

Franchise Sales Likely to Get New Level of Regulation Over Third-Party Sellers

July 29, 2024
By David Cahn

A bill passed by the California Senate on May 22, 2024, Senate Bill No. 919 (“Bill 919”), will address a gap in the regulation of franchise sales – namely, a lack of transparency regarding the role and background of independent franchisee recruiters, often known as “franchise brokers.” This bill, which has the rare support of both the International Franchise Association (the “IFA”) and franchisee advocate groups such as the American Association of Franchisees and Dealers (“AAFD”), now heads to the California General Assembly for approval. It appears to have a strong chance to become law this year and to influence franchise sales regulation nationally.

Historically, franchise laws have focused on requiring affirmative disclosures by franchisors so that franchisee prospects can obtain information about the franchise system to better understand the business opportunity that they are evaluating. While the vast majority of franchise registration states require franchisors to submit information about their third-party brokers in franchise seller disclosure forms, those provisions pre-dated the growth of franchise seller networks such as FranNet, FranChoice and The Entrepreneur’s Source (among many others). Such intermediary companies, which usually identify themselves as consultants to prospective franchisees, are a major source of new franchisees to many growing systems and play an important role in franchise sales. Because those companies have many franchises in their “inventory” (sometimes hundreds) and therefore only occasional contact with each franchisor, they don’t fit the model of a broker regularly engaged in selling for a relatively small group of brands who the franchisor would recognize as its regularly used franchise seller.

To date, only two states (New York and Washington), have historically required brokers to register themselves as franchise sellers. If passed, Bill 919 would require third-party franchise sellers, including the large networks with dozens of individual representatives, to register with the State of California. The fee for a franchise seller filing an initial registration application is \$250, with a \$150 annual renewal fee and \$50 fee to amend a registration upon a material change to the application information.

More notably, Bill 919 adds a requirement for third-party franchise sellers to provide a disclosure document to prospective franchise buyers. The broker would be required to disclose some of the categories of information that franchisors must supply in their Franchise Disclosure Document (“FDD”). Specifically, brokers must submit a Uniform Third-Party Franchise Seller Disclosure Form and a Uniform Third-Party Franchise Seller Disclosure Document (“FSDD”) along with their registration application. In addition to registering the FSDD with the state, franchise sellers must also present this document to a prospective franchisee prior to engaging with them about a franchise opportunity. The FSDD must include the following information:

- A cover page containing standardized and general language that is not specific to a particular broker and will include, at a minimum, the following information:

- A description of the types of franchise sellers
- A seller's role in the sales process
- The services a seller might provide
- Methods of compensation for a seller's services
- Examples of questions a prospective franchisee might ask a seller
- General information about the specific seller's legal and trade names, state and year of formation, principal address, owners and key personnel, and contact information
- The franchise seller's professional experience during the last five years
- Administrative, civil, or criminal actions against the seller within the last five years alleging fraud, unfair or deceptive practices, or similar violations (which aligns with the types of matters disclosed in Item 3 of a franchisor's FDD)
- The industries a seller represents and the number of brands within each industry
- A description of services provided by the seller
- How the seller is actually compensated, including how the amount of compensation is calculated
- Whether a broker network/organization or franchise sales organization may receive additional consideration
- The name and contact information for every franchisee that the seller sold a franchise to anywhere in the United States during the last calendar year, including the number of units sold to each franchisee

With respect to enforcement, Bill 919 creates a cause of action that allows franchisees to sue for damages and rescission if the seller violates the law with respect to a franchise sale. Additionally, the California commissioner can issue a stop order prohibiting a franchise seller from offering or selling franchises in the state if it finds that a seller has failed to comply with any applicable provisions of law or rules issued by the commissioner.

The new rules and penalties have the same scope as a franchise sale under the California Franchise Investment Laws. So, they will apply to franchise sellers who are based in California, but also to anyone "consulting with" a prospective franchisee who is a resident of or has a principal place of business in California, or if the franchised business will be in California. Any franchise broker that wishes to sell franchises that will be located in California, or to prospects located in California, will need to register.

The bill exempts California licensed real estate brokers and securities brokers-dealers.

Since none of the mandatory disclosure items are limited to California sellers or California franchisees, Bill 919 also may be a template for the regulation of franchise sellers on a nationwide level, particularly in those other states that require pre-sale registration of franchise offerings. If passed, Bill 919 will go into effect on July 1, 2025.