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Calif. Franchise Relations Act Could Be A Game Changer

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California will notch another franchise regulatory distinction come Jan. 1, 2016: home to the toughest franchisee-protection law in the nation. On Oct. 11, 2015, Governor Jerry Brown signed a bill amending the California Franchise Relations Act (CFRA) to expand franchisee rights when it comes to termination, renewal and transfer of franchise agreements. The new CFRA applies to franchise agreements entered into or renewed on or after Jan. 1, 2016, and to any franchise arrangement of indefinite duration (i.e., no fixed term specified) that permits either party to terminate the arrangement *without cause*. It will not, however, apply to franchise agreements executed before Jan. 1, 2016, even if the termination or sale occurs after that date.

The new CFRA's key revisions and potential tripping points for franchisors are as follows:

Termination

The amended CFRA leaves unchanged a franchisor's right to terminate a franchise agreement for enumerated "extreme" defaults without providing the franchisee with a right to cure. These are defaults that, by their nature, are either not curable or egregious enough to warrant immediate termination, like the franchisee's abandonment of the franchise business, failure to pay franchise fees for more than five days after written notice of overdue payment, fraud in obtaining the franchise rights, unauthorized use of the licensed brand, unauthorized transfers, repeat noncompliance with lawful provisions of the franchise agreement and several others.

For all other defaults, the new CFRA requires the franchisor to meet an ostensibly tougher "good cause" standard than current law and allows the franchisee at least 60 days to cure the breach (current law allows 30 days). "Good cause" under current law means the franchisee's failure to comply with *any* lawful requirement of the franchise agreement, but, after Jan. 1, 2016, it will mean the franchisee's failure to "substantially comply" with any lawful requirement of the franchise. California's new "good cause" standard is not unprecedented: New Jersey's franchise relationship law, which has been challenged extensively since its enactment some 40 years ago, also uses the equivalent "substantially comply" standard.

Outlook

Franchisors may fret that the new CFRA lowers the franchisee's performance bar and handicaps their ability to enforce system standards because, to remain a franchisee, all that a California franchisee must do is *substantially* comply with a franchise agreement. In fairness, even under current law, a franchisor may not terminate a franchise agreement based on *any breach*: the breach must be material, i.e., important, not trivial. What is perplexing is why the California legislature felt the need to rearticulate "good cause" given the lack of any evidence of widespread indiscriminate terminations of California franchisees not adequately addressed by current law. By grafting "substantially" on to the measure of a franchisee's performance, the California legislature seems, at least symbolically, to rebalance contractual power by underscoring the importance of materiality. After Jan. 1, 2016, franchisees may very well argue that the new CFRA must make it harder to terminate a franchisee, for why else would California's legislature change the "good cause" definition? Just as New Jersey's "good cause" standard has been repeatedly tested in court battles between franchise parties, the new CFRA will likely produce lawsuits over the adequacy of a franchisee's performance. It has never been easy for a franchisor to terminate a franchisee for performance-based, nonpayment defaults and, after Jan. 1, 2016, California franchisees may feel empowered to challenge terminations to test the boundaries of substantial compliance in court.

Statutory Remedies For Lawful and Wrongful Terminations or Nonrenewals

Since its enactment in 1981, the CFRA's main shortcoming has been its meager remedy for franchisees that are wrongfully terminated or not renewed in violation of the statute: the franchisor's exclusive obligation requires repurchasing the injured franchisee's inventory. This, according to franchisee advocates, fails to adequately compensate an injured franchisee for the loss of franchise rights especially when amassing an inventory is unimportant to a franchisee's day-to-day operations or business success (true of many business format franchises). Under the new CFRA, a franchisor that terminates or fails to renew a franchise without meeting the new "good cause" standard is liable to a franchisee for the fair market value of the franchised business plus any other damages the franchisee can demonstrate it sustained by the violation. While the remedy for wrongful termination/nonrenewal has counterparts in other franchise relationship laws (New Jersey's law provides a similar remedy), it should cause franchisors in California to double check their grounds and termination notice before pulling the trigger.

What is unprecedented is CFRA's new remedy for franchisees that are *lawfully* terminated if, following termination, the franchisor retains control of the franchise business premises. In franchise systems where location is essential to sustaining patronage and long-term goodwill, a franchisor will often keep site control by subleasing the franchise premises or retaining a conditional lease assignment as part of the quid-pro-quo for the franchise rights. Either approach ensures the franchisor that, when the franchise relationship ends, the franchisor or its designee (sometimes a new franchisee) can seamlessly keep the branded business operating to the public. Either approach provides the franchisor with the immediate use and benefit of all trade fixtures and pieces of equipment bolted to the walls, floor or ceiling in the former franchised place of business without having to reimburse the franchisee for its investment — because whatever is bolted down is considered legally part of the real estate and not technically owned by the franchisee despite its investment.

Outside of motor vehicle dealer laws, there are no franchise or dealer laws of general application that void a site control provision or provide remedies to a *lawfully* terminated franchisee or dealer when a site control provision is enforced after the arrangement ends. Under the new CFRA, a franchisor that *lawfully* terminates or refuses to renew a franchise and retains site control must pay the former franchisee for its original cost minus depreciation of all inventory, supplies, equipment, fixtures and furnishings purchased by the franchisee, a price that may actually exceed the then-current fair market value of the franchise assets.

The new CFRA allows a franchisor to set off any amounts owed by the franchisee to the franchisor and does not apply when franchise parties mutually agree to terminate or not renew the franchise. It does not apply when the ex-franchisee cannot or does not transfer clear title and possession of the franchise assets to the franchisor, which means there should not be a repurchase obligation when site control follows lawful termination based on the franchisee's unexcused abandonment of the franchise business and the ex-franchisee is nowhere to be found. The repurchase obligation, however, would apply when site control follows termination based on noncurable violations like misuse of trademarks and fraud as long as the franchisee can transfer clear title.

Outlook

Not only does the new CFRA's protection of a *lawfully* terminated, but displaced, franchisee stand in stark contrast to other state relationship laws, it significantly changes the contractual balance of power. California law voids post-termination noncompetition agreements, which is why site control provisions have been a franchisor's typical work-around to buffet the unenforceability of post-termination noncompetition agreements. Come Jan. 1, 2016, franchisors will face the Hobson's choice of allowing a *lawfully* terminated ex-franchisee to remain in business in the former franchised location as a competitor (albeit de-identified from the franchise brand) or, if site control is important enough, to pay an ex-franchisee guilty of breaching the franchise agreement an amount that may turn out to exceed the franchise assets' fair market value. The same Hobson's choice applies even when a franchisor owns the franchised premises. While the franchisor may offset amounts owed by the franchisee, the statute does not expressly authorize a set off for the franchisor's damages caused by the ex-franchisee's default. California's extraordinary remedy is likely to be tested in court especially in contests over the sufficiency of what the franchisor tenders for site control. The risk of legal challenges may pressure franchisors to negotiate a buyout price with ex-franchisees, something that, practically-speaking, may be difficult to accomplish when post-termination tempers run hot.

Transfers

The CFRA does not regulate a franchisor's right to refuse to consent to a franchisee's request to sell its business or forbid a franchisor from refusing to consent to a transfer without offering a reason. Under the new CFRA, a franchisor may not prevent a franchisee from selling or transferring the franchise (however an event of transfer is defined) to a person that otherwise meets the franchisor's then-existing, nondiscriminatory standards for new franchisee sales or transfers. The new CFRA will override an express contract provision that purports to give the franchisor discretion to reject buyers summarily, but does not prevent a franchisor from exercising a contractual right of first refusal.

Outlook

Very few states regulate a franchisor's right to object to franchisee transfers. In this respect, the new CFRA occupies rarified territory. Predictable friction points are bound to surface in administering these new rules. For example, what if a franchisor is no longer offering new franchises when a franchisee requests approval to sell its franchise business and there are no other contemporaneous franchisee transfer requests — will the franchisor have greater discretion to reject a buyer? May a franchisor exercise a right of first refusal provision that allows a franchisor to buy all of the equity interests of a franchisee even when a franchisee owner receives an offer to buy less than all of the equity? The new CFRA states that the *reasonableness* of the franchisor's decision rejecting a transfer request is a question of fact, but one which a court may decide as a matter of law. But juries, not judges, traditionally decide questions of fact, so despite the California Legislature's gesture, judges may be disinclined to stick their judicial necks out and summarily dismiss franchisee challenges over transfer rejections, which will prolong legal contests about transfer issues. While most franchisors today promise not to unreasonably withhold consent to franchisee transfers, the new CFRA ends a franchisor's free reign over franchisee succession decisions in California.

Conclusion

What a difference a year makes! A year ago, Gov. Jerry Brown vetoed a prior iteration of the new CFRA. This year, franchisee advocates were backed by the Service Employees International Union, which organized a significant lobbying effort. The SEIU–franchisee alliance is inexplicable: this is the same union urging the NLRB to prosecute franchisors as joint employers of their franchisees' workers, a position that franchisees oppose. Indeed, unions and franchisees make strange bedfellows: as small business owners, franchisees dislike hiring traditionally more expensive union labor. In defending their California victory, franchisees shrug off questions over their marriage of convenience with the SEIU claiming the new CFRA is a long overdue correction in the franchise balance of power. They boldly predict that other states will enact comparable laws in coming years. If nothing else, the new CFRA signals the dawn of a new political day, one that may not deter franchisors from doing business in California, but where unexpected allies help franchisees readjust the franchise playing field.

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