Strange Weather: California's Amended Franchise Relations Act, AB 525

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I. Introduction

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In 2015, California's Assembly Majority Leader Chris Holden introduced California Assembly Bill (AB) 525 to offer greater protection to franchise owners from franchisors that may seek to unjustly terminate a franchised business without fairly compensating the franchisee. Naturally, there are differing opinions between those representing franchisees and those representing franchisors about the need for this amendment to California's laws and the stated reasoning behind it. This article presents an initial analysis of AB 525 through a review of the background and intent behind AB 525, reference to similar laws in other states, and opinion about the changes from two attorneys from their respective standpoints of representing the franchisor and the franchisee viewpoints. In this point/counter-point format, the authors analyze four of the main elements of the new law:

1) revisions to California Business & Professions Code Section 20020, which limits termination for good cause after an opportunity to cure to a franchisee's failure to "substantially comply with lawful requirements of the franchise agreement"[1];

2) the addition of Section 20028, which makes it unlawful to prevent a franchisee from selling or transferring a franchise (or substantially all of its assets) if the transferee is qualified under the franchisor's standards for new/renewing franchisees;

1. All citations to the former and revised sections affected by AB 525 are from the California Business & Professions Code.

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3) the addition of Section 20022, which requires the franchisor on lawful termination or non-renewal to purchase the franchisee's inventory, supplies, equipment, and fixtures purchased under the franchise agreement for the value of price paid, minus depreciation, and

4) revisions to Section 20035, which entitles the franchisee, upon unlawful termination or non-renewal, to the fair market value of the franchised business and its assets as well as other damages.

While the bill is broader than these four points, these are essential elements and are a good starting point for understanding what the law is (and is not). This law was not without controversy, evidenced by the seven different versions of the bill proposed before the eighth and final version was approved, as well as by strong sentiments from the proponents of the bill. "Franchise corporations should not be able to use their dominance to rob franchisees of their livelihood,"[2] Majority Leader Chris Holden of the California Assembly said. "They should not be able to destroy someone's future by hiding behind an unjust contract and weak state laws."[3] The authors anticipate and agree that the new law will eventually be litigated, analyzed, interpreted by California courts, and likely amended further.

II. Section 20020 and the Good Cause for Termination Standard

Prior to AB 525, Section 20020 already prohibited a franchisor from prematurely terminating a franchisee unless: (1) the franchisor had good cause or (2) another statute in California's Franchise Relations Act otherwise permitted termination.[4] This previous version of Section 20020 defined good cause as including, but not limited to, "the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure."

Like the old Section 20020, the new Section 20020 prohibits a franchisor from prematurely terminating a franchisee unless: (1) the franchisor has good cause or (2) another statute in California's Franchise Relations Act otherwise permits termination.[5] However, the newly enacted version of Section 20020 defines good cause as follows:

> Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Except as provided in Section 20021, *good cause shall be limited to the failure of the franchisee to substantially comply* with the lawful requirements imposed upon the franchisee by the fran-

2. Don Sniegowski, *California's Governor Jerry Brown Signs Strongest Franchise Protection Rules in the U.S.*, Blue Mau Mau (Oct. 12, 2015), http://www.bluemaumau.org/14726/california%E2%80%99s_governor_brown_signs_strongest_ franchisee_protection_rules_us (last visited Feb. 22, 2016).
3. *Id.*
4. Cal. Bus. & Prof. Code § 20020 (West 2008).
5. Cal. Bus. & Prof. Code § 20020 (West 2016).

> chise agreement after being given notice at least *60 days* in advance of the termination and a reasonable opportunity, which in no event shall be less than 60 days from the date of the notice of noncompliance, to cure the failure. The period to exercise the right to cure shall not exceed 75 days unless there is a separate agreement between the franchisor and franchisee to extend the time.[6]

By amending Section 20020, AB 525 changed both the wording of the definition of good cause for termination and the required notice and cure period.[7]

A. *Good Cause Is Now Limited to Substantial Non-Compliance*

Under the former version of § 20020, good cause included, *but was not limited to*, a franchisee's "failure to comply" with *any* lawful requirement of the franchise agreement after notice and opportunity to cure.[8] AB 525 amended Section 20020 so that good cause *is limited to* a franchisee's "failure to substantially comply with" lawful requirements of the franchise agreement.

B. *Increased Notice and Cure Periods*

Under the former Section 20020, a franchisor seeking to terminate a franchisee for good cause had to give the franchisee notice of its failure and a "reasonable opportunity" to cure the deficiency of no more than thirty days.[9] AB 525 amended Section 20020's notice and cure requirements by doubling the required notice and cure period to at least sixty days.[10]

C. *Stated Reasoning Behind Section 20020*

Proponents of the bill pointed to portions of California's contract law to support this amendment: "California courts have been interpreting substantial performance of contracts dating back to at least the early 1900s."[11] Propo-

6. CAL. BUS. & PROF. CODE § 20020 (West 2016) (emphasis added).

7. The differences between the prior law and the revised § 20020 can also be seen in blackline:

> Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause.~~ Good cause shall include, but not be limited to,~~ *Except as provided in Section 20021, good cause shall be limited to* the failure of the franchisee to *substantially* comply with ~~any lawful requirement of the~~ *the lawful requirements imposed upon the franchisee by the* franchise agreement after being given notice~~ thereof~~ *at least 60 days in advance of the termination* and a reasonable opportunity, which in no event ~~need~~ *shall* be ~~more than 30 days,~~ *less than 60 days from the date of the notice of noncompliance*, to cure the failure. *The period to exercise the right to cure shall not exceed 75 days unless there is a separate agreement between the franchisor and franchisee to extend the time.*

CAL. BUS. & PROF. CODE § 20020 (West 2008), compared to CAL. BUS. & PROF. CODE § 20020 (West 2016).

8. CAL. BUS. & PROF. CODE § 20020 (West 2008). It is notable that the revisions in AB 525 are not retroactive, they apply only to "franchise agreements entered into or renewed on or after January 1, 2016, or to franchises of an infinite duration that may be terminated by the franchisee or franchisor without cause." CAL. BUS. & PROF. CODE § 20041(b) (West 2016).

9. CAL. BUS. & PROF. CODE § 20020 (West 2008).

10. CAL. BUS. & PROF. CODE § 20020 (West 2016).

11. *See*, *e.g.*, Thomas Haverty Co. v. Jones, 197 P. 105 (Cal. 1921) (holding that substantial performance was achieved when the non-breaching party still "is enjoying the fruits of the . . . work in performance of the contract").

nents also noted that current California jury instructions provide for a simple two-part test to determine the existence of substantial performance. First, the breaching party must show it "made a good faith effort to comply with the contract," and second, "[the non-breaching party] received essentially what the contract called for because . . . failures, if any, were so trivial that they could have been easily fixed or paid for."[12]

D. *Similar Statutes in Other States*

The phrasing "failure to substantially comply" has been used as a definition of "good cause" for termination of franchise agreements in states other than California. The authors reviewed some of these laws for guidance about how the phrase "failure to substantially comply" has been further detailed in practice.

1. New Jersey

New Jersey § 56:10-5 prohibits a franchisor from terminating, canceling, or failing to renew a franchise absent good cause.[13] "For the purposes of this act, good cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise."[14] New Jersey courts have held that "'substantial compliance' is surely something less than absolute adherence to every nuanced term of an agreement, but substantial compliance—at a minimum—requires that the franchisee refrain from acting in direct defiance of a term of the Agreement."[15] For example, courts have held that a franchisee was not in substantial compliance with the terms of the franchise agreement when it operated a franchise of another automobile manufacturer without the prior consent of the franchisor,[16] violated federal gas pricing regulations by overcharging its customers,[17] underreported sales to the franchisor in order to avoid paying fees and taxes,[18] and failed to build a showroom as the franchise agreement required.[19]

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12. California Civil Jury Instructions No. 312. *See also Franchise Relations: Renewal and Termination: Hearing on A.B. 525 Before the Assembly Committee on Judiciary*, 2015–16 Reg. Sess. 4–5 (Cal. Apr. 21, 2015) [hereinafter *Assembly Judiciary Comm. Hearing*].

13. N.J. STAT. ANN. § 56:10-5.

14. *Id.*

15. Gen. Motors Corp. v. New A.C. Chevrolet, Inc., 91 F. Supp. 2d 733, 740 (D.N.J. 2000). The sponsor of AB 525 cited to this case and quote to demonstrate the intended definition of "substantial compliance." Letter from Chris R. Holden, California Assembly Majority Floor Leader, to E. Dotson Wilson, California State Assembly Chief Clerk (2015) (on file with the California State Assembly, First Policy Committee File) [hereinafter Holden letter].

16. *Id.*

17. Amerada Hess Corp. v. Quinn, 362 A.2d 1258, 1267–68 (N.J. Super. Ct. Law Div. 1976).

18. Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 72–73 (N.J. 1985); *see also* Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc., 834 F. Supp. 683 (D.N.J. 1993).

19. Maple Shade Motor Corp. v. Kia Motors of Am., Inc., 384 F. Supp. 2d 770, 775 (D.N.J. 2005), *aff'd sub nom.*, 260 F. App'x 517 (3d Cir. 2008).

2. Minnesota

Minnesota's Franchise Act allows a franchisor to terminate a franchisee for good cause.[20] Good cause is defined as "failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor. . . ."[21] Minnesota statute Section 80C.14(3)(b) provides five examples of situations in which a franchisor would have good cause to terminate, much like the situations provided for in California Business and Professions Code Section 20021 that allow for termination without an opportunity to cure.[22] One Minnesota appellate court, examining Section 80C.14(3)(b), held that the trial court did not err in determining that good cause to terminate existed under the Minnesota Franchise Act after the distributor failed to make payment without explanation multiple times, despite the manufacturer's demand for payment.[23]

E. *Franchisor's Point of View About Section 20020*

One of the most eye-catching changes to California's Franchise Relationship Act was altering the wording of the definition of "good cause" as "be[ing] limited to the failure of the franchise to substantially comply with the lawful requirements imposed upon the franchisee by the franchise agreement. . . ."[24]

1. More Limited Good Cause

At the outset, franchisors should note that good cause for termination after the opportunity to cure under the new Section 20020 is *limited* to the failure to substantially comply with the franchise agreement.[25] The limitation of good cause to only breaches of the franchise agreement in Section 20020 is notable because it may provide limitations on the termination for business reasons.[26] While this is a significant change, the "substantial

20. Minn. Stat. § 80C.14, subd. 3(b)(2013).

21. *Id.*

22. Minn. Stat. § 80C.14, subd. 3(b)(1-5)(2013). Minnesota's Franchise Act allows termination for good cause, which includes, but is not limited to,

> (1) the bankruptcy or insolvency of the franchisee; (2) assignment for the benefit of creditors or similar disposition of the assets of the franchise business; (3) voluntary abandonment of the franchise business; (4) conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; or (5) any act by or conduct of the franchisee which materially impairs the good will associated with the franchisor's trademark, trade name, service mark, logotype or other commercial symbol.

23. OT Indus., Inc. v. OT-tehdas Oy Santasalo-Sohlberg Ab, 346 N.W.2d 162, 165 167 (Minn. Ct. App. 1984). While this case provides helpful background for the use of a "substantial compliance" standard, it is worth noting that, in California, one could avoid the good cause/ substantial compliance analysis under similar circumstances. The franchisor would not need to resort to § 20020 because it could terminate the non-paying franchisee under § 20021(j) for failure to pay "any amounts due to the franchisor or its affiliate within five days after receiving written notice that such fees are overdue."

24. Cal. Bus. & Prof. Code § 20020 (West 2016).

25. Cal. Bus. & Prof. Code § 20020.

26. *But see* Cal. Bus. & Prof. Code § 20021 (West 2016).

noncompliance" language may not be as big of a change and may even end up being a distinction without a difference.

2. Meaning of Substantial Compliance

Section 20020 does not define what it means to fail to substantially comply with the franchise agreement. Some of the items the proponents cited in the legislative history do not clearly lead to a definition and should be viewed with a critical eye. From a franchisor perspective, it is reasonable to assert that "the failure of franchisee to substantially comply" can include the legal principle of "material breach," even if it may not be limited to that standard.

As mentioned above, in the legislative history for Section 20020, the proponents pointed to CACI 312 (a California form of jury instruction), among other things, as showing that "substantial compliance" has been part of California's body of contract law of substantial performance.[27] Although CACI 312 indeed exists, it relates to defense—it is not an instruction for a direct claim for relief or an instruction for breach of contract. CACI 312 applies often in a construction contract situation, where the *defendant* on a breach of contract claim asserts that the *plaintiff* did not perform its obligations, and the plaintiff must show a good faith effort to comply with the contract and that the defendant "received essentially what the contract called for because [plaintiff's] failures, if any, were so trivial or unimportant that they could have been easily fixed or paid for."[28]

The proponents of the law also cited *Thomas Haverty Co. v. Jones*[29] as an example of "substantial performance" to justify the "substantial compliance" standard.[30] But this case also provided guidance that appears to be specific to construction cases. The defendant owner alleged that the plaintiff building contractor's performance was defective and that he should not have to pay.[31] The California Supreme Court affirmed the judgment for the plaintiff

27. *Franchise Relations: Renewal and Termination: Hearing on A.B. 525 Before the Senate Judiciary Committee*, 2015–16 Reg. Sess. 13 (Cal. 2015) [hereinafter *Senate Judiciary Comm. Hearing*].

28. CACI 312 Substantial Performance

> [*Name of defendant*] contends that [*name of plaintiff*] did not perform all of the things that [he/she/it] was required to do under the contract, and therefore [*name of defendant*] did not have to perform [his/her/its] obligations under the contract. To overcome this contention, [*name of plaintiff*] must prove both of the following:
>
> 1. That [*name of plaintiff*] made a good faith effort to comply with the contract; and
> 2. That [*name of defendant*] received essentially what the contract called for because [*name of plaintiff*]'s failures, if any, were so trivial or unimportant that they could have been easily fixed or paid for.

Judicial Council of Cal., Civil Jury Instructions: CACI 312 (2016), http://www.courts.ca.gov/partners/documents/caci-2016-complete-edition.pdf.

29. 197 P. 105 (Cal. 1921).

30. *Senate Judiciary Comm. Hearing*, supra note 27.

31. *Thomas Haverty Co.*, 197 P. at 107.

contractor, utilizing the following construction law principle of substantial performance:

> It has now been greatly relaxed and it is settled, especially in the case of building contracts where the owner has taken possession of the building and is enjoying the fruits of the contractor's work in the performance of the contract, that if there has been a substantial performance thereof by the contractor in good faith, where the failure to make full performance can be compensated in damages to be deducted from the price or allowed as a counterclaim, and the omissions and deviations were not willful or fraudulent and do not substantially affect the usefulness of the building for the purposes for which it was intended, the contractor may, in an action upon the contract, recover the amount unpaid of his contract price, less the amount allowed as damages for the failure in strict performance.[32]

This is not particularly illuminating in the context of a franchise termination where the franchisee generally will not pay for the failures or a cure would have already occurred.

The bill's sponsor stated, "At no time has Assembly Bill 525's 'substantial compliance' standard been intended to require a provision-by-provision analysis of a franchisee's compliance with the contract. 'Substantial compliance' has always been intended to require an analysis of the franchisee's compliance with the franchise agreement as a whole."[33]

This sounds somewhat like a finding of material breach—which is the standard in California when terminating a contract because of a breach: "The important question, however, is whether a particular breach will also give the injured party the right to refuse further performance on his or her own party, i.e., to *terminate the contract*. The test is whether the breach is material . . ."[34]

> Whether a breach of contract is total or partial depends upon its materiality. (Rest., Contracts, s 317, p. 471) In determining the materiality of a failure to fully perform a promise the following factors are to be considered: (1) the extent to which the injured party will obtain the substantial benefit which he could have reasonably anticipated; (2) the extent to which the injured party may be adequately compensated in damages for lack of complete performance; (3) the extent to which the party failing to perform has already partly performed or made preparations for performance; (4) the greater or less hardship on the party failing to perform in terminating the contract; (5) the willful, negligent, or innocent behavior of the party failing to perform; and (6) the greater or less uncertainty that the party failing to perform will perform the remainder of the contract. (Rest., Contracts, s 275, pp. 402–03).[35]

A franchisor looking for clarity on the meaning of "failure to substantially comply" may also look to New Jersey and Connecticut for examples. In *General Motors Corp. v. New A.C. Chevrolet, Inc.*, the court noted that the parties agreed that "substantial compliance" is simply the absence of a material

32. *Id.* (emphasis added).
33. Holden Letter, *supra* note 15.
34. Witkin, *Summary of California Law*, CONTRACTS § 852 (10th ed. 2005).
35. Sackett v. Spindler, 248 Cal. App. 2d 220, 229 (1967).

breach of contract.[36] In an earlier portion of the same case, the court held that "'substantial compliance' is surely something less than absolute adherence to every nuanced term of an agreement, but substantial compliance—at a minimum—requires that the franchisee refrain from acting in direct defiance of a term of the Agreement. This is especially true when, as here, the franchisee has received specific notice from the franchisor that its behavior is a violation of the agreement."[37] Indeed, the proponents of AB 525 cited this very opinion and quote to state that the "substantial compliance language as applied in California is intended to follow the New Jersey court's interpretation of 'substantial compliance. . . .'"[38]

Connecticut's courts have addressed the meaning of "failure to comply substantially with any material and reasonable obligation of the franchise agreement" and have found it to "leave[] no doubt that good cause exists when the franchisee materially breaches the agreement."[39]

Under this revised section, it is likely that franchisors will continue to be able to terminate franchise agreements at least when franchisees directly defy provisions of the franchise agreements or are in material breach of the contracts. And, as noted in the franchisee section below, the California legislature has provided that franchise agreements may be terminated for other specific items listed in Section 20021 without an opportunity to cure.

F. *Franchisee's Point of View About Section 20020*

Franchisees should appreciate the hard work of proponents of AB 525, whose stated purpose was to protect franchisees and to expand the rights of franchisees in relation to termination and nonrenewal by the franchisor. The prior version of Section 20020 allowed franchisors to prematurely terminate a franchise for "good cause." Previously Section 20025 allowed franchisors to refuse to renew a franchise simply by providing 180 days' written notice.[40] Franchisees were faced with acting quickly and spending significant funds, to the extent they could do so, to prosecute injunction actions to save their businesses and preserve their goodwill. Those provisions, contrary to their intent, permitted some unscrupulous franchisors to take advantage of franchisees and use immaterial or typically waived provisions of the franchise agreement to steal franchisees' businesses. A franchisor could terminate a

36. 263 F.3d 296, 317 n.8 (3d Cir. 2001).

37. Gen. Motors Corp. v. New A.C. Chevrolet, Inc., 91 F. Supp. 2d 733, 740 (D.N.J. 2000).

38. Holden Letter, *supra* note 15.

39. Petereit v. S.B. Thomas, Inc., 63 F.3d 1169, 1184–85 (2d Cir. 1995) (holding that "good cause" for termination is not limited to a franchisee's non-performance, but included the franchisor's business goal of increasing sales). *See* CONN. GEN. STAT. § 42-133f(a) ("No franchisor shall, directly, or through any officer, agent or employee, terminate, cancel or fail to renew a franchise, except for good cause which shall include, *but not be limited*, to the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement or for the reasons stated in subsection (e) of this section.") (emphasis added).

40. CAL. BUS. & PROF. CODE § 20025 (West 2008).

franchisee, take over the franchised business itself or sell a franchise to a new franchisee, and place the new franchisee in the terminated franchisee's location, allowing the new franchisee to benefit from the local goodwill developed by the terminated franchisee, receive royalties on the former franchisee's business, and then go to court and seek lost profit damages from the terminated franchisee.[41]

AB 525 makes it more difficult for franchisors to terminate franchisees without a just cause and provides greatly improved remedies for violations of the law, which should deter franchisors from taking unfair advantage of franchisees. The revised act also allows more time to cure (sixty days) than some franchise agreements presently permit and allows termination only for failure to substantially comply with the franchise agreement and failure to cure the breach. This should prohibit franchisors from terminating any franchisee that is in substantial compliance with the franchise agreement. That standard should be much narrower than one based broadly on a franchisee's failure to comply with any requirement of the franchise agreement. Many large franchisors have a working definition of substantial compliance in their system already and those franchisors and their franchisees should already have a common understanding of the franchisor's expectations and the conditions under which termination is proper under the statute.

However, the new Sections 20020 and 20021 may have the unintended effect of encouraging franchisors to utilize Section 20021 and any possible argument thereunder to immediately terminate a franchisee without providing an opportunity to cure. That will leave franchisees in the same position as they were prior to the revisions to the California Franchise Relations Act (CFRA); they will have to scramble to scrape together a retainer and hire counsel to seek injunctive relief. Section 20021 was left largely unchanged by AB 525. On its face, Section 20021 expands the definition of good cause and provides a litany of specific situations in which a franchisor can immediately terminate a franchisee with no notice or opportunity to cure. Although Section 20020 limits good cause as a franchisee's substantial failure to comply with the franchise agreement, Section 20020 also incorporates Section 20021 as providing circumstances that constitute good cause for immediate termination. Section 20021 provides twelve circumstances that qual-

41. Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, at n.9 (1996). In *Postal Instant Press*, the plaintiff franchisor declared overdue payments for past royalties a material breach and sent the defendant franchisee a termination letter in 1992. The franchisor then brought action for breach of franchise agreement and the Superior Court of Los Angeles County entered judgment, including damages for lost future profits, for the franchisor. The franchisee appealed and the California Court of Appeal held that the franchisee's failure to make past royalty payments was not the proximate cause of the franchisor's failure to receive future royalty payments and even if it were, an award of future lost profits as damages for the franchisee's breach would be unreasonable, unconscionable, and oppressive. The Court of Appeal reversed the judgment insofar as it awarded estimated future lost profits and remanded. Rehearing and review were denied in 1996.

ify as good cause and allows the franchisor to terminate a franchisee immediately upon notice and without an opportunity to cure.[42]

Good cause, the prior standard, was loosely defined in Section 20020 of the CFRA, which provided that "good cause shall include, but not be limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement" after notice and the applicable cure period. In addition, prior Section 20021 specified various grounds under which immediate notice of termination without an opportunity to cure was per se reasonable. It still does.

Although Section 20021 was on the books prior to AB 525 and routinely relied upon by franchise counsel, Section 20020 did not expressly incorporate the section. Despite the eight versions of AB 525 prior to its adoption, and the fact that the revised and adopted Section 20020 specifically mentions the provisions of Section 20021, the two sections still do not incorporate the same standards. Now, except as provided by Section 20021, good cause is limited to a franchisee's failure to *substantially* comply with lawful requirements imposed on the franchisee by the franchise agreement after being given the statutory notice and opportunity to cure. The new reference in Section 20020 to Section 20021 may cause confusion because Section 20020 requires that a franchisee's failure be substantial to constitute good cause, but Section 20021 does not require a substantial failure, or indicate that the delineated failures are "substantial," but allows immediate termination.

The new law also added a right for the franchisor to terminate without notice or an opportunity to cure if there is a lawful termination or nonrenewal of a *separate* motor fuel franchise that is operated by the franchisee or an affiliate of the franchisee located at the same business premises if both franchises are granted by the same franchisor or an affiliate of the franchisor.[43] This new provision, and specifically the use of the word "separate," may be the California legislature's answer to the successful argument of the franchisee in *Aurigemma v. Arco Petroleum Products Co.*[44] In that case, a federal district court held that, under the Connecticut Franchise Act, a franchisor's unilateral decision to withdraw from marketing of petroleum in

42. The circumstances include a franchisee: (i) filing for bankruptcy or admitting inability to pay debts; (ii) failing to operate the franchise for five days; (iii) agreeing in writing to terminate the franchise; (iv) making material misrepresentations to acquire the franchise; (v) failing to comply with federal, state, or local laws and regulations after ten days of notice; (vi) engaging in the same noncompliant behavior after previously curing that behavior; (vii) repeatedly failing to comply with one or more franchise requirements; (viii) being convicted of a felony or criminal misconduct relevant to the franchise; and (ix) failing to pay overdue franchise fees or other amounts within five days of receiving notice. Additional grounds include: (x) if the franchise or its premises are seized by the government or foreclosed by a creditor, (xi) the franchisor makes a reasonable determination that continuing to operate the franchise will result in imminent danger to public health or safety, and (xii) if the franchise is a motor fuel franchise and permits termination under the Petroleum Marketing Practices Act. Cal. Bus. & Prof. Code § 20021 (West 2016).

43. Cal. Bus. & Prof. Code § 20021(l) (West 2016).

44. 698 F. Supp. 1035, 1042 (D. Conn. 1988).

Connecticut did not constitute "good cause" for terminating franchises for the operation of convenience stores associated with gasoline stations.

Worse than that limitation on franchisee rights, Section 20021(f) arguably makes "substantial compliance" with "lawful requirements" irrelevant. Section 20021 expressly states that immediate notice without the opportunity to cure is reasonable if the franchisee repeatedly fails to comply with one or more requirements of the franchise, whether or not corrected after notice. The "requirements" of Section 20021(f), on their face, need not be "lawful" and the failure to comply need not be "substantial," merely repeated after notice. It seems likely that franchisors will rely, at least in the alternative, on Section 20021 when terminating a franchisee. If that occurs, California courts may avoid interpreting or analyzing Section 20020, at least in some cases.

Section 20021(j) also permits termination without the newly enacted sixty-day cure period if the franchisee fails to pay any franchise fees or other amounts due to the franchisor or its affiliate within five days after receiving written notice that such fees are overdue. The amount of the fees or sums due need not be substantial for a franchisor to rely on Section 20021(j). Thus, Section 20021(j) may be another alternative avenue for termination without consideration of the new Section 20020. Undoubtedly, creative franchisors and franchisor counsel will find additional ways to rely on Section 20021. This could lead to increased litigation as franchisees faced with immediate termination without an opportunity to cure will be left with few avenues to pursue other than to seek injunctive relief.

Proponents of AB 525 sought to protect franchisees' investments in their franchises from being taken without compensation. The authors of the bill believed that the previous Business and Professions Code Section 20020 allowed "some franchisors to unfairly take advantage of franchisees by using the contract to punish franchisees by taking their business away and to avoid their legal obligations to give franchisees another chance." "Accordingly," they wrote a bill to "allow termination of franchise agreement for good cause only upon the failure of the franchisee to substantially comply with any lawful requirement of the franchise agreement, and give the franchisee advance notice and an opportunity of at least 60 days to cure the breach."[45] In addition, they wrote the bill to prohibit a franchisor from failing to renew a franchise unless the franchisee failed to substantially comply with the franchise agreement. According to the bill's authors, this provision, new Section 20020, ensures fairness to franchisees. But, without corresponding changes to Section 20021, it is unclear whether the authors' intentions will be met.

45. *Assembly Judiciary Comm. Hearing*, *supra* note 12.

III. Section 20028 and the Ability to Transfer Franchises

Prior to the enactment of AB 525, California law protected franchisees' ability to transfer their franchises to family members upon death.[46] AB 525 expanded living franchisees' ability to sell and transfer their franchises to anyone through the enactment of new Section 20028, which states:

> (a) It is unlawful for a franchisor to prevent a franchisee from selling or transferring a franchise, all or substantially all of the assets of the franchise business, or a controlling or noncontrolling interest in the franchise business, to another person provided that the person is qualified under the franchisor's then-existing standards for the approval of new or renewing franchisees, these standards to be made available to the franchisee, as provided in Section 20029, and to be consistently applied to similarly situated franchisees operating within the franchise brand, and the franchisee and the buyer, transferee, or assignee comply with the transfer conditions specified in the franchise agreement.[47]

To ensure franchisors are given notice, Section 20028(b) states that franchisees do not have the right to sell, transfer, or assign their franchises, franchise assets, or their franchise interest without written consent of the franchisor, which the franchisor cannot withhold unless the potential new owner does not meet standards referenced in Section 20028(a) or does not comply with transfer conditions put forth in the franchise agreement.[48] Section 20028(c) clarifies that this section does not bar a franchisor's contractual right of first refusal to buy the franchise or part of it.[49]

It is notable that the original proposed version of Section 20028 prohibited a franchisor from *unreasonably* withholding consent to a proposed transfer.[50] The revised statute, as adopted, does not include a reasonableness limitation and provides only that consent must not be withheld unless the transferee does not meet the standards for new or renewing franchisees or the franchisee and the transferee do not comply with transfer conditions specified in the franchise agreement.

A. *Intent Behind Section 20028*

The intent behind the new Section 20028, and its related Section 20029 regarding the timeline and process for sale, was to help small business owners pass their business on to family members and sell their franchises as a

46. Cal. Bus. & Prof. Code § 20027 (West 2016). Under Section 20027 of California's Business and Professions Code, a franchisor cannot not deny a surviving spouse, heir, or estate of a deceased franchisee or majority holder in a franchise from participating in the franchise for a "reasonable" amount of time after the franchisee's or majority franchise holder's death. If the estate fails to meet the current qualifications for a purchaser of the franchise, the estate can "sell, transfer, or assign the franchise to a person who satisfies the franchisor's then current standards for new franchisees." *Id.*

47. Cal. Bus. & Prof. Code § 20029 (West 2016).

48. Cal. Bus. & Prof. Code § 20028(b) (West 2016).

49. Cal. Bus. & Prof. Code § 20028(c) (West 2016).

50. A.B. 525, 2015–16 Leg., Reg. Sess. (as amended in the Assembly, Apr. 6, 2015).

source of retirement income.[51] The bill's sponsor stated "[t]he 'similarly situated franchise' standard requires franchisors to treat a franchisee's proposed transfer similarly to those proposed by other franchisees with comparable business volume, size and locations."[52]

B. *Similar Statutes in Other States*

Other states have limited a franchisor's ability to refuse a transfer of a franchise to situations where the transferee fails to meet the franchisor's standards. For example, the Michigan Franchise Investment Law voids any provision in a franchise document that "permits a franchisor to refuse to permit a transfer of ownership of a franchise, except for good cause."[53] Good cause includes, among other things, a proposed transferee's failure to meet the franchisor's then existing, reasonable standards.[54] But this law was limited in its effect for franchisees when a Michigan court found that liability for a violation of this section was limited to persons seeking to purchase franchises—the sellers did not have a private right of action under this act.[55]

C. *Franchisor's Point of View About Section 20028*

Franchisors will note that the newly added Section 20028 limits their ability to refuse any transfer of a franchise, the assets of a franchise, or any interest (controlling *or* non-controlling) if the transferee "is qualified under the franchisor's then existing standards for the approval of new or renewing franchisees . . . ."[56] It is notable that Section 20028 applies to essentially any interest in a franchised business—not just a controlling interest. This breadth could actually allow for *more* franchisor control over the transfer process since it could be interpreted as approving a franchisor's refusal of a transfer of even a very small interest in a franchisee when that transferee does not meet the standards for approval of a new or renewing franchisee.

Because the existence of standards appears to be the main reason a franchisor could refuse a transfer of any portion of the franchise (unless it utilizes a right of first refusal, see Section 20028(c)), it is likely that this section will

51. The bill's author asserted that "the new standards and processes for transfers will reduce litigation by providing a clear, step-by-step procedure for the approval or denials of a transfer. . . . AB 525 requires the franchisor to clearly state the grounds for denying transfer, which so long as they are equally applied to other similarly situated franchisees, precludes the franchisee from objecting to the denial." The bill was supposed to "establish a streamlined process and timeline for the sale or transfer of a franchise without decreasing the advance notice period of 180 days that franchisees must provide to the franchisor. The bill requires the franchisor to approve the sale or transfer request without unreasonably withholding consent." *Senate Judiciary Comm. Hearing*, supra note 27.

52. Holden Letter, *supra* note 15.

53. MICH. COMP. LAWS ANN. § 445.1527(g).

54. MICH. COMP. LAWS ANN. § 445.1527(g)(i); see also MINN. STAT. ANN. § 80C.14(5) ("[i]t is unfair and inequitable for a person to unreasonably withhold consent to an assignment, transfer, or sale of the franchise whenever the franchisee to be substituted meets the present qualifications and standards required of the franchisees of the particular franchisor.").

55. Drery v. Marathon Oil Corp., No. 200674, 1998 WL 1989877, at *8 (Mich. Ct. App. Sept. 25, 1998).

56. CAL. BUS. & PROF. CODE § 20028 (West 2016).

cause franchisors to issue more and detailed standards for what is required to be a franchisee in the system or any part of a franchisee in the system. One can envision comprehensive requirements, such as minimum net worth, minimum cash on hand, credit history, education, and business experience. This greater degree of certainty will hopefully help reduce litigation.

Section 20028 also calls for the standards "to be consistently applied to similarly situated franchisees operating within the franchise brand." This requirement could cut both ways in terms of being a benefit or a negative for franchisors and franchisees. Although it calls for uniform treatment, it could be argued that this requirement limits the franchisor's ability to make reasonable exceptions or leeway in standards for unique circumstances. A rejoinder to this is that special circumstances are just that—special and outside the standards because the transferee may not be "similarly situated"—and thus are not impacted by the consistently applicable standard. Moreover, because the sponsor intended for the consistency to relate to the business volume, size, and location, the franchisor may have more leeway in dealing with unique situations.[57] In any case, this standard is another of the items that could lead to litigation.

D. *Franchisee's Point of View About Section 20028*

This section recognizes that franchisees build valuable relationships and equity in their franchise businesses and develop personal and local goodwill, apart from the corporate goodwill that may be associated with the franchisor's trademarks and system. These new provisions may also make succession planning easier for franchisees and their families because franchisees now may be more confident that their heirs can take over their franchise business.

On the other hand, the sections contain ambiguities and do not reduce the likelihood that a franchisee will have to litigate a franchisor's unreasonable decision not to permit a transfer. The new law also does not change the reality that it may be difficult to keep up with, and to understand, the franchisor's then current standards. And, unfortunately for franchisees, there is no remedy prescribed for the event when the franchisor wrongfully refuses to permit a transfer. So the legislation does not deter franchisors from being unreasonable or compel them to be even-handed.

Despite the issues that may arise related to the enacted Sections 20028 and 20029, one intended benefit of the law will likely triumph. Sections 20028 and 20029 should make reasonable succession planning and inheritance by spouses and children of franchisees easier. The new transfer provision of the CFRA contains a self-explanatory procedure to make it easier for franchisees to pass their businesses on to family members. The procedure provides some certainty for franchisees and franchisors. Prior California law did prohibit a franchisor from denying the surviving spouse, heirs, or estate of a deceased franchisee or the majority shareholder of the franchisee the

57. Holden Letter, *supra* note 15.

opportunity to own the franchise for a reasonable time after the death of the franchisee or the majority shareholder of the franchisee.[58] The surviving person had to satisfy the franchisor's then current standards for new franchisees and maintain all standards and obligations of the franchise. This did not prohibit the franchisor from exercising its right of first refusal to purchase a franchise after receiving a bona fide offer to purchase the franchise by a proposed purchaser of the franchise.[59]

Of course, just as they did prior to AB 525, franchisors and franchisees will have different opinions about whether franchisors' decisions not to renew are "reasonable." Franchise transfer law in California was fairly well developed through the judicial system. There is uncertainty as to the effect of those decisions now. For example, since 2008 franchisors have known that a requirement that prospective transferees pass an English Language Proficiency Assessment was enforceable.[60] Franchisees may attempt another bite at that apple under the new sections.

IV. Section 20022 and Repurchase Rights Upon Lawful Termination and Non-Renewal

Section 20022 requires franchisors to purchase from franchisees numerous supplies and equipment upon *lawfully* terminating or declining to renew the franchise contract. Specifically, Section 20022(a) states:

> Except as provided in this section, upon a lawful termination or nonrenewal of a franchisee, the franchisor shall purchase from the franchisee, at the value of price paid, minus depreciation, all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources, that are, at the time of the notice of termination or nonrenewal, in the possession of the franchisee or used by the franchisee in the franchise business. The franchisor shall have the right to receive clear title to and possession of all items purchased from the franchisee under this section.[61]

Section 20022 then puts forth six exceptions detailing certain items a franchisor need not purchase or certain situations in which a franchisor need not purchase any items from the franchisee upon termination or non-renewal.[62] These include: (1) a franchisor need not purchase "any personalized items, inventory, supplies, equipment, fixtures, or furnishings not reasonably required to conduct the operation of the franchise business in accordance with the franchise agreement or any ancillary or collateral agreement," or items to which the franchisee cannot grant the franchisor clear title;[63] (2) the franchisor need not purchase any items from the franchisee if the

58. Cal. Bus. & Prof. Code § 20027 (West 2008).
59. *Id.*
60. DeWalshe v. Togo's Eateries, Inc., 567 F. Supp. 2d 1198, 1203 (C.D. Cal. 2008).
61. Cal. Bus. & Prof. Code § 20022(a) (West 2016).
62. Cal. Bus. & Prof. Code § 20022(b–g).
63. Cal. Bus. & Prof. Code § 20022(b) (West 2016).

franchisee declines a "bona fide offer of renewal;"[64] (3) the franchisor need not purchase any items if the franchisor "does not prevent the franchisee from retaining control of the principal place of the franchise business;"[65] (4) the section does not apply if a franchisor decides to completely withdraw from franchise activity in the "relevant geographic market area" where the franchise is located, and the decision to withdraw is non-discriminatory and publicly announced;[66] (5) the section is inapplicable if the franchisor and franchisee agree in writing to terminate or not renew the franchise;[67] and (6) the section does not apply to any items the franchisee sells before stopping the operation of the franchise.[68] Additionally, the section's final subsection allows a franchisor to offset amounts owed to the franchisor against amounts owed to a franchisee under Section 20022.[69]

While Section 20022 begs certain questions like what constitutes a bona fide offer of renewal or what items are not reasonably required to conduct the franchise business, the final, enacted version of Section 20022 is infinitely clearer than its initial proposed version. AB 525's initial version of Section 20022 gave franchisees "the opportunity to monetize any equity the franchisee may have developed in the franchised business prior to the termination of the franchise agreement."[70] From first to final version, many noteworthy changes were made to Section 20022, which served to clarify its ambiguities, but also to increase franchisors' obligations and franchisees' benefits.

A. *Intent Behind Section 20022*

Through their addition of Section 20022, AB 525's proponents again sought to protect franchisees and their investments in their franchises. Proponents believed that under the existing law, monetary remedies available to franchisees upon dissolution of their franchises were inadequate.[71] While franchisees could recover the cost of existing resalable inventory upon terminations that violated the relationship law before AB 525,[72] proponents believed that franchisors were unjustly enriched because they could "essentially take all equity, personal capital, and goodwill a franchisee has developed upon franchise dissolution," leaving franchisees with little.[73]

Proponents specified that Section 20022's "narrow compensation requirements" apply only when a franchisor retains the franchise premises.[74] Proponents believed Section 20022 would help both franchisees and franchisors by

64. Cal. Bus. & Prof. Code § 20022(c).
65. Cal. Bus. & Prof. Code § 20022(d).
66. Cal. Bus. & Prof. Code § 20022(e).
67. Cal. Bus. & Prof. Code § 20022(f).
68. Cal. Bus. & Prof. Code § 20022(g).
69. Cal. Bus. & Prof. Code § 20022(h).
70. A.B. 525, 2015–16 Leg., Reg. Sess. (as amended in the Assembly, Apr. 6, 2015).
71. *Assembly Judiciary Comm. Hearing*, *supra* note 12.
72. Cal. Bus. & Prof. Code § 20035 (West 2012).
73. *Assembly Judiciary Comm. Hearing*, *supra* note 12.
74. *Senate Judiciary Comm. Hearing*, supra note 27.

"simply provid[ing] the franchisee compensation for goods they purchased that can now be used by the franchisor, or future franchisee, in running the business for a profit."[75]

B. *Similar Statutes in Other States*

Section 20022 was based on Connecticut and Washington franchise laws.[76] Under Section 19.100.180(2)(i) and (j) of Washington's Revised Code, respectively, a franchisor may not fail to renew or terminate a franchisee unless the franchisor compensates the franchisee for the fair market value of things like inventory and supplies, with some exceptions.[77] It is significant that a Washington court found that the reimbursement right was not equivalent to an automatic right to renewal and that franchises are terminable in accordance with their terms as long as the franchisor complies with reimbursement requirements.[78]

C. *Franchisor's Point of View About Section 20022*

There are many exceptions to Section 20022—so many that the new rule essentially applies when the franchise is "lawfully" terminated for the franchisees' breach of the franchise agreement (now called "substantial noncompliance"). The rule to pay the franchisee at the end of a franchise does not apply, for example, when "when the franchisee declines a bona fide offer of renewal from the franchisor" or when "the franchisor does not prevent the franchisee from retaining control of the principal place of the franchise business."[79] These various factual situations listed in the statute raise questions as to how it will actually be enforced and may lead to litigation.

1. No Buyback If the Franchisee Keeps the Location

Section 20022(d), which does not require buyback if the franchisee can retain control of the principal place of business, is equitable to the franchisee because there is no reason the franchisee needs to be compensated for items it purchased for the business if it can operate a business at the premises. But

75. *Id.*

76. "Section 20022 is based, in large part, on franchise law from Washington and Connecticut, which require the franchisor to reimburse the franchisee, upon termination under the terms of the franchise (WASH. REV. CODE § 19.100.180(i)-(j), CONN. GEN. STAT. § 42-133f(c))." Holden Letter, *supra* note 15. Connecticut's General Statutes § 42-133f(c) differs from Section 20022 in that the former only applies to termination and sets compensation price at a "fair and reasonable" amount, whereas the latter applies to termination and non-renewal and sets compensation price at price paid minus depreciation. While one Connecticut federal court described § 42-133f(c) as a remedy "protect[ing] a franchise from being stuck with useless inventory at termination," the authors found no cases meaningfully interpreting Section 42-133f(c). Chem-tek, Inc. v. Gen. Motors Corp., 816 F. Supp. 123, 128, 131 (D. Conn. 1993) (denying defendant-motor company's motion to dismiss and holding, in relevant part, that the court could not determine on the pleadings whether the plaintiff-company was a franchisee protected under the Connecticut Franchise Act).

77. WASH. REV. CODE ANN. § 19.100.180(2)(i) & (j).

78. Thompson v. Atl. Richfield Co., 649 F. Supp. 969, 973 (W.D. Wash. 1986).

79. CAL. BUS. & PROF. CODE § 20022 (c) & (d) (West 2016).

it is not entirely clear how the phrase "does not prevent the franchisee from retaining control" could play out in all circumstances.

2. No Buyback If the Franchisor Is Withdrawing from the Area

Section 20022(e), which does not require buyback if the franchisor is withdrawing from franchise activity in the area of the franchise, is another section left open as to its effect. It requires that the franchisor "publicly announce" its withdrawal from the region, but there is no statement as to what the announcement must be like or where it must be announced. Additionally, this requirement seems punitive and unnecessary to the application of the section. Hopefully, franchisors in this situation can fashion a public announcement that makes the withdrawal of the relevant area clear, but does not impact their business more widely than the geographic area at hand.

Even the statement that the franchisor must "completely withdraw" may require some focus. For example, imagine if the franchisor decides to wind down the system in a certain area by not renewing contracts as they legally expire. Although the franchisor would not be participating in franchise sales activity in that situation, the franchisor may be in some form of franchise activity in that it has other franchisees still existing in the area. Franchisor counsel may argue such a franchisor is not subject to the repurchase provision because it does not make sense to require a franchisor that is winding down a system in an area to buy materials back.

3. Items and Pricing of Buyback May Be Disputed

The language of Section 20022(a) is stated in broad terms that are not necessarily framed in the reality of how franchised businesses operate. It calls for the repurchase of "all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary agreement or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources. . . ." The statute does not detail what it means to purchase or pay for something under the terms of an agreement. If the agreement actually said, "franchisee must buy X," that is one thing, but many agreements are not structured to that level of detail and, with good reason, because operations may differ by location, and the franchisee may be in charge of deciding what items to buy for the business the franchisee operates.

The pricing structure of the repurchase—"value of price paid, minus depreciation"—may result in litigation. This section seems to assume the franchisee has proof or receipts, which is not necessarily reality. There is no provision for valuation where one does not know the value of the price paid. Accordingly, some valuation of the item (from the time of purchase) would likely need to be made by a qualified party, probably an accountant. This sounds much like a litigation exercise in damage analysis. Yet, there is no guidance in the statute as to who has the burden to prove the value or the depreciation—certainly each party will be pointing at the other.

The expansion of this section to not only items purchased under the franchise agreement, but also to items purchased under ancillary and collateral agreements with approved suppliers and sources could take this section to unreasonable places. One potential effect is that the franchisor may pare down amenities and suppliers, as well as equipment required for production, in order to better control its ultimate risk. This is not necessarily a win for franchisees because having approved suppliers and items can streamline the choices facing franchisee business owners. Nor is this a win for franchisors, or the ultimate customer, as it could cause less consistency in the brand and quality.

D. *Franchisee's Point of View About Section 20022*

Section 20022 is now the toughest franchisee protection law in the nation and probably the world. Previously, Section 20020 provided a meager remedy for wrongfully terminated franchisees.[80] The pendulum has swung. Section 20022 is likely to be the most frequently litigated section of the revised Act. So, while it favors franchisees in the sense that it protects from franchisor abuses, recognizes franchisees' equity in their businesses, and encourages continued investment in the franchised business, including upgrades even near the end-of-term, the cost of litigation will be high because the stakes are high and it is not clear how to value the cost of inventory, supplies, etc.

Franchisees should delight in the extraordinary remedy provided by Section 20022 and both franchisors and franchisees should recognize that the fairness in Section 20022 is in the legislature's nod to site control. If the former franchisee keeps the site and the entrenched local goodwill, the franchisor does not have a repurchase obligation. By enacting Section 20022, California has said that it will not allow the franchisor or its designee, often the fair-haired franchisee neighboring the terminated franchisee, to step in and commandeer the terminated franchisee's goodwill and continue running the store. Of course, franchisors can also set off amounts owed by the former franchisee, which seems fair in principle, but which may provide unscrupulous franchisors with a mechanism for abuse. The reality of Section 20022 is that it should compel franchisors and franchisees to negotiate, but with as much at stake as the statute puts on the line, the provision will likely be frequently litigated.

V. Section 20035 and Remedies for Unlawful Termination and Non-Renewal

In its former version, Section 20035 governed franchisees' rights after *lawful* termination or non-renewal,[81] which was amended and moved to Section 20022. Section 20035 was amended so that it now speaks to franchisees'

80. CAL. BUS. & PROF. CODE § 20035 (West 2008).
81. CAL. BUS. & PROF. CODE § 20035 (West 2008).

rights upon termination or non-renewal in violation of the Act.[82] According to the new Section 20035:

> (a) In the event a franchisor terminates or fails to renew a franchisee, in violation of this chapter, the franchisee shall be entitled to receive from the franchisor the fair market value of the franchised business and franchise assets and any other damages caused by the violation of this chapter.
>
> (b) A court may grant preliminary and permanent injunctions for a violation or threatened violation of this chapter.[83]

In its final form, Section 20035 varies from AB 525's initial, proposed version of Section 20035 in two important ways.

Whereas new Section 20035 provides compensation to a franchisee that is unlawfully terminated or not renewed, AB 525's initial, proposed version of Section 20035 also provided franchisees the option for reinstatement under the same terms as the existing franchise agreement plus resulting damages.[84] Under the enacted Section 20035, reinstatement is not an available, stated remedy. However, proponents of AB 525 believe that Section 20035 still provides specific relief for franchisees that wish to continue operating their franchises by allowing "unlawfully terminated franchisee[s] to seek an injunction to preserve the status quo in addition to seeking monetary relief."[85]

While the legislative history from the proponent of the bill suggests injunctions can be obtained to preserve the status quo, franchisors can argue (1) affirmative injunctions are disfavored in California; and (2) injunctions that force franchisors to do business with and entrust their brand to a person/franchisee that the franchisor may no longer trust are not the proper use of injunctive relief, especially when the statute itself says damages are available.

A. *Intent Behind Section 20035*

Upon unlawful termination or non-renewal, proponents sought to protect franchisees by providing them monetary compensation or their ability to continue operating their franchise businesses in the event of actual or threatened unlawful termination/non-renewal through specific relief.[86]

B. *Similar Statutes in Other States*

Similar to California Business and Professions Code Section 20035, Arkansas and Hawaii have adopted statutes requiring franchisors to pay fair market value for some number of franchise assets upon termination or non-renewal. Arguably the most similar to Section 20035, Arkansas Code Section 4-72-209 requires a franchisor that terminates a franchisee without

82. Cal. Bus. & Prof. Code § 20035 (West 2016).
83. *Id.*
84. A.B. 525, 2015–16 Leg., Reg. Sess. (as amended in the Assembly, Apr. 6, 2015).
85. Holden Letter, *supra* note 15.
86. *Id.*

good cause to repurchase, "at the franchisee's option," "the franchisee's inventory, supplies, equipment, and furnishings purchased by the franchisee from the franchisor or its approved sources" at a value of the franchisee's net cost minus reasonable depreciation.[87]

Hawaii Revised Statutes Section 437-58(g) requires an automobile franchisor that terminates or fails to renew a franchise without good cause to compensate the franchisee at fair market value for the franchisee's "capital investment, which shall include the going business value of the business, goodwill, property, and improvement owned or leased by the dealer for the purpose of the franchise."[88]

C. *Franchisor's Point of View About Section 20035*

Although it is clear that Section 20035 was implemented in order to give franchisees additional remedies for a wrongful termination of a franchise, it is not so clear how it is going to work in practice, except that it seems destined to lead to litigation.

First, the section calls for the franchisee "to receive from the franchisor the fair market value of the franchised business. . . ." Often "fair market value" of a business is determined via a battle of the experts in the course of litigation, and there is litigation over how this valuation should occur. This remedy may become a matter of expert opinion because there is no process put in place by Section 20035 to create a path to a valuation outside of litigation, unless the parties create a path of their own—perhaps in the franchise agreement.

And there are differing methods of valuation, such as:

1) the cost or book value approach, which values the balance sheet assets or calculates the replacement cost of the balance sheet assets minus liabilities (though this balance sheet may not show intangible assets);
2) the income or capitalization of earnings approach, which assumes the earnings of a business constitute an annual percentage return on the value of the business, or, that the present discounted value of the business's earnings into the future is the current business value;
3) the comparable sales approach, which examines the recent sales of similarly situated businesses and utilizes actual prices, as opposed to esti-

87. Ark. Code. Ann. § 4-72-209.

88. Hawaii Revised Statute Section 437-58(g) is a statute under Hawaii's Motor Vehicle Industry Licensing Act and therefore not applicable to all franchises generally. Nonetheless, § 437-58(g) is noteworthy because it is very analogous to California Business and Professions Code § 20035 in that it incorporates the concepts of: (1) payments at fair market value and (2) lack of good cause to terminate or not renew. Hawaii's general franchise law also includes a compensation statute if a franchisor fails to renew or terminates a franchisee. *See* Hawaii Rev. Stat. Ann. § 482E-6(3). However, that section does not differentiate between termination and non-renewal with good cause and absent good cause, as do the California Business and Professions Code § 20035 and Hawaii Revised Statute § 437-58(g).

mates (although what is similarly situated is frequently subject to dispute).[89]

These differing tests alone show that the fair market value standard for termination damages may be a recipe for lawyers and experts.

Second, the section calls for valuation not only of the franchised business, but also of "franchise assets." There is no definition in the statute of how these two phrases differ in reality. Goodwill seems like a likely area of contention here in that the franchisee will seek personal goodwill for its business, but the franchisor will argue that it owns the institutional, corporate, and national goodwill.

From the franchisor perspective, this section does not account for the varied realities that exist in franchising. For example, this section seems to assume that the franchised business is taken away from the franchisee in its entirety by the termination—location, inventory, and all. But many terminations are essentially only a termination of the right to use the branding and the now former franchisee retains the location and the business—just under a different name and branding. Under this statute, to allow the franchisee to obtain the value of the business and assets, while still keeping them, would permit unjust enrichment, which is not permissible under California law.[90] Having recouped its entire investment, the franchisee seemingly could continue a similar business in the same place having retained good will established using the franchisor's brand and implementing the franchisor's business methods.

The question is left open—can franchisors draft definitions to include in their franchise agreements that would address some of the uncertainty of the statute? One possibility could be to define exactly how the business and/or assets would be valued upon such a termination. Another possibility could be that the parties agree what will not be considered in such a valuation. This is yet untested, but it seems like an area franchisors will want to explore.

D. *Franchisee's Point of View About Section 20035*

The new Section 20035 is another example of the legislature's recognition of the local and personal goodwill developed by successful franchisees and the significant investment required of such franchisees. It levels the playing field and acts as a deterrent against unlawful termination of franchisees. On the other hand, like many other aspects of the Act, it contains a material and undefined term, "fair market value," and essentially forces franchisees to seek injunctive relief. A real problem then develops because franchisors are generally much less likely to engage in meaningful negotiation and dispute resolution once a franchisee commences a legal action, which must be disclosed

89. Nicole Liguori Micklich, Michael W. Lynch & Ingrid C. Festin, *The Continuing Evolution of Franchise Valuation: Expanding Traditional Methods*, 32 Franchise L.J. 223, 223 (2013).

90. *See e.g.*, First Nationwide Sav. v. Perry, 11 Cal. App. 4th 1657, 1663 (1992) (discussing general principles of restitution and unjust enrichment).

in the Franchise Disclosure Document. Franchisees then must either pay for lawyers and experts and spend considerable time and resources engaged in a legal action that might otherwise be avoided, or, if such legal action is cost prohibitive, waive the "fair market value" and/or "other damages" afforded by the law.

AB 525 as adopted in the new CFRA is the most franchisee-friendly legislation in the nation. It is not without flaws, however, and it is likely to lead to costly litigation. It also failed to provide many protections that franchisees seek: (1) it does not empower franchisee associations, (2) it does not impose a good faith requirement on all of a franchisor's dealings with franchisees, and (3) it does not address a common problem for franchisees in the form of contractual limitations periods that essentially waive protections for franchisees. In the future, hopefully the California legislature, and legislators in other states, will further deter opportunistic behavior by franchisors, including territorial encroachment and the use of mandated suppliers. Strong state laws can level the playing field for franchisees that otherwise are bound by one-sided non-negotiable franchise agreements.

VI. Conclusion

Since AB 525 was enacted in October 2015, it has been one of the most hotly contested topics among the franchise bar. The authors expect it also will become the most hotly litigated law soon. Without the aid of court guidance, parties are already becoming entrenched in their beliefs about how the law should be applied and interpreted. And, despite its intended clarity, AB 525 is likely to drive parties into court. Like most statutes, however, as courts interpret the law, the hope is that a greater sense of clarity will arrive to provide both franchisees and franchisors with more certainty about their relationship.