcing covenants not to compete against a transferor, although it would not limit franchisors' ability to enforce covenants against exploiting trade secrets or trade dress and other intellectual property rights. *Id.* § 6(j).

The Fair Franchise Act would also set standards governing renewal and termination, including specific notice and cure periods, and a requirement that a franchisor compensate a franchisee for the fair market value of the franchise assets upon termination or waive the covenant not to compete. *Id.* §§ 7, 8. The Act would grant franchisees a statutory right to terminate their franchise agreements for good cause. *Id.* § 8(g). Good cause could include the imposition of any substantial change to the franchise business that causes a financial hardship on the franchisee. *Id.* Thus, franchisees would not have to accede to unreasonable

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requirements to make system modifications without redress.

Private Rights of Action, Prospective Application: The Act would give franchisees a private right of action for any statutory violation within the federal court where the franchisee is located, with the right to recover attorney fees and costs. *Id.* § 11. For example, if a franchisor attempted to manufacture a default to thwart or penalize a franchisee for joining a franchise association, the franchisee could sue the franchisor under the statute to enjoin the termination and recover attorney fees.

The Act would apply prospectively for the most part. *Id.* § 12(a). But Section 3, which relates to unfair trade practices, would take effect ninety days after enactment and would apply to all practices, disclosures, and statements that occur on or after the ninety-day period expires. Franchisors and franchisees alike should pay particular attention to Section 3, because it may be used to challenge certain provisions in franchise agreements, such as mandatory arbitration provisions, and to defend against unfair termination or non-renewal for reasons such as refusal to participate in a franchisor's promotional campaigns. *Id.* §§ 3(b)(6), (7)(A)).

The Time Is Right for Change

Franchising as an industry is getting more national attention than ever before, much of it critical of franchisors. The National Labor Relations Board has issued rulings threatening franchisors with joint employer liability. The Service Employees International Union has petitioned the Federal Trade Commission to investigate "the existence and extent of abusive and predatory practices by franchisors toward franchisees." Even though franchisors and their defenders still suggest there is little to nothing wrong with the legal framework of franchising, the unfettered right of franchisors to use one-sided, take-it-or-leave-it franchise agreements has increasingly come under fire.

For years, franchisees and franchise associations have sought basic fairness protections on these very issues. *See, e.g.*, Asian American Hotel Owners Association's Points of Fair Franchising, *available at* http://www.aahoa.org. The SBA Loan Transparency Act and the Fair Franchise Act would provide such protections. The bills have garnered the support of the Coalition of Franchisee Associations (CFA), the Edible Arrangements Independent Franchise Association, the Independent Organization of Little Caesar Franchisees, the International Association of Kumon Franchisees, the Meineke Dealers Association, the North American Association of Subway Franchisees, and the Service Station Franchisee Association, among others.

The International Franchise Association has proclaimed concern that franchise growth will be crippled by paternalistic governmental intervention—even though it has projected for five years running that franchised businesses will grow faster and create more jobs than any other business sector.

But the SBA Loan Transparency Act and the Fair Franchise Act are likely to encourage franchise growth, not discourage it, because they would bring a level of fairness to the franchisor-franchisee relationship. By protecting the investment of small business owners, they are likely to spur further investment in the franchise sector.

With an election year on the horizon, congressional leaders are eager to shore up support from the small business community. Some manner of franchise reform would allow them to do just that. ■