

SBA-Backed Franchise Lending

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By Thomas Pitegoff

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This blog post may contain information that was accurate at the time of publication but could become outdated over time. We strive to provide relevant and timely content, but circumstances, facts, and data can change. Users are encouraged to verify the current status of any information presented and seek updated guidance where necessary.

The U.S. Small Business Association's loan guaranty program has undergone several changes over the years. The [January 1, 2018](#) rule supersedes changes described in my past blog postings in December [2014](#) and [2016](#).

A franchisor that wants its franchisees to be able to obtain SBA-backed loans to finance their franchised businesses must be listed on the [SBA Franchise Directory](#). The directory, which is maintained on the SBA's website, shows to franchisees and lending banks the franchise systems that qualify for SBA-backed lending.

To be listed on the SBA Franchise Directory, a franchisor must submit to the SBA its franchise agreement, its franchise disclosure document (FDD), and any other documents the franchisor requires the franchisee to sign. The SBA then undertakes an affiliation review (explained below) and an eligibility determination.

If the franchisor uses the SBA Addendum ([SBA Form 2462](#)), the SBA will only undertake an eligibility review and will not conduct an affiliation review. For each listed franchise system, the SBA Franchise Directory indicates whether an addendum is needed, and whether that will be the SBA Addendum or an SBA Negotiated Addendum.

Franchisors that are already listed on the SBA Franchise Directory and are not using the standard SBA Addendum must recertify with the SBA each year.

As used by the SBA, the term "affiliation" relates to the question of whether the borrower is an independent small business. A lack of affiliation is a condition to being eligible for SBA-backed loans. If affiliation exists, the franchisee is not an independent small business as defined in the SBA's regulations. Affiliation exists when the franchise agreement gives the franchisor excessive control. In order to qualify for the SBA loan program, the applicant must have the right to profit from its efforts and must bear a risk of loss commensurate with the concept of ownership of an independent business.

The SBA Addendum establishes the lack of affiliation by stating the following:

Change of Ownership

- The franchisor may exercise an option or right of first refusal to purchase a partial interest in the franchisee's business only if the proposed transferee is not one of the current owners of the business or a family member of a current owner.
- If the franchisor's consent is required for any transfer (full or partial), the franchisor will not unreasonably withhold its consent.
- Once a transfer takes place, the transferor cannot be liable for the actions of the transferee.

Forced Sale of Assets

- If the franchisor has an option to purchase the assets of the franchised business upon the franchisee's default or termination of the franchise agreement and the parties are unable to agree on the value of the assets, the value will be determined by an appraiser agreed upon by the parties.
- If the franchisee owns the real estate where the franchised business operates, the franchisee will not be required to sell the real estate upon default or termination, but the franchisee may be required to lease the real estate for the remainder of the term of the franchise agreement (excluding additional renewals) for fair market value.

Covenants

- If the franchisee owns the real estate where the franchised business operates, the franchisor must not record against the real estate any restrictions on the use of the property.
- If any such restrictions are recorded against the franchisee's real estate, they must be removed in order for the franchisee to obtain SBA-assisted financing.

Employment

- The franchisor will not hire, fire or schedule the franchisee's employees.
- For temporary personnel franchises, the temporary employees will be employed by the franchisee, not the franchisor.

The SBA Addendum is a form that calls for blanks to be filled in. The text of the addendum may not be altered.

Franchisors listed on the SBA Directory that do not use the standard SBA Addendum or who are using an SBA Negotiated Addendum and who do not want to begin using the SBA Addendum, must submit to the SBA each year the "Annual Franchisor Certification" stating that the terms of the franchise agreement have not substantively changed and that no changes have been made to the SBA Negotiated Addendum. If there has been a change, the franchisor must resubmit its franchise documents to the SBA for review.

The annual certification requirement ends only if the franchisor begins using the standard SBA Addendum. The opportunity to avoid an annual SBA affiliation review is one reason, then, for a franchisor to use the standard SBA Addendum even if the franchisor's standard franchise agreement already contains the provisions of the SBA Addendum.

If a franchisor is willing to use the standard SBA Addendum, it might actually make sense for the franchisor to change its standard terms to include the provisions of the SBA Addendum. For one thing, some franchisees may be unhappy with the fact that only those franchisees who seek SBA-backed loans receive the benefits of the SBA Addendum. Other franchisees will certainly learn about franchise agreement terms offered to some but not all franchisees, and this difference might cause discord.

In addition, including the terms of the SBA Addendum in a franchisor's standard franchise agreement can reinforce a franchisor's position that the franchisor is not a joint employer of the franchisee's employees and that the franchisor is not liable for the franchisee's negligence or wrongdoing. After all, as the SBA sees it, these provisions prove that the franchisee bears a risk of loss commensurate with the concept of ownership of an independent business.

Before the SBA established the SBA Franchise Directory, a company called FRANdata maintained the Franchise Registry, the forerunner to the SBA Franchise Directory. FRANdata continues to maintain its Franchise Registry. While being listed on FRANdata's Franchise Registry is not required in order for a franchise brand to be eligible for SBA financing, FRANdata does offer assistance to franchisors and more information to prospective lenders than a listing on the SBA Franchise Directory. As a private company, FRANdata charges a fee to franchisors for its services.

Tom Pitegoff,
Tom.Pitegoff@offitkurman.com