Negotiated Franchise Sales in California: Making Sense of the Rules and Regulations

In connection with preparing for this year's franchise registration filings, I recently re-read California's statute and regulation on negotiated changes. For those of you who are not already familiar with that law, it is part of California's overall regulation of franchise sales under the California Franchise Investment Law ("CFIL"), which can be found at Cal. Corp. Code §31109.1. Briefly, the statute creates a precondition to all franchise sales (above and beyond those included in the CFIL registration scheme) made in California. Specifically, a franchisor must make available to a California-based prospective franchisee any terms different from those contained in the franchisor's disclosure document that have been negotiated with franchisees in California during the previous year. In other words, if a franchisee has been given a "special deal" that is not part of the franchisor's standard offering, the terms of that deal must be disclosed to subsequent franchisees.

In reviewing California's requirements on negotiated sales, I again noted a disparity between the statute (cited above) and the regulation covering the same issue, which was enacted by the Department of Corporations ("DOC"). The two provisions use different approaches to address the same issue, as explained further below. By researching the background of the statute and the regulation, I was able to determine why they are different and, most importantly, what options a franchisor has to comply with their requirements.

Purpose Behind the Provisions

Ostensibly, the purpose of the law (as well as the regulation) is to control discrimination or favoritism among franchisees. If one franchisee obtains the benefit of special terms, the reasoning is that all other franchisees should be able to see those terms and possibly use them as a basis for negotiating similar changes for themselves. In that way, the playing field among franchisees is somewhat leveled – those franchisees who are not savvy or aware of the franchisor's willingness to negotiate additional or different terms to the agreement are given the benefit of those that are.

While the purpose of California's law on negotiated changes is to promote fairness in franchising among franchisees in California, many argue that in reality, the law has the opposite effect: it acts as a disincentive for franchisors to negotiate with California-based franchisees *at all*. There are at least two reasons why this is so. First, the provision creates an additional burden on franchisors, which must disclose (and potentially file with the DOC) all negotiated changes to subsequent franchisees for a rolling 12-month period. Second, franchisors that would otherwise be inclined to amend a contract to sweeten the pot for a franchisee risk having every subsequent prospect ask for the benefit same terms – regardless of whether the deal made with the first franchisee was based on special considerations that were unique to that transaction.

The negotiated changes rule and regulation present one more significant problem. The law can act as a trap that can ensnare a franchisor that is unaware of the law, regardless of the franchisor's innocent intentions. As presently written, the DOC is given wide latitude in the statute to assess penalties for violations, no matter how large or small the amount of actual damage caused to subsequent franchisees.

As far as I know, California and Wisconsin are the only states that specifically regulate the disclosure of negotiated terms. The Federal Trade Commission and other states, to the extent that they do address the possibility of negotiated changes, give franchisors and franchisees wide latitude to negotiate agreements as they see fit. For example, the Washington Franchise Investment Protection Act states that it "does not preclude negotiation of the terms and conditions of a franchise at the initiative of a franchisee," and specifies that a franchisor "need not provide an amended offering circular" due to its agreement to the negotiated changes. *See* RCW 19.100.184. This hands-off policy encourages free negotiation between the parties, which is consistent with the goals of franchise regulations in general.

Resolving the Apparent Inconsistency Between the Law and the Regulation

The other problem is that the current status of the law on negotiated sales is confusing to even experienced franchise practitioners. Specifically, the statute on negotiated sales (Cal. Corp. Code §31109.1) requires a franchisor to disclose to prospective franchisees "a summary description of each material negotiated term that was negotiated for a California franchise during the 12-month period" immediately prior to the offer. This summary description does not have to be included as an exhibit to the FDD, but instead can be given to a prospect as a "separate appendix." Then, if a prospective franchisee asks, a franchisor must give to the prospect copies of the actual negotiated terms (as opposed to the "summary description" of the terms given to the prospect with FDD). Importantly, however, the statute **does not** require the franchisor to file either the summary description *or* copies of the negotiated changes with the DOC.

The regulation is different, and is more burdensome than the statute in two ways. First, the regulation a franchisor that makes negotiated changes is required to file a "Notice of Negotiated Sale of Franchise" with the DOC within fifteen business days after the negotiated sale is consummated. For active franchisors, this added filing requirement creates more work for the franchisor in order for it to stay compliant. Second, the franchisor is *also* required to amend its FDD to state that it has made negotiated changes, and to attach all negotiated sales notices as an exhibit to the FDD. Because all FDDs filed in the State of California are available for download online (link), this potentially makes the negotiated terms available to prospective franchisees everywhere – not just those covered by California law.

So, given that the two provisions are inconsistent with one another, what should a prudent franchisor do to comply? First, the franchisor must determine whether the negotiated terms, on the whole, confer additional benefits to the franchisee (which is usually the case). If not, then the franchisor must comply with the more rigorous requirements of the regulation. If the provisions do, however, confer additional benefits on the franchisee, the franchisor has two separate and distinct paths available for compliance – it can follow either the statute *or* the regulation. Most franchisors will prefer to follow the statute, since no filing is required and the negotiated changes will not be available publicly.

Given that the practical effect of the negotiated sales provisions is to discourage franchisors to negotiate with their franchisees, both provisions (the statute and the regulation) should be re-examined by the State to determine whether they should even remain on the books. If the State is determined as a matter of policy to retain a law on negotiated changes, then one or both of the provisions should be amended to avoid future confusion by franchisors and practitioners.