

Date of Hearing: June 17, 2024

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Timothy Grayson, Chair

SB 919 (Umberg) – As Amended May 16, 2024

SENATE VOTE: 37-1

SUBJECT: Franchise Investment Law: third-party franchise sellers

SUMMARY: Requires, beginning on July 1, 2025, a third-party franchise seller to register with the Department of Financial Protection and Innovation (DFPI) and to comply with new disclosure requirements.

Specifically, **this bill:**

- 1) Defines a “third-party franchise seller” as a person who directly or indirectly engages in the business of the offer or sale of a franchise, including but not limited to franchise broker, a broker network, and a franchise sales organization. “Third-party franchise seller” does not include a franchisor, subfranchisor, or an area representative or any of their officers, directors, or employees.
- 2) Makes it unlawful for a third-party franchise seller to effect or attempt to effect the sale of a franchise unless registered with DFPI as a third-party franchise seller.
- 3) Beginning on July 1, 2025:
 - a) Provides that it is unlawful for a third-party franchise seller to offer or sell a franchise in this state unless the third-party franchise seller is registered.
 - b) Requires a third-party franchise seller to register by filing online specified information with the DFPI commissioner, including a Uniform Third-Party Franchise Seller Disclosure Document (Seller Disclosure), which must include specified information such as compensation and a description of services performed, any additional documents or exhibits prescribed by the commissioner, and a registration fee. The third-party franchise seller must notify the DFPI commissioner of any material change in information, such as a change in litigation history or change in compensation.
 - c) Provides that it is unlawful for a third-party franchise seller to engage with a prospective franchisee before providing a copy of the completed Seller Disclosure.
 - d) Requires a third-party franchise seller to comply with existing provisions of the Franchise Investment Law (FIL) related to false advertising and how registration can be characterized.
 - e) Authorizes DFPI to issue a stop order suspending or denying the effectiveness of a registration or barring a third-party franchise seller from offering or selling a franchise in this state if the third-party franchise seller has failed to comply with the FIL, as specified.
- 4) Provides that a third-party franchise seller who offers or sells a franchise in violation of the FIL is liable to the franchisee, who may sue for damages caused thereby. Provides that the

franchisor may also sue for damages or may assert claims of indemnity against the third-party franchise seller caused by the violation, including, but not limited to, indemnity for any damages awarded in connection with rescission awarded to the franchisee.

EXISTING LAW:

- 1) Provides the FIL that generally requires franchisors to register with the commissioner of DFPI before offering and selling franchises in this state. (Division 5 of Title 4 of the Corporations Code, commencing with Section 31000 et seq.)
- 2) Provides that it is unlawful for a person to offer or sell a franchise unless the offer has been registered under the FIL, unless exempted. (Corporations Code Section 31110)
- 3) Requires that an application for registration to be accompanied by a proposed franchise disclosure document containing specified information and containing a disclaimer that the registration does not constitute approval, recommendation, or endorsement by DFPI. (Corporations Code Section 31114)
- 4) Requires that a person provide to a prospective franchisee, at least 14 days prior to the sale of a franchise, a copy of the franchise disclosure document, together with a copy of all proposed agreements related to the sale. (Corporations Code Section 31119)
- 5) Prohibits various fraudulent acts and practices related to the sale of a franchise, such as making untrue or misleading statements. (Corporations Code Section 31200 – 31204)
- 6) Prohibits a person to effect or attempt to effect a sale of a franchise, except in specified exempt transactions, unless such person is:
 - a) Identified in an application filed with DFPI pursuant to the FIL,
 - b) Licensed by the Bureau of Real Estate as a real estate broker or real estate salesperson, or
 - c) Licensed by DFPI as a broker-dealer or agent pursuant to the Corporate Securities Law of 1968. (Corporations Code Section 31210)
- 7) Imposes civil liability, as specified, on any person who offers or sells a franchise in violation of the FIL. (Corporations Code Section 31300 et seq.)
- 8) Requires DFPI to charge fees for filing specified applications, an amendment, or an initial notice of exemption, ranging from \$50 to \$675 per filing. (Corporations Code Section 31500)

FISCAL EFFECT: Unknown. This bill is keyed Fiscal by Legislative Counsel.

COMMENTS:

- 1) Purpose.

According to the author:

Senate Bill 919 increases transparency in the franchise sales process for prospective franchisee in the State by providing information not only about what

the prospective franchisee is buying (a franchise opportunity) but also who is selling it to them. SB 919 ensures that a prospective franchisee understands the role of the third party franchise seller and the incentives they may receive for referring the prospective franchisee to one franchise opportunity over another. By improving franchise presale disclosures, prospective franchisees will be better able to evaluate and make investment choices among the wide range of franchise opportunities presented to them and to choose from those that meet their goals, ambitions, financial and other requirements.

2) Background: Franchises and the Franchise Relations Act (FRA) and the FIL

A franchise is a type of license that grants a franchisee access to a franchisor's proprietary business knowledge, processes, and trademarks, thus allowing the franchisee to sell a product or service under the franchisor's business name. In exchange for acquiring a franchise, the franchisee usually pays the franchisor an initial start-up fee and annual licensing fees.

Franchises are a fairly common way for an entrepreneur to start a business because the entrepreneur has access to an established brand name. According to a 2017 US Census Bureau survey, approximately 11.4% of all businesses are franchises, with the limited service restaurant industry having the most franchise establishments of any industry.¹

Because of the unique relationship between the franchisee and the franchisor, the franchise process is subject to tailored laws and rules. The FRA was enacted in 1980 to govern relationships between franchisors and franchisees after they have entered into contract with each other. The FRA is designed to prevent unfair practices in the transfer, renewal or termination of a franchise, and prohibits the termination of a franchise agreement except for good cause and only after notice and an opportunity to fix the problem. It also lays out certain circumstances where immediate termination is permitted, for example: bankruptcy, abandonment, mutual agreement, material misrepresentation, illegal activity, or a failure to pay franchise fees and imminent danger to the public.

The FIL, which this bill amends, was enacted to protect California investors from potentially fraudulent franchise investments. Under the FIL, franchisors must disclose to prospective franchisees the information necessary to make an informed decision about franchise offers, and prohibits the sale of franchises that would lead to fraud or the likelihood that a franchisor's promises would not be fulfilled. The FIL allows for enforcement through damages (payment for economic losses) and rescission (cancellation of the contract). It also provides for injunctive relief (to require or prohibit a specific action), and reasonable costs and attorneys' fees in certain circumstances.

3) Background: The role of third-party sellers.

As part of the franchising process, a number of third parties can play a role in facilitating or otherwise brokering the sale of a franchise to a potential buyer. In theory, these brokers can offer expertise in areas like brands, applicable laws, local economic and demographic trends, and local real estate.

¹ <https://www.census.gov/library/stories/2021/12/franchising-is-more-than-just-fast-food.html>

However, these entities have also come under scrutiny for the risk they can pose for both the franchise owner (seller) and the franchisee (buyer). Simply put, these entities make money when a franchise sale goes through, and they bear none of the risk of a failed franchise arrangement. This incentive can lead to unfavorable or risky arrangements that may not have been made if the two parties communicated directly. These concerns are backed by comments from industry participants who argue that bad actors often sell to unqualified candidates, misrepresent franchise offerings, and make unauthorized financial performance representations.

A 2011 report by the American Bar Association lays out the types of third-party franchise sellers that exist today, some (but not all) of which are the focus of this bill.² These third parties include:

- Lead generators. A lead generator is simply a person or organization that, in exchange for a fee, provides a franchisor a list of potential investors. A lead generator does not generally work to convince the prospective franchisee to purchase the franchise.
- Franchise brokers. A franchise broker, who appears to be the main focus of this bill, is an organization or a person who, in exchange for compensation from the franchisor, will actively offer for sale the franchise. The broker is a salesperson: they take a much more proactive role in convincing the potential investor to move forward with the purchase. Importantly, the broker is not party to the agreement between the franchisor and the franchisee.
- Local area representative. A local area representative engages in franchise selling activities in a defined geographic area. Under this model, the area representative may pay an initial fee for the right to enter into an agreement with the franchisor, and the representative will help sell the franchise in that region as well as offer post-sale services such as marketing support and workplace training.

4) What does SB 919 do?

SB 919 requires third-party franchise sellers to register with DFPI and to provide both DFPI and potential investors a Seller Disclosure that contains specified information that is meant to highlight the seller's incentives to secure the sale.

The Seller Disclosure is the lynchpin of SB 919's protections for franchisors and franchisees. This document must contain information on the third-party seller's role in the franchise sales process, the different ways the third-party may be compensated, the industries or brands they represent, and their professional experience and administrative, civil, or criminal actions initiated against the third-party franchise seller in the last five years.

There remain questions about SB 919's scope. As noted the Senate Banking and Financial Institutions Committee's analysis, the definition of "third-party franchise seller" creates significant uncertainty about who is covered and who is not. SB 919 does not specify that these entities must receive compensation for their activities, which is generally the impetus for the identified market problems. Moreover, the definition includes those who "indirectly"

² https://www.americanbar.org/content/dam/aba/publications/franchising_past_meeting_materials/2011/w18.pdf

engage in the business of offering or selling a franchise, which could be read as applying to a broad range of activities likely not intended to be covered since those actors would not need to provide a disclosure as required by other parts of the bill.

5) Interaction with the Model Franchise Broker Registration Act

On May 13, 2024, the North American Securities Administrators Association (NASAA) released the *NASAA Model Franchise Broker Registration Act* (Model Law). NASAA describes the need for the Model Law as follows:

Franchise brokers have been the subject of complaints, including allegations of misrepresentations, hard sell tactics, and confusion about their role. Although franchisors are required to register with state franchise administrators in 15 states, currently only two states, New York and Washington, require franchise brokers to register with a state franchise administrator. Franchisors also are subject to certain disclosure obligations to prospective franchisees under the Federal Trade Commission Franchise Rule, but franchise brokers have no obligations under the Franchise Rule.

Like SB 919, the Model Law requires third-party sellers to disclose certain information and to register with the state. The Model Law also includes provisions related to prohibited practices, examination requirements, continuing education, and financial and insurance requirements. While the Model Law simply *authorizes* a regulator to develop specific rules around financial and insurance criteria as a condition for registration, SB 919 contains no such provisions. In this way, SB 919 might be read as having less onerous requirements on franchise brokers than the Model Law, though the approaches taken by the two proposals are generally the same.

6) Recent legislation.

AB 676 (Holden), Chapter 728, Statutes of 2022, made modest changes to various provisions of the FIL and FRA, including a provision that deems void and unenforceable any provision of a franchise agreement that disclaims or denies representations made by the franchisor or its personnel or agents to a prospective franchisee, reliance by the prospective franchisee on any representations made by the franchisor or its personnel or agents, reliance by the prospective franchisee on any representation in the franchise disclosure document including any accompanying exhibits, or violation of any provision of the FIL.

7) Amendments

The committee recommends the following amendments to align the definition of “third-party franchise seller” with the definition of “franchise broker” in the Model Law. Specifically, the committee recommends the following amendments:

(a) “Third-party franchise seller” means a person who directly or indirectly engages in the business of the offer or sale of a franchise **and receives, or is promised, a fee, commission or other form of consideration from a franchisor, subfranchisor or franchisee, or an affiliate of a franchisor, subfranchisor or franchisee. A third party franchise seller includes but is not limited to,** ~~including, but not limited to,~~ a franchise broker, a broker network, a broker organization, and a franchise sales organization.

(b) A “third-party franchise seller” does not include any of the following:

- (1) A franchisor or its officers, directors, or employees.
- (2) A subfranchisor or its officers, directors, or employees.
- (3) An area representative or its officers, directors, or employees.
- (4) An employee of an affiliate of a franchisor or subfranchisor.
- (5) A franchisee of the franchise offering being presented to a prospective franchisee, unless the franchisee operates a franchised broker business.

8) Support

The Coalition of Franchise Associations, a co-sponsor of this bill, writes:

Senate Bill 919 will specifically require franchise sellers to register with the state, provide significant disclosures to its clients, and assign liability if they don't provide accurate information on the franchise they are selling. Currently, franchise sellers, often called franchise brokers, have no requirements. For example, to become a franchise broker, all you have to do is call yourself one. The importance of registration and disclosure is because buying a franchise puts the franchisee at significant risk. Most franchises, and often the loans required to obtain the franchise, require personal guarantees by the franchisee. Unlike most other large investments where only the investment is at risk, buying a franchise can put ALL your assets at risk. Because of these risks it is critical that franchise sellers have disclosure requirements and liability if they provide improper information about the franchise they are selling.

REGISTERED SUPPORT / OPPOSITION:

Support

Alta Mere Auto Care
 Beauty Bungalows
 Bishops Cut and Color
 Brain Balance
 Bright STAR Care
 Capriotti's
 Certapro Painters
 Church's Texas Chicken
 City Wide Facility Solutions
 College H.u.n.k.s Hauling Junk
 Dr. Nick Tranmissions
 Drybar
 Eatgatherlove
 Elements Massage
 Elmer's Restaurants, Inc,
 Fastsigns
 Firstservice Brands/California Closets
 Fitness Together
 Floor Covering International
 Frenchie's Modern Nails

Gojoe Patrol, INC.
Great Clips
GYMGUYZ
Home Helpers Home Care
Ikids U Franchise, LLC
Instant Imprints
International Franchise Association
Inxpress
Milex Complete Auto Care
Mr. Transmission
Msa Worldwide
Multistate Transmission
Wise Coatings Franchises

Opposition

None on file.

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