

Date of Hearing: June 28, 2022

ASSEMBLY COMMITTEE ON JUDICIARY

Mark Stone, Chair

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

PROPOSED CONSENT (As Proposed to be Amended)

SENATE VOTE: 29-0

SUBJECT: FRANCHISES

KEY ISSUE: SHOULD FRANCHISORS BE REQUIRED TO PROVIDE FRANCHISEES AND PROSPECTIVE FRANCHISEES NOTICES REGARDING THE VALUE OF REBATES AND OTHER BENEFITS POTENTIALLY PROVIDED TO THE FRANCHISEE?

SYNOPSIS

Historically, the relationship between franchisors and franchisees has been significantly skewed to favor the franchisor. In recent years, the Legislature has taken steps to balance this relationship and ensure that franchisee's rights are protected under the law. Nonetheless, issues remain, particularly surrounding the disclosures provided to a franchisee at the onset of the contractual relationship with the franchisor. Despite all of the drawbacks of the franchise model, one potential perk of franchising is the ability to reap large benefits as a result of the significant purchasing power held by many businesses purchasing large quantities of the same product. However, franchisors frequently require prospective franchisees to waive their right to these benefits, thus permitting the franchisor to be the sole beneficiary of the purchasing power of the franchise. This behavior is especially troublesome as it is the individual franchisee's money being utilized to purchase these products. Attempting to address this issue, this bill would require a franchisor to disclose the potential or current gross value of all rebates, promotions, allowances, or other monetary incentives for the sale of a product offered to a franchisee before a franchisor could seek a waiver of such rights in a franchise agreement. The bill also requires an annual accounting of the value of such rights and benefits to be provided to existing franchisees. While not outright prohibiting such waivers, this bill at least ensures that franchisees are fully appraised of the value of the benefits they are being asked to forego, thus potentially allowing them to negotiate with the franchisor.

This bill is supported by the American Association of Franchisees & Dealers and the Asian American Hotel Owners Association who note that this bill will provide franchisees greater transparency so they better understand the cost structures of the franchise arrangement. As currently in print, and as proposed to be amended, this bill has no known opposition. This bill was previously heard and unanimously approved by the Assembly Committee on Business and Professions.

SUMMARY: Enhances the disclosures a franchisor is required to provide to California-based franchisees to include disclosures related to franchisor rebates and other benefits. Specifically, **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 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 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.

EXISTING LAW:

- 1) Establishes the "California Franchise Relations Act" which, generally, provides for the rules governing the termination, nonrenewal, and transfer of franchises between a franchisor, subfranchisor, and franchisee. (Business and Professions Code Section 20000 *et seq.*)
- 2) Requires a franchisor, upon the lawful termination of a franchise agreement, to purchase from the franchisee, at the value of price paid, minus depreciation, all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources, that are, at the time of the notice of termination or nonrenewal, in the possession of the franchisee or used by the franchisee in the franchise business. (Business and Professions Code Section 20022.)
- 3) Requires a franchisee, prior to the sale, assignment, or transfer of a franchise, all or substantially all of the assets of a franchise business, or a controlling or noncontrolling interest in the franchise business, to another person, to notify the franchisor, of the franchisee's intent to sell, transfer, or assign the franchise, all or substantially all of the assets of the franchise business, or the controlling or noncontrolling interest in the franchise business. (Business and Professions Code Section 20029 (a).)
- 4) Requires a franchisor, within 60 days of the receipt of the information provided pursuant to 3) to notify the franchisee of the approval or disapproval of the proposed sale, assignment, or transfer, as specified. (Business and Professions Code Section 20029 (b).)
- 5) Establishes the "Franchise Investment Law" which, generally, provides for the disclosures and documentation governing the sale of franchises in California. (Corporations Code Section 31000 *et seq.*)
- 6) Requires any person seeking to offer a franchise for sale in California to register with the Commissioner of the Department of Financial Protection and Innovation. (Corporations Code Section 31110.)

- 7) Imposes civil liability, as specified, on any person who offers or sells a franchise in violation of the Franchise Investment Law. (Corporations Code Section 31300 *et seq.*)
- 8) Authorizes, whenever it appears to the Commission of the Department of Financial Protection and Innovation, that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of the Franchise Investment Law, any rule or order thereunder, the Commissioner may bring an action, or request the Attorney General to bring an action in the name of the people of the State of California, in the superior court to enjoin the acts or practices or to enforce compliance with the law. (Corporations Code Section 31400.)
- 9) 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. (Corporations Code Section 31410.)

FISCAL EFFECT: As currently in print this bill is keyed fiscal.

COMMENTS: Franchise agreements, the contract authorizing the purchase of a franchise and dictating how the business is to be operated, are typically standardized “take-it-or-leave-it” agreements. While existing California law spells out numerous disclosures that a franchisor must make to a prospective franchisee, information regarding the amount of money that may be generated from rebates, promotions, allowances, or other monetary incentives, services and benefits are not required to be disclosed. However, franchise agreements frequently ask franchisees to waive the right to access such benefits. This bill prohibits a franchisee from being required to waive the right to such benefits without being notified of the potential or current gross value of that right. The bill also provides a mechanism for updating current franchisees of the value of these benefits. In support of the bill, the author states:

California franchise owners deserve to be fully informed about how much money they are signing away at the beginning of the franchise contract and they should continue to be informed about how much money they continue to generate by their financial and sweat equity that flows to the Franchisor year after year.

This bill will more fully inform new franchise owners from the beginning what they can reasonably expect as profit. This is very important to managing expectations for a franchise and once this information is more clearly conveyed may become dispositive for making the decision on whether or not to invest in the franchise.

A brief overview of franchising. Franchising is one of the more popular models of operating a business in the United States. Many national brands are involved in the franchise model, from fast food restaurants like Burger King and Subway and business support organizations like the UPS Store; to hotels like Hilton’s Hampton Inn. Under a franchise model, a large corporation, such as Subway, operates as the franchisor. The franchisee is a small business owner who invests into the business by purchasing the franchise, thus giving the franchisee access to the branding, promotional assistance, product procurement, and business support services provided by the franchisor. In return for this assistance, the franchisee must *strictly* adhere to branding, product quality, and other requirements imposed by the franchisor. Typically, the franchisor audits

franchisees on a regular basis to ensure they are complying with these rules. In many cases, a failure to adhere to these requirements can result in the termination of the franchise.

Although the franchise model presents benefits to both the franchisee and franchisor, franchisees bear the overwhelming majority of the risk. Purchasing a franchise can cost hundreds of thousands of dollars or more in initial investments. According to the industry group Franchise Grade, as of the end of 2018 nearly \$460 billion dollars had been invested into purchasing the over 475,000 franchises operating nationwide. On top of these investments, franchisees must purchase supplies, décor, and other items from the franchisor in order to comply with the branding and product requirements of the franchisor. Adding additional risk to the relationship, and financial uncertainty for franchisees, over the course of a decades long franchise agreement, the franchisor may abruptly require the franchisee to purchase new products or décor as the franchisor's national business model or marketing plans change.

Although state and federal laws provide a modicum of protection for franchisees, the business model still places thousands of California-based small business owners, who have invested (or will invest) significant sums into the business, and their employees at the whims of multinational corporations and their regional franchise managers.

The fraught history of California franchise law. Since the 1970s, the relationship between franchisors and franchisees in California have been covered by the Franchise Investment Law and the California Franchise Relations Act. The Franchise Investment Law requires any party seeking to sell a franchise in this state (the franchisor) to register with the now-named Department of Financial Protection and Innovation, and dictates the disclosures that must be given to prospective franchisees prior to the consummation of the franchise agreement. Recognizing that investing in a franchise is similar to investing in securities, one of the primary purposes of the Franchise Investment Act is to deter and punish fraudulent representations from being made to franchisees at the onset of the franchise relationship.

The provisions of the actual franchise agreement and the rules governing franchise relations are dictated by the California Franchise Relations Act. That Act specifies the rules for maintaining, signing, and renewing franchise contracts, governs the conduct that may rise to a breach of the franchise agreement, and specifies the franchisor and franchisee's duties and obligations at the end of the franchise agreement. Pursuant to the original California Franchise Relations Act, a franchisee could lose their business for *good cause* (defined in prior law as "any lawful requirement" imposed by the franchise agreement). That law left California franchisees with significantly fewer contractual rights than typical contractual agreements that require a "*material breach*" of a contract for termination and will recognize the contract's performance so long as there is substantial compliance with the original agreement. (Rest.2d. Contracts, Section 241.)

Recognizing the imbalance in franchise contracting, beginning in 2010, the Legislature sought to address the issue. However, given the significant advantages the existing law provided, the efforts were stridently opposed by the franchisors. Accordingly, two measures AB 2305 (Huffman, 2012) and SB 610 (Jackson, 2014) failed to be enacted. After significant negotiation, in 2015, AB 525 was signed into law by Governor Brown and provided that a franchise agreement can only be terminated when a franchisee fails to "substantially comply" with the agreement. That bill also made significant improvements to a franchisee's rights with regards to contract renewals, franchise ownership transfers, and the monetization of franchise assets at the end of a franchise relationship. While AB 525 made dramatic improvements to the processes for

winding down franchises, that measure did not impact the benefits a franchisee might have surrendered at the onset of the franchise agreement.

A benefit of franchising is the purchasing power conferred on large groups of business owners, however, these benefits do not always flow to the individual franchisee. For all of the above-noted drawbacks of the franchise model, one benefit is being part of a large network of businesses purchasing identical products. This purchasing power provides for significant discounts, rebates, and other incentives from suppliers. However, rather than passing these savings onto individual franchisees, far too frequently a franchisor requires a franchisee to waive the right to these incentives and instead keeps the monetary benefits for itself. Frequently, the waivers of these rebates and benefits are included in the initial franchise agreement, thus forcing a franchisee to waive the right to potentially lucrative kickbacks before they even fully understand the scope of these potential benefits.

This bill. At the onset of a franchise relationship the right to receive gains from the above-mentioned rebates, promotions, allowances, or other monetary incentives, services and benefits provided by franchisors rests with the franchisee. However, many franchisors require prospective franchisees to waive the right to reap these benefits in the initial franchise agreement. Once these benefits are waived, a franchisee would need to wait for the renewal of the agreement, frequently every 15 years, to reobtain these benefits for their own. To prevent a prospective franchisee from unwittingly giving up their right to these benefits, this bill would prohibit the waiver of the right to gain from any rebates, promotions, allowances, or other monetary incentives, services and benefits offered by a franchisor unless the franchisor discloses the potential or current gross value of that right. As proposed to be amended, the bill slightly revises these provisions to ensure the full scope of benefits offered to a franchisee are captured. This bill also requires the franchisor to annually disclose this information to current franchisees, as well as providing the information to a franchisee at any time upon their request.

In conjunction with other legislative efforts this bill would dramatically improve the disclosures made to franchisees. This measure is not the only bill pending before the Legislature seeking to boost the rights provided to franchisees. Previously this year, this Committee heard and approved AB 676 (Holden, 2022) which would enhance disclosures to a franchisee regarding why a potential agreement was rejected by the franchisor. That bill also enhances the powers of the Department of Financial Protection and Innovation to police the initial disclosures provided to franchisees. This bill would build on those efforts by addressing the benefit waiver issue. In conjunction with the Department's enhanced disclosure oversight, should both bills become law, this will represent significant progress on ensuring that prospective franchisees invest with full knowledge of the risks and opportunities associated with the franchise business model.

Proposed technical amendments. As currently in print this bill requires existing franchisees to be provided information regarding the franchisor's annual fiscal accounting of any moneys, goods, services, or anything of value received by the franchisor from an entity with whom the franchisee does business. To ensure that this language is sufficiently broad to cover all benefits a franchisee may receive, the author is proposing the following amendment to the proposed Section 20033 of the Business and Professions Code to read:

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.

ARGUMENTS IN SUPPORT: This bill is supported by the Asian American Hotel Owners Association as well as the American Association of Franchisees and Dealers, the trade association for franchisees. In support of this bill the American Association of Franchisees and Dealers writes:

Senate Bill 1247 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 has squeezed their margins, contributed to lower pay for our employees, and ultimately costs the consumer.

REGISTERED SUPPORT / OPPOSITION:

Support

American Association of Franchisees & Dealers
Asian American Hotel Owners Association

Opposition

None on file

Analysis Prepared by: Nicholas Liedtke / JUD. / (916) 319-2334