

SBA Exiting Regulation of Franchise Relationships as Part of Effort to Increase Availability of Its Small Business Loan Programs

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The U.S. Small Business Administration (SBA) is amending various regulations governing SBA's 7(a) Loan Program and 504 Loan Program, including streamlining determinations of loan applicants' eligibility as small business owners. As part of the amended regulations, the SBA is removing the provisions relating to affiliation based on franchise and license agreements, along with all other provisions evaluating affiliation based on factors other than actual or indirect (or "beneficial") ownership. Because of that removal, the SBA is eliminating the SBA Franchise Registry as of May 11, 2023.

As stated by the SBA, "These revisions remove the principle of control of one entity over another from consideration of affiliation; therefore, the mere fact that an applicant may be a franchisee is not in itself a reason that would render the applicant ineligible for an SBA loan, and thus there is no longer a compelling reason to maintain the SBA Franchise Directory". In addition, the SBA will not require franchisors and franchisees to sign any sort of standard or pre-negotiated franchise agreement addendum to obtain an SBA-guaranteed loan.

Instead, as is a requirement for all SBA guarantees of loans, lenders must examine the franchised business for affiliation based on ownership. The SBA announcement described the following as an example: "(W)hen lending to a Franchised business, the SBA Lender must determine who owns the applicant business and any businesses the applicant owns in accordance with these regulations. However, neither the SBA Lender nor SBA will review the applicant Franchised business for affiliation with other entities beyond ownership; the applicant business will not be considered affiliated with the Franchisor or other Franchised businesses except by ownership."

What Does This Mean for Franchising?

As to regulation of the franchise relationship, this marks a major retrenchment of SBA's involvement in that area, having required franchise agreement changes as a condition of lending for several decades. However, readers should note that the Federal Trade Commission is scrutinizing franchise relationships due to a large volume of complaints it has received from franchisees in the process of considering updates to its long-standing Franchise Sales Rule. During March 2023, the FTC issued a "Solicitation for Public Comments on Provisions of Franchise Agreements and Franchisor Business Practices" that may be a preliminary step towards FTC issuing rules restricting franchise agreement terms and/or franchisor business practices that it perceives to be "unfair" to franchisees. In addition, the FTC is accepting comments on extending its proposed rule banning non-competition agreements in employment agreements to include franchise relationships. Finally, bills have been introduced in several state legislatures to substantively regulate aspects of franchise relationships.

In terms of franchisee financing, this change may streamline obtaining an SBA-guaranteed loan. However, as the SBA noted

in issuing its new regulations, to obtain an SBA guarantee a lender must determine whether the applicant meets all eligibility and other SBA Loan Program Requirements, including:

- certifying that the applicant does not have the ability to obtain some or all of the requested loan funds on reasonable terms from non-government sources,
- ensuring that applicants are U.S. citizens or Legal Permanent Residents,
- obtaining personal and corporate guaranties,
- confirming that the applicant business has the ability to repay the loan through cash flow of the business, and has eligible uses of proceeds,
- verifying financial information,
- obtaining proper collateral and lien position,
- determining whether there is a direct or indirect impact on historic properties (and) compliance with environmental policies and procedures, and
- closing the loan in accordance with SBA program requirements.

This is a reminder that obtaining an SBA loan is still not the easiest way to finance. Also, we anticipate that, for the development of new franchise locations, lenders may require heightened business plan verification and support from franchisors, especially for emerging franchise systems and for applicants that are new to the system (even for larger franchisors). It may be more important than ever for franchisors to have a package of unit-level financial performance information to provide to lenders.