Proposed Legislation Would Harm Franchisors Doing Business In California

By Kevin A. Adams

Proposed amendments to the California franchise laws are quickly advancing through the State Capitol. California Senate Bill 610 and Assembly Bill 1141 were introduced this legislative session in an attempt to radically change California's franchise laws. SB 610 has already passed though the State Senate and is just steps away from being presented to Governor Brown for signature.

If enacted, SB 610 would impose a nebulous "good faith" requirement on franchisors operating in California – providing plaintiffs' attorneys with ammunition to attack the black and white terms of the contract as "bad-faith." The bill would also increase damages available to franchisees and provide for one-sided attorneys' fees. These proposed changes, among others discussed below, would likely result in increased litigation and negatively impact franchising in California.

Below, I attempt to provide a brief history of California's existing franchise laws, past failed attempts to amend the laws, narrative summaries of both SB 610 and AB 1141, and the anticipated consequences of the bills should they become law.

A Brief History of California Franchise Laws

In 1970, a bill was introduced in the California Senate to regulate offers and sales of franchises. The bill – known as the California Franchise Investment Law ("CFIL") – was later signed into law by then Governor Ronald Reagan, making California the first state to regulate the sale of franchises. In short, the CFIL regulates franchisors' dissemination of information to prospective franchisees, allowing the prospects to make informed decisions regarding their potential franchise investments. One decade later, the California Franchise Relations Act ("CFRA") was enacted to govern the end or renewal of the franchise relationship. Most notably, the CRFA prohibits the early termination of the franchise absent "good cause," and a "reasonable opportunity" to cure. Few substantive changes have been made to the CFIL and CFRA since their inception – allowing for stability and growth to California's strong franchise economy/industry.

Recent Attempts to Amend the California Franchise Laws

The California legislature's recent attempts to introduce – and develop – amendments to the CFIL and CFRA have proved futile. Last year, I wrote about California Assembly Member Jared Huffman's proposed AB 2305 – and its promise to provide a "level playing field" for franchisees by amending both the CFIL and CFRA. In reality, if enacted, AB 2305 would have provided numerous litigation possibilities for plaintiffs' attorneys, thereby restricting the growth of franchise systems in California. AB 2305 ultimately "died" in the Assembly's Committee on Business, Professions and Consumer Protection.

In varying degrees, current members of both the Senate and Assembly are trying to revive AB 2305 for the 2013/2014 legislative session.

Senate Bill 610

State Senator Hannah-Beth Jackson introduced SB 610 to the State Senate on February 22, 2013. The bill purportedly "proposes modest changes to California franchise law." These proposed changes can be summarized as:

- The requirement that the parties deal with each other in "good faith in the performance and enforcement of the franchise agreement";

- An extension on the current private right of action available to a franchisee under the CFIL to include any violations of the proposed "good faith" requirement;

- Increased remedies available to franchisees, including injunctive relief, "damages caused thereby," and reasonable attorneys' fees and costs for prevailing franchisees; and

- Franchisors would be prohibited from restricting the right of franchisees to join or participate in a franchisee association to the extent the restriction is prohibited by the CFIL.

Listed sponsors of the SB 610 include the American Association of Franchisees and Dealers, plaintiffs' attorneys, and various California franchisees. These proponents argue that "greater protections are needed to protect franchisees against the unfair, bad-faith practices – made easier by the inherent one-sidedness of the franchise relationship." The opponents of SB 610 – which include the International Franchise Association, the California Chamber of Commerce, and other prominent business associations – argue that the "bill will hurt business in California by interfering in contracting relationships between consenting parties that is needed to freely develop new franchise businesses." Also, the opponents contend that the proposed changes to the law are unnecessary because the "existing California law and the Federal Trade Commission (FTC) already require extensive disclosure documents to ensure that both parties know what is expected from the other before they enter into a franchise agreement."

While SB 610's proposed changes to California's franchise laws are less drastic than those proposed by AB 1141 (discussed below), these changes could still usher in serious consequences for franchisors operating in California. For example, contracting parties already have a legally enforceable common law implied duty of good faith and fair dealing in the performance of the contract. With this existing duty already in place, it appears as though the "good faith" language proposed by SB 610 is superfluous – adding nothing to the rights or obligations of the parties. On the other hand, adding the nebulous term "good faith" to the statute may allow plaintiffs' attorneys to go beyond the existing duty of good faith in the performance of the contract, and provide them with ammunition to attack the black and white terms of the contract as "bad-faith" – irrespective of the franchisee's acquiescence to such terms.

Similarly, the proposed expansion of damages and one-sided attorneys' fees and costs that would be available to the franchisee for the "bad-faith" conduct of the franchisor may create significant incentives for plaintiffs' attorneys to file suit. These one-sided remedies may result in meritless and potentially inconsequential claims for violation of the franchise laws to allow for plaintiffs' attorneys to recover their fees. Also, the opponents to SB 610 argue that, even though its changes would instill in both the

franchisor and franchisee a duty of good faith and fair dealing, the bill only provides the franchisee with a private right of action to sue for such a breach.

Additionally, the bill's proposed change to the CFRA – prohibiting franchisors from restricting the rights of their franchisees from joining franchisee associations – is already part of California's franchise laws. The CFIL, at Corporations Code § 31220, has made it unlawful for franchisors to "prohibit the right of free association among franchisees for any lawful purpose" since its enactment in 1977. SB 610's proposed change to the CFRA adds nothing but increased volume and complexity to California's franchise laws.

SB 610, if enacted, would likely have a negative impact on franchisors doing business in California and promote additional franchise litigation.

Assembly Bill 1141

Assembly Member Brain Dahle – working in conjunction with the Coalition of Franchisee Associations and the American Association of Franchisees and Dealers – has introduced bill AB 1141, the more extreme of the two franchise bills currently before the California legislature. If enacted, AB 1141 would limit a franchisor's ability to terminate a franchisee unless the termination is conducted "in accordance with the current terms and standards established by the franchisor then equally applicable to all franchisees, . . . and is not arbitrary." Additionally, AB 1141 redefines "good cause" – needed to terminate the franchise relationship – from the franchisee's "failure to comply with any lawful requirements of the franchise agreement" to "a substantial and material breach" of the franchise agreement.

AB 1141 also seeks to change the natural expiration of the franchisor/franchisee contractual relationship. If enacted, the law would mandate a perpetual franchise relationship that can only be terminated by the franchisor if the franchisee "substantially and materially breached the franchise agreement" – irrespective of the term agreed to by the parties at the onset of their relationship.

Application of the ambiguous language in AB 1141 would likely promote litigation by allowing plaintiffs' attorneys to attack the conduct of the franchisor notwithstanding the franchisor's compliance with the actual terms of the franchise agreement.

The changes proposed by AB 1141 would also ease the franchisee's burden of proving a violation of the franchise laws, while expanding the damages available to the franchisee for such a violation. For example, AB 1141 seeks to exclude the elements of "scienter" and "reasonable reliance" – currently needed for a franchisee to prove its claims for "fraud, deceit, misrepresentation, or omissions." This change would seemingly allow plaintiffs' attorneys to avoid having to prove the more difficult intent and reliance elements of their fraud claim. The bill also seeks to expand damages available for violations of the CFIL – currently limited to rescissionary damages – to include "restitution" and "ancillary damages."

While the changes to the franchise laws advanced by AB 1141 do not end with those identified above, these changes exemplify many of the concerns raised by the opponents of the bill.

Current Status of SB 610 and AB 1141

After passing seamlessly through the State Senate, the milder of the two franchise bills, SB 610, was slowed during its June 24, 2013 reading by the Assembly. The Assembly amended the bill to include a waiver provision that would void any attempts by franchisors to require franchisees to waive the changes to the law as a condition of doing business with the franchisor. The amended SB 610 was then referred back to the Committee of Business, Professions and Consumer Protection for review. On August 13, 2013, the aforementioned Committee issued an updated summary of SB 610 as amended. The bill now appears to be ready for a third reading by the Assembly.

For those of us not as familiar with the operations of Capitol Hill, a bill is only read three times before it is voted on by members of that house. Thus, SB 610 will soon be read for a final time on the Assembly floor before a vote of the Assembly Members. If the bill is approved of by at least 41 of the 80 Members of the Assembly, it would pass through that House and – as a result of the amendment – go back to the Senate for further review. If the bill again generates enough “aye” votes in the Senate, it would go to the Governor’s desk for signature, veto, etc.

The prospect of AB 1141 becoming law is not as concerning – as it has not had any movement in the Assembly since it was referred to the Assembly’s Judiciary Committee on April 16, 2013. No updates from the Committee have been provided on AB 1141 since that time.

Because of the anticipated negative effects both SB 610 and AB 1141 would have on franchising in California – most notably the anticipated increase in litigation – we will continue to track their progress and provide you with regular updates via Twitter and blog post.