BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

LEGISLATIVE PROPOSAL (BLS-2006-04):
CALIFORNIA FRANCHISE INVESTMENT LAW:
FRACTIONAL FRANCHISE EXEMPTION

TO: State Bar Office of Governmental Affairs
FROM: BLS – Franchise Law Committee
Jeffrey C. Selman, Vice Chair Legislation - Executive Committee
DATE: July 11, 2005

RE: California Franchise Relations Act – Fractional Franchise Exemption
Proposed Bus & Prof. Code Section 20001(d)

SECTION ACTION AND CONTACT(S):

Date of Approval by Section Executive Committee: July 11, 2005
Date of Approval by Section Committee/Standing Committee: May 24, 2005
Approval vote: For: 16 Against: 0

CONTACT	SECTION LEGISLATIVE CHAIR
Name: Stafford Matthews, Esq. Address: Morrison & Forester, LLP 425 Market Street San Francisco, CA 94105 Phone: (415) 268-7000 Fax: (415) 268-7522 Email: smatthews@mofo.com	Name: Jeffrey C. Selman, Esq. Address: Heller Ehrman LLP 275 Middlefield Road Menlo Park, CA 94025 Phone: 650-324-7000 Fax: 650-324-0638 Email: jeffrey.selman@hellerehrman.com

DIGEST: Proposed Business & Professions Code §20001(d)(4) would exempt from the provisions of the California Franchise Relations Act certain franchises (so-called "fractional franchises") where at the time the initial agreement is entered into between the parties, the franchisee had substantial experience in the relevant business and no more than 20 percent of the franchisee's revenues would be expected to be generated from the franchised business on an annual basis. The exemption is similar to the existing fractional franchise exemption from the registration and disclosure requirements of the California Franchise Investment Law under

California Corporations Code Section 31106 and the FTC Franchise Rule. The present proposal has the support of both franchisee and franchisor representatives on the Franchise Law Committee.

PURPOSE:

State of Existing Law: CFIL and FTC Franchise Rule. The California Franchise Investment Law ("CFIL") [Cal. Corp. Code §§31000 *et seq*] makes it unlawful to offer or sell a franchise in this state unless the offer has been registered or a statutory exemption or exclusion applies. The CFIL contains a series of exemptions from the registration and disclosure requirements of the Law for certain classes of franchisors or franchisees. These exemptions and those separately provided in the Federal Franchise Rule promulgated by the US Federal Trade Commission are based on the conclusion that certain classes of potential franchisees have sufficient experience or financial backing to protect themselves in their dealings with the franchisor. For example, in 2004 the Franchise Law Committee, with the support of the Business Law Section Executive Committee and the State Bar Office of Governmental Affairs, proposed a new "sophisticated purchaser" exemption to the registration and disclosure rules of the CFIL, similar to the accredited investor status under general securities laws. That exemption was eventually enacted by the Legislature as new Cal. Corp. Code Section 31109.

One exemption to registration and disclosure rules contained in both the CFIL and the FTC Franchise Rule is the so-called **"fractional franchise"** exemption. Cal. Corp. Code § 31108; 16 C.F.R. 436.2. While some details differ, there are three essential elements of the fractional franchise exemption under both sets of rules:

- The franchisee or its director or executive officer must have been engaged in a "substantially similar or related" business [CFIL] or "the type of business" [FTC] as the franchise business.

- The franchisee or one of its directors or officers must have been in the business for a period of at least 2 years prior to the franchise investment.

- At the time of the franchise investment, sales arising from the franchise relationship must be expected to represent no more than 20 percent of the sales in dollar volume of the franchisee on an annual basis.

The rationale for these "fractional franchise" exemptions is that the parties to such contracts have a more conventional commercial relationship and the risk factors significantly differ from the normal franchise situation. In such a case the "franchise" is basically an extra line of products or services added on to an existing operation, and thus the success of the business as a whole is not considered to be dependent upon the success of the franchised product or service. Because the putative franchisee must be experienced and conduct most of its business with unrelated third parties to qualify under the exemption, the franchisee is deemed to have a high degree of independence in its affairs and to be able to protect its own interests in negotiating terms for the relationship on an arm's length basis.

Existing Law : California Franchise Relations Act. The California Franchise Relations Act [Bus. & Prof. Code §§20000 et seq] (CFRA) was enacted in 1980 in order to separately establish rules for termination, nonrenewal and transfers of California franchises during the period of the ongoing franchise

relationship. The CFRA is not a disclosure and registration statute but a relationship one. For example the CFRA imposes certain limitations on the right of a franchisor to terminate the franchise relationship other than for good cause, without regard to the terms of the contract. Cal. Bus. & Prof. Code §20020. The CFRA also can invalidate other contractual provisions negotiated between the parties, such as certain choice of forum clauses.

The definition of "franchise" in the CFRA is the same as that contained in the CFIL. However the CFRA currently does not provide for the same series of exemptions provided in the CFIL or the FTC Federal Rule. As a result the application of the CFRA rules to commercial relationships in the state is much broader than the CFIL and can implicate many more transactions than the Committee believes the CFRA was intended to affect.

Problems with Existing Law: The "Accidental Franchise".

The term "franchise" is broadly defined under the California franchise laws. However the absence of exemptions in the California Franchise Relations Act (CFRA) can create circumstances where the parties enter into a normal commercial sales or distribution relationship but both parties discover well after the fact that their negotiated rights and obligations under the contract have been significantly modified by the CFRA.

These types of relationships at most can be characterized as "incidental" or "accidental" franchises involving commercially competent parties with proportionately minor interdependence. In such situations substantially all of the business is conducted with unrelated third persons, and the required experience and minor sales percentage of the "franchisee" fairly ensure that the contract negotiations between the parties will be at arms-length and between "a willing buyer and a willing seller, neither under a compulsion to buy or sell". In our view the protections of the CFRA are not needed in this situation and the potential for abuse of the statute exists.

Confined to the very strict and limited circumstances being proposed here, our Committee believes that such a reclassification of a relationship between two competent commercial parties can be unfair and commercially disruptive and potentially expensive for the parties involved, inevitably resulting in increased costs to both franchisors and franchisees and their customers in the market generally.

Remedy for Problems Posed by Current CFRA. The proposed legislation would establish an exemption from the CFRA relationship laws for "fractional franchises" under the limited circumstances provided.

DOCUMENTATION: Please see the foregoing discussion in the "Problems with Existing Law – Accidental Franchise" section.

HISTORY; PENDING LITIGATION: None, to our knowledge.

LIKELY SUPPORT AND OPPOSITION: The Franchise Law Committee – which is comprised of attorneys with many years of experience representing franchisors and franchisees respectively – believes that the proposed fractional franchise exemption should be widely

supported by industry groups and by legal counsel for both sides. The proposed fractional franchise exemption was approved without objection by the Committee as a whole.

In this connection, the provisions of the CRFA would still be applicable to the substantial majority of franchise relationships, where the franchisee is inexperienced or where the expected revenues from the franchise are more than a minor part of the business of the franchisee, which is the norm in the true franchise relationship. Given these continuing safeguards and limitations, and given the efficiencies and cost-savings represented by the proposed exemption, it is expected that both franchisors and franchisees generally should support the proposed change.

The California Attorney General has the jurisdiction to enforce the CFRA. Although not known at this time, it does not seem likely that there would be opposition from that office. We expect the Attorney General and any other relevant state agency to fairly consider the proposed exemption in light of the strong support being given by representatives of both franchisors and franchisees.

FISCAL IMPACT: None. The CFRA does not require any registrations or the payment of any fees. The existing "fractional franchise" exemption under the California Franchise Investment Law and any filing fees relating to that exemption would be unaffected by the proposed legislation.

GERMANENESS: The subject matter of this proposal is one in which the members of the Business Law Section have special experience, and which requires their special knowledge, training and technical expertise. In addition, the proposed statute will promote clarity, consistency and comprehensiveness in the law.

TEXT OF PROPOSED STATUTE:

SECTION 1. Section 20001 of the Business and Professions Code is amended to read:

20001. As used in this chapter, "franchise" means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and

(b) The operation of the franchisee's business pursuant to that plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and

(c) The franchisee is required to pay, directly or indirectly, a franchise fee.

(d) "Franchise" does not include any of the following:

(1) Any franchise governed by the Petroleum Marketing Practices Act (P.L. 95-297).

(2) Lease departments, licenses, or concessions at or with a general merchandise retail establishment where the lease department, licensee, or concessionaire is incidental and ancillary to the general commercial operation of the retail establishment. Sales of a leased department, license, or concessionaire are incidental and ancillary to the general commercial operation of the retail establishment if they amount to less than 10 percent of the establishment's sales.

(3) A nonprofit organization operated on a cooperative basis by and for independent retailers which wholesales goods and services primarily to its member retailers and in which all of the following is applicable:

(A) Control and ownership of each member is substantially equal.

(B) Membership is limited to those who will use the services furnished by the organization.

(C) Transfer of ownership is prohibited or limited.

(D) Capital investment receives no return.

(E) Substantially equal benefits pass to the members on the basis of patronage of the organization.

(F) Members are not personally liable for obligations of the organization in the absence of a direct undertaking or authorization by them.

(G) Services of the organization are furnished primarily for the use of the members.

(H) Each member and prospective member is provided with an offering circular which complies with the specifications of Section 31111 of the Corporations Code.

(I) No part of the receipts, income, or profit of the organization are paid to any profitmaking entity, except for arms-length payments for necessary goods and services and members are not required to purchase goods or services from any designated profitmaking entity.

(J) The nonprofit organization is subject to an action for rescission or damages under Section 3343.7 of the Civil Code if the organization fraudulently induced the plaintiff to join the organization.

(4) Any relationship which is a "fractional franchise". The term "fractional franchise" means any relationship in which (i) the franchisee (or an existing executive officer, director or managing agent of the franchisee) has been engaged in a business substantially similar or related to the business arising from the relationship for a period of at least 24 months prior to the date the agreement establishing the relationship was reached; (ii) the product or service subject to the agreement is substantially similar or related to the products or services being offered by the existing business of the franchisee; (iii) the parties anticipated, in good faith, on the date the agreement establishing the relationship was reached, that the sales arising from the relationship would not represent more than 20 percent of the total sales in dollar volume of the franchisee on an annual basis; and (iv) the franchisee is not controlled by the franchisor."