The 2004 California Omnibus Franchise Bill
-
A Further Step to Franchise Reform

by

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<u>Executive Summary</u>

The 2004 California Omnibus Franchise Bill (AB 2921, introduced by Assemblyman Cox), and signed by Governor Schwarzenegger on September 10, 2004, is a joint effort of the Franchise Law Committee of the Business Law Section of the California State Bar and the California Department of Corporations. The bill is intended to reform a number of areas of California franchise law, make the regulation of franchises in California more effective and rational, better allocate the Department of Corporations' regulatory resources and update California franchise law to more nearly meet the needs of today's franchising community.

- Perhaps the most important part of the legislation, in terms of immediate benefit to Franchisors and Franchisees, is a section providing that the California Finance Lenders Law (California Financial Code Section 22000 *et seq.*; regulations found at 10 C.C.R. Sec. 1404, *et seq.*) does not apply to "franchise loans" made by a Franchisor to a Franchisee.

  This change resolves an area of concern raised by comments made by Department of Corporations examiners within the past year and allows Franchisors to return to their normal practice of assisting Franchisees with their financial needs, typically by financing the initial franchise fee or providing similar assistance with respect to real estate, construction or equipment financing, without the regulatory burden of compliance with a complex statute of little application in the franchising context. This concern existed notwithstanding the opinions of experienced franchise counsel that such transactions did not, in fact, involve loans but merely deferred payment arrangements which were, arguably, not subject to the California Finance Lenders Law in any event.

  That portion of the law took effect on the Governor's signature, while other portions of the law will become effective on January 1, 2005.

Other significant portion of the bill are as follows:

- The Bill confirms that the Department of Corporations will continue a "risk-based" process of reviewing franchise applications. This means that the Department will review application information that poses the most risk to prospective franchisees, including risks associated with the franchisor's financial condition, the franchisor's compliance record and deficiencies with the franchisor's application. The Department of Corporations should, therefore, spend less time concentrating on grammar and other minor issues in filings, and devote more resources to enforcement.

- The Bill also provides a new exemption from registration for offerings to sophisticated franchisees (patterned after similar exemptions under the California Corporate Securities Law) and amends provisions related to negotiated sales transactions, including removal of the requirement for placement of information in the Uniform Franchise Offering Circular ("UFOC") regarding past negotiated sales.

- Amendments will also allow UFOCs to be delivered electronically (as already allowed by the Federal Trade Commission, in some circumstances) via Internet, Zip® disk or otherwise, the details to be worked out in later regulations to be adopted by the Department of Corporations and in which the Franchise Law Committee anticipates the opportunity to have input.

- The bill amends the provisions regarding material modification of an existing franchise, removing the requirement for a filing with the Department of Corporations in many instances.

- Additionally, the bill amends the enforcement provisions, giving the Department of Corporations expanded powers, and increases the fines for violations, in some cases by substantial amounts.

Details regarding all of these (and other) changes are provided below. References are to new or amended sections of the California Franchise Investment Law Calif. Corporations Code, Sec. 31000 *et seq.*; regulations found at 10 C.C.R. Sec. 310.002, *et seq*.), unless otherwise noted.

Background

For a number of years, the Franchise Law Committee, with members primarily representing both Franchisors and Franchisees, has had a record of proposing, and achieving enactment of, provisions to the California Franchise Investment Law (CFIL) designed to modernize franchise laws and regulations in California. Within the last few years, there has developed an ongoing, and highly productive, dialogue between the Franchise Law Committee and senior staff of the Department of Corporations.

During 2003 and 2004, that dialogue reached a policy consensus that:

(1) more effective and efficient administration of the CFIL could be achieved, and there would be a more appropriate allocation of resources, if the Department was to use a risk-based process of reviewing franchise applications, with emphasis on the risks associated with the franchisor's financial condition and the franchisor's compliance record with the franchise laws, rather than continuing to expend resources on grammatical corrections, “plain English” and other less substantive matters;

(2) enhanced enforcement tools, patterned in large measure after those already present in the California Corporate Securities Law, would allow the Department to address true cases of fraud and misrepresentation; and

(3) expansion of certain exemptions would more closely focus resources on those persons most in need of protection under the CFIL, while minimizing the burdens and costs to Franchisors, as well as bringing California’s franchise law more in accordance with that of the Federal Trade Commission and other states.

That consensus then resulted in a number of specific proposals, some from the Franchise Law Committee and some from the Department, for legislative changes. While a few proposed changes were left for probable action in future years, the vast majority of the proposals from both the Franchise Law Committee and the Department found their way into the new law.

Proposals not yet adopted, and regulations related to the new legislation and to be adopted in the near future, are expected to be the subject of the continuing and highly constructive dialogue already begun between the Franchise Law Committee and the Department.

Details

Set out below are some of the details regarding the specific sections of the new law. Necessarily, these are general summaries, and a close reading of the actual provisions (many of which are highly technical) themselves is always required.

Let’s segment our discussion by dividing the changes into three parts: (a) those covering general matters, registration/disclosure and related exemptions, (b) those related to enforcement matters and (c) a separate section, not under the CFIL, and dealing with Franchisor financing for Franchisees.

General Matters, Registration/Disclosure and Related Exemptions

31001 – Legislative Purpose

This section previously contained language to the effect that “it is the intent of this law . . . to protect the franchisor by providing a better understanding of the relationship . . .” (Emphasis added.)

Clearly, this language, which has been in the CFIL since its inception, is inconsistent with the understanding of all California franchise law practitioners that the primary purpose of the CFIL is the protection of prospective and actual Franchisees; accordingly, the section was amended to reflect that policy and to include protection of Franchisees within the intent of the law.

31001.1 – Risk-Based Review

This new section embodies the current approach to franchise regulation in California, with specific language regarding the adoption of a risk-based process of reviewing franchise applications.

Under that process the Department will, as planned, move away from a focus on the specific language of UFOCs (which had made, in many cases, registration and renewals in California among the most complex, costly and detail-oriented in the country), and, instead, concentrate on risks associated with the Franchisor’s financial condition, its compliance record in other jurisdictions and the more significant deficiencies in its application.

This should make the registration, amendment and renewal process in California among the most efficient in the nation, and initial signs are that the new approach is generally being followed by examiners. Of course, continued implementation of that goal will depend on appropriate management of the registration process by the Department, as well as practitioners doing their best with respect to the filings they make. Senior staff at the Department assure us that they are firmly committed to the risk-based approach to franchise regulation and we see every sign that that’s true.

Practitioners can assist in that transition by bringing to the attention of senior Department personnel, or members of the Franchise Law Committee, instances in which they feel that actual review of filings might be inconsistent with the new policy and the related legislation.

Section 31109 – Sophisticated Franchisee Exemption

This is a new section for the CFIL, and introduces a “sophisticated Franchisee” exemption into the law. The drafters adopted the general approach taken by the California Corporate Securities Law and related regulations, and determined that the registration and disclosure provisions of the CFIL were not needed to protect select classes of investors. As one of the drafters commented at the time, Michael Eisner and Host Marriott Corporation probably do not need the disclosures available under the CFIL, being entirely capable of protecting their own interests!

The task, then, was to appropriately define the class of investors who would not need such protection. Modeling the new statute after related California Corporate Securities Law provisions, Section 31109 exempts offers and sales for proposed transactions where <u>all</u> of the following are true (this is a case where it is particularly important to review the section for the precise language involved, this being a highly technical exemption; the following is a paraphrase in the interest of brevity):

(a) <u>Each</u> purchaser of the franchise is one of the following (in other words, if <u>any</u> purchaser does not fall within one of the following classes, the transaction – this being a transaction-based exemption - is not exempt under 31109, although another exemption might still apply, such as that provided by Section 31106, relating to experienced Franchisees):

(1) A partner, executive officer or director of the Franchisor, or any executive officer of the Franchisor's corporate general partner, if the Franchisor is a partnership, or any manager if the Franchisor is an LLC.

(2) Any entity with assets over $5,000,000 as shown in its most recent financial statements and which was not organized for the purpose of acquiring the franchise subject to the exemption. The relevant financial statements are not expressly required to be audited, but must be of a date within 90 days of the date the Franchisee pays consideration or signs binding documents, and must either be prepared in accordance with GAAP (and prepared on a consolidated basis) or meet SEC requirements.

Note that the requirement that the entity not have been "organized for the purpose of acquiring the franchise subject to the exemption" was intended to track provisions in other (non-franchise) laws and a policy argument can be made that it should not have been used here.

For example, assume that for reasons of liability limitation a prospective well-capitalized Franchisee wishes to organize a subsidiary for the purposes of acquiring and operating a franchised unit, and is willing to fund it in excess of $5,000,000. It's difficult to understand why that scenario should fall outside the exemption, but it clearly does and this may be one area where future revisions to the statute are appropriate.

(3) A natural person whose net worth (along with that of their spouse, but excluding certain personal assets) exceeds $1,000,000.

(4) A natural person whose gross income exceeded $300,000 in each of the last two years, or whose income, together with that of their spouse, exceeded $500,000 in each of those years, and who reasonably expects to reach the same levels in the current year.

(5) Any entity, all of whose equity owners meet the any of the above standards. Therefore, an entity which had a net worth of only $500,000, but where each of its owners had a net worth of $2,000,000 or more, would qualify.

(b) The purchaser has sufficient knowledge and experience in financial and business matters, either on their own or with the assistance of advisors unaffiliated with the Franchisor, such that the Franchisor reasonably believes that they can evaluate the merits and risks of an investment in the franchise and to protect their interests.

As noted, the Franchisor is required to have a reasonable belief that the purchaser meets these requirements and we would anticipate the Franchisors utilizing this exemption will obtain appropriate representations supporting this judgment, as well as demonstrating compliance with the other requirements of the section.

Note that application and interpretation of this subsection will raise interesting issues where the purchaser is a business entity.

Consider the situation in which the business entity has assets over $5,000,000 (or all of its owners meet the test set out above) but the business entity has just been formed and has no knowledge or experience in business and financial affairs. Can the knowledge and experience of its owners be attributed to it, even though they are not the "purchaser?" On policy bases, such an attribution should be made and we may expect that principles of interpretation which have evolved under analogous securities law provisions will guide the interpretation of this subsection.

On the other hand, where the owners of the entity do not all meet the knowledge and experience test (*e. g.* a publicly held corporation), but the entity has such knowledge and experience, that presumably would suffice, under a "plain meaning" reading of the subsection.

Finally, assume that neither the entity nor its owners have the requisite knowledge and experience, and intend to retain appropriate advisers to meet the requirements of the subsection. May the advisers merely advise the entity, who is the purchaser, but not the owners? Again, principles of interpretation which have evolved under securities law analysis will probably guide the interpretation of this subsection and it would appear that if the "purchaser" is the entity so advised, the relevant requirement will have been met.

(c) The purchaser of the franchise is making the purchase for their own account and not with a view to distribution.

As experienced franchise practitioners know, subfranchises are often purchased by investors who would normally meet the net worth, income, experience, etc. elements of this exemption, but the nature of a subfranchise is such that resales (albeit of unit franchises) are <u>precisely</u> what is contemplated by the purchaser. Is a purchase of a subfranchise then not qualified for the exemption. This author believes not, and that the exemption should apply, since the franchise purchased (the subfranchise rights) are intended to be held, and not further distributed, by the subfranchisee and it is only a related right (unit franchise rights) that may be sold under the subfranchise.

However, the language in the statute prohibiting "distribution of . . . any interest in the franchise," while fairly subject to interpretation as including only partial interests in the subfranchise itself, is somewhat ambiguous and this may be an area ripe for clarification, whether by regulation or interpretive opinion.

As a result of the presence of subfranchising arrangements in the franchise industry, and the fact that many purchasers of master or subfranchise rights might otherwise qualify for this exemption, . . . Future legislation/rulemaking?

(d) The cash payment by the purchaser, where that person is a human being and not a business entity, must not exceed 10% of the purchaser's net worth (or the net worth of the purchaser and his/her spouse), again excluding certain personal assets.

(e) Finally, the Franchisor is required to file a notice of exemption with, and pay a filing fee to, the Department of Corporations <u>before</u> any offer or sale to be covered by the exemption.

This provision may constitute a trap for the unwary on two levels:

First, a Franchisor who makes such an offer (let alone a sale) without having filed the notice and paid the fee will have technically violated the provision, and arguably will have subjected themselves to exposure for rescission and damages, as well as Departmental enforcement action.

Therefore, prudent Franchisors, who anticipate even possibly using the exemption, will, therefore, file the notice and pay the fee at the beginning of each year. Otherwise, preliminary discussions regarding the possibility of awarding a franchise may be later interpreted as constituting an offer made in the absence of the required filings.

Second, suggestions were made, but not adopted, that if a Franchisor failed to file the notice or pay the fee prior to the sale, it could cure the omission by doing so thereafter, albeit at a higher fee level and remove any exposure for the prior failure. This approach seems rational, since, if the offer and sale is to a qualified purchaser, and meets all other requirements of the section other than the filing/fee requirement, no harm has been done to the purchaser (as a result of the late filing) who is, by definition, fully qualified under the exemption.

To allow recovery by such a qualified purchaser, for an omission which is highly technical and did not harm them in any way, seems unduly harsh. This may be another area for future legislation, or rulemaking, to address.

Finally, practitioners should note that Section 31106 of the CFIL contains a related, but distinct, exemption covering experienced prospective Franchisees, and that a transaction not qualifying under 31109 may qualify under 31106.

Section 31109.1 – Negotiated Sales

This section, newly added to the CFIL, makes a number of changes in the pre-existing California rules with respect to negotiated sales; situations in which the Franchisor awards a franchise on terms different from those described in the UFOC or the Franchise Agreement, typically at the request of the prospective Franchisee.

Under existing law, sale of a franchise on terms different from those registered is allowed only on compliance with the provisions of Reg. 310.100.2, a material element of which is a requirement that the Franchisor, before selling another franchise, amend its UFOC to disclose the prior sale on differing terms, and provide copies of Negotiated Sales Notices as exhibits to the new UFOC, for 12 months. The new law significantly affects these requirements, as detailed below.

In essence, the new section allows the offer and sale of a franchise on terms different from those registered if each of the following conditions are met:

(1) The initial offer must be the one registered with the Department. In other words, the starting point for any negotiations must be the Franchise

Agreement and related terms as disclosed in the UFOC on file with the Department.

(2) The prospective Franchisee receives all of the following, in a separate written appendix to the UFOC (Note that such an appendix may be created, and delivered, after the initial offer and resulting negotiations,):

(a) A description of “material” terms [defined in subsection (d) as terms a reasonable franchisee would view as important in negotiating the franchise] negotiated with respect to other California franchises during the preceding 12 months. This allows the prospective Franchisee who is currently involved in a negotiation with a Franchisor to learn what changes have been agreed to in the recent past.

Note that this approach differs from that applicable under the prior regulations, in which a summary of prior negotiated terms was included in the UFOC given to all prospective franchisees, whether or not the Franchisor was willing to engage in negotiations with them. For example, if the Franchisor entered into different terms with a large prospective Franchisee, such as Host Marriott, it could be required to disclose the changes to subsequent individual prospective Franchisees, with respect to whom it had no intention (or need) to make such changes.

(b) A statement that copies of the negotiated terms are available on request.

(c) Contact information with respect to the representative of the Franchisor from whom such copies may be obtained.

(3) The Franchisor certifies, in an appendix to its application for renewal, that it has complied with Section 31109.1

[This appears to mean that such a certification is to be appended to the renewal application to be next filed after the negotiation. Thus, for a Franchisor with a calendar fiscal year, a negotiation in May of 2005 would trigger a filing of an appendix with its renewal application in the Spring of 2006. On the other hand, the subsection can be read as requiring a Franchisor completing a negotiated deal in February of 2005 to file the certification as part of its renewal application in the Spring of 2005, even though the negotiation took place in the current fiscal year and the renewal application normally covers only matters (such as financial statements, franchise system statistics, etc.) related to the fiscal year just completed. It seems that the certification should only relate to compliance in the prior fiscal year, and that clarifying regulations may be appropriate in this area.]

(4) The negotiated terms must, on the whole, confer additional benefits on the Franchisee. Discussions at the time of adoption made it clear that this did not mean that each of the negotiated terms be pro-Franchisee, but only that, when all of the proposed negotiated terms are taken into account, on balance they benefit the Franchisee.

This provision, not in the bill as originally introduced, was included at the specific request of legislative staff. Clearly, the provision introduces a "gray area" into the exemption, notwithstanding the fact that most modifications from the Franchisor's "standard deal" are at the request of, and presumably benefit, the Franchisee.

For example, consider the situation in which a Franchisor has been awarding individual unit franchises, and is met with a request to award an area development arrangement (X number of units to be opened in Y territory over Z period of time) or is invited by a tenant holding rights to multiple locations to place units in the various locations, but only with significant changes to the Franchisor's standard offering.

A two-sided negotiation may result in addenda to the Franchise Agreement, an Area Development Agreement, revisions to lease terms, etc., all of which involve concessions on both sides. Under this provision, a Franchisor seeking this exemption is at risk if it concludes that all of the negotiated terms, taken as a whole, benefit the Franchisee, a judgment subject to classic "Monday morning quarterbacking" by a Franchisee seeking to unwind a deal (and his confidentiality, non-competition and other commitments) for business or personal reasons.

As a further example, suppose, that a prospective Franchisee asks for a waiver of a non-compete provision as it relates to a related business operated by her husband, but is willing to accept a reduced territory or the presence of a company-operated outlet within her territory in exchange for the concession by the Franchisor. On what basis will the determination be made as to net benefits? The only clear advice that can be given is when in doubt to proceed as if the exemption is not available.

While the new exemption will allow some degree of "horse trading" in negotiations between a Franchisor and a prospective Franchisee, it will also raise sometimes difficult questions for franchise counsel.

Prudent counsel will, therefore, be careful in using this exemption in deals involving complex, multi-element negotiations. While having the prospective Franchisee sign a certification that the negotiated terms, on the whole, conferred additional benefits on him/her/it, the utility of this exemption in such circumstances has been significantly limited, something that may be an appropriate subject for future legislation, since no other state has a similar requirement and there seems to be no empirical evidence of abuse in this area.

Finally, the philosophical basis for the requirement of net benefit for the Franchisee seems unclear, since the CFIL is a disclosure statute, not one in which the Department of Corporations reviews offerings to determine that they benefit Franchisees. In addition, given a disclosure regimen, the one thing that we can be reasonably confident most prospective Franchisees understand are changes, which they accede to, from the standard deal, particularly when nearly all of those changes result from discussions initiated by the prospective Franchisee.

In addition to the above, the Franchisor must, on request, provide the prospective Franchisee with copies of the previously negotiated terms within five business days of the request. Note that this approach is substantially different from that under the current regulation, which requires that the UFOC disclose prior negotiated terms to all Franchisees, whether they are to be offered other than standard terms or not. This new approach may be responsive to past Franchisors' general reluctance to negotiate terms where they were required to disclose to all prospects, whether or not they wish to negotiate terms, any previous deviations from the Franchisor's standard terms.

Finally, the Franchisor must maintain copies of all material negotiated terms for five years and make copies available to the Commissioner on request.

<u>Section 31119 – Electronic Disclosure</u>

A new subsection (b) has been added to this section, authorizing Franchisors to provide disclosures by electronic means (presumably including email, CDs/DVDs and Zip™ disks) under rules to be adopted by the Department.

While the starting point for drafting of those rules will probably be the current FTC and NASAA guidelines, certain technical problems with those standards should be resolved before final regulations are adopted by the Department. Among others, current NASAA guidelines require that the electronic file containing the disclosure be a "single, integrated, document or file," raising technical issues when elements of the disclosure may only exist in different computer formats. We expect that further discussions between the Franchise Law Committee and the Department (and possibly involving NASAA and the FTC) should resolve these matters.

<u>Section 31125 – Material Modifications</u>

Section 31125, already a part of the CFIL, covers situations in which a Franchisor and Franchisee wish to modify their existing relationship, typically by means of an amendment to the Franchise Agreement.

Under prior law, a material modification could be accomplished in either of two ways.

Under the first alternative, the Franchisor prepared a form of disclosure relating to the proposed modification, filed it with the Department and then provided that "mini-disclosure" to the Franchisee, generally five business days prior to execution of the modification.

The second alternative allowed the Franchisor to dispense with the filing and disclosure requirements if the modification was in connection with the resolution of a dispute or default, the Franchisee received the proposed modification at least five business days before execution (but could not be executed during the first 12 months after the date of the franchise agreement and must not waive any rights under the California Franchise Relations Act, but can include a general release) and was not applied on a system-wide basis, an undefined term.

Under the new law, a series of three alternative approaches to dealing with material modifications of relationships with existing Franchisees are offered.

1. Under the first alternative, the traditional requirements with respect to creation of a "mini-disclosure" document, related filing and providing the disclosure to the Franchisee are retained, as one alternative means of soliciting and executing material modifications.

2. Under the second alternative, no "mini-disclosure" is required to be filed or delivered, but all of the following requirements must be met:

a. As under the prior law, the Franchisee must, in general, receive the proposed modification at least five business days before execution (but, as under prior law, the modification must not be executed during the first 12 months after the date of the franchise agreement and must not waive any rights under the California Franchise Relations Act, but can include a general release.) Note that the section contains a provision allowing, in effect, the Franchisor to avoid compliance with the five business day prior presentation element, subject to the Franchisee having a right to rescind the modification for five business days after execution.

b. The modification meets one of the following requirements:

(1) The modification is in connection with the resolution of a *bona fide* dispute or claimed or actual Franchisee or Franchisor default and

the modification is not applied on a franchise system-wide basis at the time of execution. A modification will not be regarded as being made on a franchise system-wide basis if it is voluntary and is offered to fewer than 25% of the Franchisor's California franchises within any 12-month period.

(2) The modification is simply offered on a voluntary basis to fewer than 25% of the Franchisor's California franchises within any 12-month period (thereby dispensing with the requirements with respect to *bona fide* disputes or claimed or actual defaults), if the Franchisee is given the right to rescind the modification if the Franchisor fails to comply with the five business day disclosure/rescission rights requirements of the section.

3. Under the <u>third alternative</u>, again no "mini-disclosure" is required, but the modification must be offered on a voluntarily basis and must not substantially and adversely affect the Franchisee's rights, benefits, obligations, etc.

Additionally, the revised section now includes a definition of "California franchise", necessitated by the use of that phrase in the section. The definition is similar, in concept. to the provisions of the out-of-state sale exemption in California (CFIL 31105) and will deem a franchise owned by a California resident or with a retail location in California to so qualify.

A California franchise is defined as a franchise that is either (a) one with a location in California from which sales, leases or other transactions are made between the franchised business and its customers, or from which goods or services are distributed, or (b) one where a California resident owns, controls or has an equity interest in the franchise. This definition, then, provides a basis for calculating the 25% requirement of the exemption.

Finally, there is a prohibition on the Franchisor making modifications in consecutive years for the purpose of evading the 25% requirement. As was contemplated at the time of drafting, this provision was intended only to cover substantially identical modifications; clearly, substantively different modifications would not come under this prohibition. Apparently, what was intended to be forbidden was a Franchisor's plan to offer essentially the same modification (say, the institution of a marketing fund requirement) to 20% of its California franchises in late 2005 and to 15% of its California franchises in late 2006, all designed to avoid compliance with the CFIL's otherwise applicable requirements. Note, however, that only one leg of Section 31125's exemption uses the 25% standard.

While the changes to this section will make it significantly easier for Franchisors and Franchisees to effect modifications subject to California law, California requirements remain substantially more challenging than those of nearly all other domestic and foreign jurisdictions, which do not impose any special requirements when a Franchisor and one or more of its Franchisees wish to modify an existing agreement. It will be interesting to see if California eventually adopts the approach favored by essentially all other jurisdictions that regulate the offer and sale of franchises and simply de-regulate voluntary modifications of existing franchise agreements.

Enforcement Matters

Section 31300 – Liability for Violation of CFIL

This section was amended to clarify the fact that the offer or sale of a franchise in violation of the requirements of an exemption from the CFIL can result in liability for the Franchisor, among others. In other words, the offer or sale of an unregistered franchise in reliance on a particular exemption, when the conditions for application of that exemption have not been satisfied, can constitute a violation of Section 31300 and give rise to liability to the Franchisee.

While this policy should not be a surprise to experienced practitioners, it was thought appropriate by the drafters to make the result under California law more clear.

Section 31402 – Desist and Refrain Orders, Offerings Subject to Registration

This section has been amended to shorten, from one year to 60 days, the period within which a person receiving a desist and refrain order from the Department must request a hearing.

Section 31403 – Desist and Refrain Orders, Offerings Exempt from Registration

This section has been amended and now mirrors amended Section 31402 with respect to offerings exempt from registration being offered without compliance with applicable law and the shortened period in which to request hearings with respect to a desist and refrain order.

Section 31405 – Civil Penalties

Consistent with the Department's increased emphasis on enforcement activities and a greater allocation of resources to enforcement, this section was amended to increase, from $2,500 to $10,000 per violation, the civil penalties for violation of the CFIL or orders issued under it. Hopefully, this and related changes will either have an appropriate deterrent effect or, if deterrence fails, increase revenue to the state from those most appropriate to pay it!

Section 31406 – Desist and Refrain Orders, Active Violations

This is a new section for the CFIL, giving the Department the express authority to issue citations, and related desist and refrain orders, with respect to matters where the Department believes that a violation of the CFIL (or any order under it) is taking place. Administrative penalties under this section are only $2,500 per violation, an interesting deviation from the generally higher levels of penalties now available under other sections of the CFIL.

Provision is made for hearings when such a citation has been issued, but practitioners should note that failure to request a hearing within 60 days of receipt of the citation will result in the citation becoming final.

Section 31407 – Order of Discontinuance

Another new section, this one allowing the Department to issue an order to discontinue conduct of activities in violation of the CFIL.

While the order is effective immediately on issuance, it does not become final except on notice to the person affected. This would seem to imply that in a situation in which an order was issued (and thereby became effective) but the person had not yet received notice of it, a violation of the order might occur prior to notice (*e.g.* offers of franchises under a, perhaps good faith, belief that an exemption applied) and thereby subject the person to resulting liability, leaving them only with the remedy of requesting a hearing (which the person must do within 60 days of mailing or service of the notice of the order) with respect to the order, a somewhat draconian result and one which may conceivably raise due process concerns.

Section 31408 – Ancillary Relief

This new section gives the Department the authority to include in any administrative action, including a stop order, a claim for ancillary relief, including rescission, restitution, disgorgement or damages on behalf of the persons (presumably Franchisees) injured.

Interestingly, the section also provides for possible orders requiring the person(s) affected to attend remedial education, similar to a process used in the past by the FTC. This innovative approach is to be commended, since experience indicates that many technical violations of what is probably the most complex and subtle franchise law in the nation (the CFIL) are made through ignorance. Hopefully, such education will be provided in California and delivered by experienced California franchise law experts.

Finally, this section allows the administrative law judge to require payment of the Department's (but not a private litigant's) costs, including reasonable attorney's fees and investigative costs.

Section 31410 – Penalties for Willful Violations

Amendments to this section increase the maximum monetary penalty for a willful violation of the CFIL from $10,000 to $100,000, giving the Department adequate tools to deal with scofflaws. The author anticipates that such maximum penalties will rarely be sought, or awarded, except in the most egregious cases. Note that this is a fine payable to the State of California, and not damages to be paid to a Franchisee.

Section 31411 – Penalties for Willful Fraud or Deceit, etc.

Similar to the changes to Section 31410, this section has been amended to change the maximum monetary penalty for fraud or deceit in connection with the offer or sale of a franchise from $10,000 to $100,000. As was the case with the prior section, this is a fine payable to the State of California, and not damages to be paid to a Franchisee.

Franchisor Financing for Franchisees

As noted above, this section of the bill is perhaps the most important part of the legislation, in terms of immediate benefit to Franchisors and Franchisees. Unlike all of the other sections, it took effect on the Governor's signature, and amended the California Finance Lenders Law (California Financial Code Section 22000 *et seq.*; regulations found at 10 C.C.R. Sec. 1404, *et seq*.) In essence, it provides that the California Finance Lenders Law ("CFLL") does not apply to "franchise loans" made by a Franchisor to a Franchisee.

Franchise loans are defined as commercial loans (as further defined in another section of the CFLL) by a Franchisor to a Subfranchisor or Franchisee for the "acquisition, construction, operation, development, equipping, expansion, contraction, consolidation, merger, recapitalization, reorganization or termination of a franchised business <u>if</u> the following conditions are met:

(1) The Franchisor must comply with all applicable federal and state franchise registration and disclosure (but not relationship) laws. This means that failure to so comply may lead not only to adverse consequences under those franchise laws, but to similarly unpleasant results under the CFFL.

(2) The proceeds of the loan must be intended to be used primarily for other than personal, family or household purposes. This may be an area in which prudent franchise counsel will recommend the obtaining of appropriate representations from the prospective borrower and such representations, and the Franchisor's reliance on them, are expressly contemplated in the statute.

(3) The loan, if secured, is secured only by the assets of the franchised business, and not property used by the borrower primarily for personal, family or household purposes and not by the borrower's personal

residence. After discussion between the drafters, the Department and legislative representatives, it was their mutual intention that real property used in the franchised business could be used as security for a franchise loan without making the exemption unavailable.

(4) The loan is subject to the implied covenant of good faith and fair dealing under Section 1655 of the Civil Code. Conservative practitioners may decide to include an express term to this effect in the loan documents, to assure that this condition is expressly (and not merely impliedly) met.

(5) There is clear disclosure to the borrower of the applicable interest rate, charges and costs of the loan. Apparently, these costs could be disclosed in Item 10 of the UFOC.

The Future

As noted above, there are at least a few ambiguities in the new law, as there probably are in any legislation, as well as some areas where implementing regulations will need to be drafted.

The most significant of these areas concerns the actual practice of the Department with respect to risk-based review. In this area, at least to the author's best knowledge, initial reports are positive, based on anecdotal information reported from the 2004 renewal season. It's clear that senior staff of the Department are serious in this area, and the prospects for continued simplification of the filing and renewal/amendment process seem to be positive. At the same time, practitioners are urged to bring to the attention of the Franchise Law Committee, or the senior staff of the Department, any instances where they feel that the intent of the new law is not being placed into practice.

Finally, a highly constructive dialogue has emerged between the Franchise Law Committee and the senior staff of the Department. That relationship should continue to grow, and the results for California franchise law and practice should be nothing but favorable.

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The views and analysis presented in this article are those of the author only, and are not necessarily those of the California State Bar or the California Department of Corporations.