

Date of Hearing: June 21, 2022

**ASSEMBLY COMMITTEE ON BUSINESS AND PROFESSIONS**

Marc Berman, Chair

SB 1247 (Hueso) – As Amended June 8, 2022

**NOTE:** This bill is double referred and if passed by this Committee will be referred to the Assembly Committee on Judiciary.

**SENATE VOTE:** 29-0

**SUBJECT:** Franchises.

**SUMMARY:** Establishes new disclosure requirements related to franchisor rebates and other benefits and requires a franchisor to disclose the value of all monetary benefits in any agreement that requires a franchisee to assign or waive the franchisee's right to the benefit.

**EXISTING FEDERAL LAW:**

- 1) Regulates unfair and deceptive business practices under the Federal Trade Commission Act and establishes the Federal Trade Commission (FTC) to administer and enforce the act. (15 United State Code) (USC) §§ 41-58)
- 2) Regulates franchise agreements and establishes disclosure requirements under the FTC's Franchise Rule. (Title 16 Code of Federal Regulations (CFR) Parts 436 and 437)
- 3) Defines "franchise" as any continuing commercial relationship or arrangement in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, all of the following:
  - a) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark. (16 CFR § 436.1(h)(1))
  - b) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation. (16 CFR § 436.1(h)(2))
  - c) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate. (16 CFR § 436.1(h)(3))
- 4) Defines "franchisee" as any person who is granted a franchise. (16 CFR § 436.1(i))
- 5) Defines "franchise seller" as a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does

not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor. (16 CFR § 436.1(j))

- 6) Defines “franchisor” as any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For purposes of this definition, a “subfranchisor” means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance. (16 CFR § 436.1(k))
- 7) Makes the offer or sale of a franchise an unfair or deceptive act or practice in violation of the Federal Trade Commission Act unless the franchisor furnishes a prospective franchisee with a copy of the FTC’s Franchise Disclosure Document, except as specified. (16 CFR § 436.2)

#### **EXISTING STATE LAW:**

- 1) Regulates franchise agreements under the California Franchise Relations Act and establishes requirements on franchisors related to the termination, renewal, and transfer of a franchise. (Business and Professions Code (BPC) §§ 20000-20043)
- 2) Regulates the sale of franchises under the Franchise Investment Law and tasks the Department of Financial Protection and Innovation with administering and enforcing the law. (Corporations Code (CORP) §§ 31000-31516)
- 3) Makes a violation of any provision of the Franchise Investment Law punishable, upon conviction, by a fine of not more than \$100,000 or imprisonment under felony sentencing guidelines, or in a county jail for not more than one year, or be punished by both that fine and imprisonment; but provides that no person may be imprisoned for the violation of any rule or order if they prove that they had no knowledge of the rule or order. (CORP § 31410)

#### **THIS BILL:**

- 1) Requires a franchisor and its affiliated companies, within 120 days of the end of the franchisor’s fiscal accounting year, to report to its California franchisees, upon a franchisee’s request, any money, goods, services, things of value, or entities with whom the franchisee does business on account of the franchise.
- 2) Requires the reported data to be detailed by each entity that provides the benefit.
- 3) Makes it a violation of the Franchise Investment Law for a franchisor to execute an agreement that requires the assignment or waiver of a franchisee’s right to rebates, promotions, allowances, or other monetary incentives for the sale of a product within the state unless the agreement states the potential or current gross value of that right.
- 4) Requires the franchisor, if the actual gross value of the assigned or waived right is unknown, to include a reasonable estimate of the value based on the average value for similarly situated franchises.
- 5) Provides that the violation of the Franchise Investment Law created under this bill does not constitute a crime.

**FISCAL EFFECT:** Unknown. This bill was rekeyed as fiscal by the Legislative Counsel in the June 8, 2022, amendments.

**COMMENTS:**

**Purpose.** This bill is co-sponsored by the *American Association of Franchisees and Dealers* and the *Asian American Hotel Owners Association*. According to the author, “This bill will require a Franchisor to provide how much is generated from rebates, promotions, allowances, or other monetary incentives, services and benefits where the franchise contract includes a clause requiring the waiver or assignment of all rights to the Franchisor for those funds. The disclosure of the amount shall be specific to a location similar to the one the Franchisee is considering. Currently, a potential Franchisee has little conceptual grasp of the true amount of the funds they are signing away at the beginning of their franchise contract nor how much they are continuously giving away to the Franchisor over the course of the contract, largely because the current required disclosure is the sum of everything the Franchise company is receiving from all of their outlets. That number can be so large as to be overwhelming and impossible to figure out how much just one outlet will be giving away. Additionally, this bill has a requirement for ongoing reporting of these funds to the Franchisee, one time per year and upon Franchisee’s request, over the life of the contract. These changes will make the contract fairer to the Franchisee and bring about a truer meeting of the minds between Franchisor and Franchisee.”

**Background.** A franchise is a contractual business arrangement where a business (franchisor) authorizes another person or entity (franchisee) to establish their own business using the franchisor’s brand and to sell its products or services utilizing a defined marketing or business system established by the franchisor. The franchisor benefits from the expansion of its brand and additional income from fees, royalties, or other payments. The franchisee’s business benefits from the name recognition and the convenience of using an established product or service and business model.

However, lack of transparency and deceptive practices in the contract negotiations have led to the regulation of franchises at both the federal and state level. As noted in the Franchise Investment Law findings and declarations:

The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. Prior to the enactment of this [law], the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to those transactions. California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor and franchisee by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship.

*Federal Franchise Disclosure Document.* At the federal level, the FTC has promulgated a package of regulations known as the Federal Franchise Rule. Among other things, the rule requires all franchisors to create a document known as the Franchise Disclosure Document (FDD), and provide that document to franchisees before the completion of a franchise contract. The purpose of the document is to ensure all parties to the agreement are informed of the details of the arrangement.

The Federal Franchise Rule requires the FDD to contain 23 aspects of the business agreement, including franchisee obligations, fees, start-up costs, supplier restrictions and rebates, and territorial rights and restrictions. For supplier restrictions and rebates, the FDD requires franchisors to disclose which goods, services, or other products franchisees must purchase from specific sources and the total revenue or material benefits the franchisor may receive from those purchases.

This bill would establish a similar California-specific requirement, except that a franchisor would be required to report rebates on an ongoing basis, as well as disclose the revenue amounts by each vendor. It would also require the franchisor to appraise and disclose the value of any monetary benefit a franchisor may be required to waive or assign away as part of the franchise agreement, such as discounts or other incentives.

#### **ARGUMENTS IN SUPPORT:**

The *American Association of Franchisees and Dealers* and the *Asian American Hotel Owners Association* (co-sponsors) write in support, "[This bill] will specifically require franchise companies to annually report the rebates and other benefits vendors provide to the franchisors based on franchisee purchases. These rebates, or kickbacks, have become greater over the years, and instead of enjoying the promised benefits of group purchasing power, franchisees are often required to purchase goods and services from limited suppliers at higher costs. Having these rebates reported annually will give transparency to what franchisees are really paying for, which squeezes our margins, contributes to lower pay for our employees, and ultimately costs the consumer."

#### **ARGUMENTS IN OPPOSITION:**

None on file

#### **IMPLEMENTATION ISSUES:**

*Clarifying Changes.* This bill requires that franchisors report things of value and entities to its franchisees, but is unclear on the relation of the items being reported to the franchise agreement.

If this bill passes this Committee, the author may wish to clarify the bill in the Assembly Committee on Judiciary with the following amendments:

On page 2 of the bill, lines 7 to 13:

**20033.** Within 120 days of the end of the franchisor's fiscal accounting year, the franchisor and its affiliated companies shall report to its California franchisees, upon ~~their~~ *a franchisee's* request, any moneys, goods, services, anything of value, or any other *benefit received by the franchisor from an* entity with whom the franchisee does business on account of ~~that business.~~ *the franchise.* The reported data shall be detailed by each entity that provides the benefit.

**REGISTERED SUPPORT:**

American Association of Franchisees and Dealers (co-sponsor)

Asian American Hotel Owners Association (co-sponsor)

**REGISTERED OPPOSITION:**

None on file

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