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Matthew J. Kreutzer

California Amends Its Franchise Relations Act

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In October 2015, Governor Brown signed into law AB 525, substantially amending California's Franchise Relations Act. The new law is one of the most significant revisions to any state's franchise law within the last decade, and is certain to change the landscape of franchisee-franchisor relations in California. Matthew Kreutzer reviews the highlights.

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Our Picks for Top Recent Business Law Cases

We do the work for you: Here are the significant recent business law cases, with expert commentary on the most important ones.

- **Although ERISA's fiduciary duties apply equally to all plans, whether or not they own employer stock, plaintiffs have a couple of pleading hurdles to get over to state a claim for breach of the duty of prudence against a plan administrator.**
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- **Two administrative rules set forth different overtime pay rates for agricultural workers who harvest fruit and for those who process fruit for market; generally speaking, the latter receive more generous overtime pay. *Baines v DIR* plumbs the line dividing the workers subject to each rule.**
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- **A third party beneficiary with an independent cause of action for breach of contract has standing to sue the promisor, even when the promisee is a suspended corporation lacking the capacity to sue.**
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- **A law firm's simultaneous representation of a corporation and one of its officers and directors constituted a conflict of interest, requiring the firm's automatic disqualification.**
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Davis v U.S. has some important lessons to bear in mind when dealing with the IRS in the settlement of an action. Marilyn Barrett discusses this Ninth Circuit decision. >> See Page 123

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Internet Remedies

Deletion of user's uploaded content constituted "omissions" of content as defined in limitation of liability clause in terms of service agreement, precluding damages element for breach of contract claim.

Lewis v YouTube, LLC [Cal App] 130

Business and Professions

Attorneys

Law firm's simultaneous representation of corporation and its principal constituted conflict of interest requiring automatic disqualification.

M'Guinness v Johnson [Cal App] 130

FEATURED ARTICLES

California Amends Its Franchise Relations Act

Matthew J. Kreutzer

In October 2015, Governor Jerry Brown signed into law Assembly Bill 525, substantially amending the existing California Franchise Relations Act (CFRA) (Bus & P C §§20000–20043). The new law is one of the most significant revisions to any state's franchise law within the last decade, and is certain to materially change the landscape of franchisee-franchisor relations in California.

The new amendments are limited in application to franchise agreements entered into or renewed after January 1, 2016, or to franchises of an indefinite duration that may be terminated without cause. As a result, franchisors and their counsel will need to be mindful of the new provisions of the CFRA that will apply to new franchise agreements, particularly those relating to termination, nonrenewal, and transfer or assignment of a franchise. The new law's provisions are summarized below.

Franchise Terminations

Historically, the CFRA has imposed few limitations on a franchisor's ability to terminate its franchisees. As amended, the law now contains new and significant limits on terminations by a franchisor. Specifically, Bus & P C §20020 has been amended as follows:

Termination for "Good Cause" Restricted to Substantial Compliance. Under the prior version of the CFRA, a franchisor was permitted to terminate a franchise before the expiration of its term only for "good cause." The law states that "good cause" includes (but is not limited to) the failure of a franchisee to comply with any lawful requirement of the franchise agreement, after the franchisee is first given notice and an opportunity to cure the failure. As amended, "good cause" under the CFRA now exists only when the franchisee has failed to *substantially* comply with the lawful requirements of the parties' franchise agreement.

60-Day Cure Period. The CFRA previously did not set any minimum number of days that a franchisor must provide to a franchisee so that it may cure a material default under the franchise agreement. Instead, the law stated that the cure period need not be more than 30 days. The amended law will now require a franchisor to provide a *minimum* of 60 days' advance notice and opportunity to cure a default, which period will be measured from the date the franchisee is notified of the noncompliance. The law change also prohibits a franchisee's cure period from exceeding 75 days, unless the parties otherwise agree to extend the time.

Importantly, the existing carve-outs from the mandatory 60-day cure period (identified in Bus & P C §20021) have

not been affected by the new amendments. This means that a franchisor will continue to be permitted to terminate a franchisee on 10 or fewer days' advance notice for certain types of time-sensitive material defaults, including those when the franchisee (a) fails to timely pay amounts due to the franchisor or its affiliate; (b) abandons the business; (c) engages in conduct that reflects materially and unfavorably on the franchise system; (d) fails to comply with laws or regulations; or (e) commits repeated defaults under the franchise agreement, even when those defaults were timely cured.

Franchisor's Obligations After Termination or Refusal to Renew

What are arguably the most significant changes to the CFRA relate to a franchisee's rights, and a franchisor's obligations, on either (1) termination of the franchise contract or (2) the franchisor's refusal to renew the agreement. These new provisions impose a duty on the franchisor to provide value to a departing franchisee under many circumstances, including even those situations where the franchisor terminated the franchisee in compliance with the CFRA and the franchise agreement. These new requirements (enacted in new Bus & P C §20022 and in the newly replaced Bus & P C §20035) include the following:

Obligation to Repurchase Assets. When a franchisee is lawfully terminated or not renewed by the franchisor, the franchisor will now have the obligation to purchase from the franchisee "all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for" by the franchisee, if those purchases were made in accordance with the requirements of the franchise agreement. To be covered by this provision, the franchisee must still possess the assets at the time it ceases operating the business as a franchise, and must be able to give the franchisor clear title to the assets.

Only a few limitations apply to this new provision. Specifically, this repurchase requirement will *not* apply when

- The assets to be purchased were not "reasonably required to conduct the operation of the franchise business";
- The franchisee is unable to give the franchisor clear title and possession to the assets;
- The franchisee declined an offer from the franchisor to renew the agreement;
- The franchisor does not prevent the franchisee from retaining control of the franchise business location after the termination or nonrenewal (by requiring the franchisee to assign the site lease to the franchisor);
- The reason for the franchisor's termination or nonrenewal of the franchisee is a publicly announced, nondiscriminatory decision to completely withdraw its franchise activity within the geographic market area where the franchisee is located; or
- The parties mutually agree in writing to terminate or to not renew the franchise.

Importantly, the franchisor *is permitted* to offset the purchase price of the assets against the money that the franchisee owes to the company. This right of offset will take some of the sting out of the new law for franchisors in termination situations, because most early terminations leave the franchisee owing the franchisor substantial amounts of money. These posttermination debts by the franchisee can take the form of early termination damages, liquidated damages, attorney fees, indemnification, or similar types of charges.

Damages for Failure to Comply With CFRA. Before the amendment, §20035 of the CFRA was largely considered to be toothless, because it required a franchisor that failed to comply with the law's termination or renewal provisions only to repurchase a franchisee's resalable inventory. That section has been repealed and replaced. The newly amended provision adds sharp new teeth for a franchisee claiming that the franchisor violated the CFRA.

Specifically, new Bus & P C §20035 states that in the event a franchisor terminates or fails to renew a franchisee in violation of the CFRA, the aggrieved franchisee will be entitled to receive from the franchisor "the fair market value of the franchised business and franchise assets," as well as any other damages caused by the franchisor's violation of the CFRA. In other words, the newly amended law requires the franchisor to essentially compensate the franchisee for its loss of the franchise business as a going concern. The newly enacted statute also authorizes a court to grant preliminary and permanent injunctive relief for a franchisor's violation (or threatened violation) of the statute.

Franchisee's Right to Sell

Finally, the CFRA has a new framework enabling franchisees to sell or transfer their businesses. Under the newly enacted provisions, the CFRA now requires the following:

Right of Sale. Under the new law (enacted in new Bus & P C 20028), a franchisor *may not* prevent a franchisee from selling (a) the franchise; (b) all or substantially all of the assets of the franchise business; or (c) an interest in the franchise business or franchisee business entity (whether controlling or noncontrolling) to another person. The only exceptions to this are when (1) the buyer does not meet the franchisor's then-existing standards for new or renewing franchisees, or (2) the franchisee and its proposed buyer fail to comply with the transfer provisions specified in the franchise agreement.

Required Notice. The revised CFRA (specifically, new Bus & P C §20029) will now require a franchisee to notify its franchisor, in writing, of its intention to sell all or substantially all of the franchise. The notice must contain the proposed buyer's name and address; a copy of all agreements related to the sale; and the proposed buyer's application to become a successor franchisee, which must include the forms, financial disclosures, and other information the franchisor generally uses in reviewing new prospective franchisees. If the franchisor's then-existing standards for approving new franchisees are not generally available to the selling franchisee, then the franchisor must provide those standards within 15 days of receiving the franchisee's written notice.

Notification Period. As also stated in new Bus & P C §20029, the franchisor must now inform the selling franchisee of its approval or disapproval of the sale in writing within 60 days of its receiving from the franchisee all of the required documentation. If the franchisor does not approve the sale, it must inform the franchisee in writing of the reasons for its disapproval. Any failure by the franchisor to approve the sale within 60 days of the franchisee's request will result in the sale automatically being deemed approved. The statute also expressly authorizes a trier of fact to determine whether a franchisor's disapproval of a sale was reasonable, considering all existing circumstances. As a result, California may experience a significant uptick in litigation over franchisor refusals to approve these transfers.

Importantly, a franchisor's contractual right of first refusal will not be affected by any of the new provisions, except that for that right to be valid, the franchisor must offer the seller payment that is equal to or greater than the value offered by the third party prospective buyer.

What Does the Future Hold?

The newly amended CFRA substantially changes franchisee-franchisor relations in California. Franchisors must be mindful of how the law will affect franchisee relationships, and franchisees should be aware of the important new rights they will have under the law.

Although the new law has been hailed by franchisee groups as a positive change for franchising, franchisor organizations see it as a giant step backwards—reversing a decade-long trend toward fewer regulations in franchising. The new law seems certain to generate litigation, and the franchise community as a whole will be closely watching for court decisions interpreting the newly revised CFRA. We will have to wait for such decisional case law to learn what constitutes "substantial" compliance by a franchisee in a termination context.

Moving forward, franchisors should be especially cautious in terminating or refusing to renew their newer franchisees. Franchise companies should particularly be mindful of the repurchase requirements imposed by the newly added provision.

Finally, the Department of Business Oversight has not yet taken a position regarding whether California state-specific addenda to Franchise Disclosure Documents must be changed in light of the law. Franchisors should, however, consider reevaluating the disclosures they make in those documents to determine whether changes are necessary in view of the law, to avoid needless delays to their state registrations.

DEVELOPMENTS

Contracts

Contract Modifications

Fee owed under contract could be modified by parties' conduct, and arbitrator could enforce contract as modified despite contract provision that modifications be in writing.

Epic Med. Mgmt., LLC v Paquette (2015) 244 CA4th 504

Dr. Paquette contracted with Epic Medical Management, LLC to supply nonmedical management services to his practice. The contract provided that, for each month Epic provided services, Paquette would pay a fee equal to 120 percent of the costs Epic incurred in providing the service. The fees would not exceed 50 percent of Paquette's professional revenues plus 25 percent of his surgical revenues. The parties performed under the agreement for 3.5 years until Paquette terminated the contract in 2012. During that time, however, Epic never charged—and Paquette never paid—the fee based on 120 percent of Epic's costs. Instead, Epic charged a fee equal to 50 percent of office medical services, 25 percent of surgical services, and 75 percent of pharmaceutical expenses (the "50–25–75" method). After Paquette terminated the agreement, Epic sued for its share of revenues, under the 50–25–75 method, that were collected after the termination date, but were derived from services performed before that date. Paquette filed a cross-complaint, arguing that Epic breached the contract by failing to charge the 120-percent-of-costs fee set forth in the contract.

The matter proceeded to arbitration under an arbitration clause in the agreement. The arbitrator concluded that the parties' conduct had modified the agreement and that Epic was entitled to its remaining outstanding fees under the 50–25–75 method. The arbitrator also rejected Paquette's argument that, because some of the fees were paid for Epic's marketing services, the payments constituted an illegal kickback scheme for referred patients in violation of Bus & P C §650. It was undisputed that some of Epic's physician members referred patients to Paquette. However, the arbitrator ruled that the violation was "technical" in nature and did not impact the award. The trial court confirmed the award, and Paquette timely appealed.

The Second District Court of Appeal affirmed, holding that the arbitrator did not exceed her powers by finding that the parties modified the agreement and that the award did not violate Bus & P C §650. Although parties may limit the arbitrator's authority to find facts, interpret the contract, or award certain relief, there was no such limitation in the arbitration provision here. Indeed, language in the contract providing that any modification must be in writing did not preclude the arbitrator from considering the parties' conduct;