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**SBA LENDING:
CONSIDERATIONS FOR
FRANCHISORS AND FRANCHISEES**

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¹ The opinions expressed by Stephen J. Olear in this paper and during the oral presentation are his own and do not necessarily represent the views of the United States Small Business Administration.

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SBA LENDING: CONSIDERATIONS FOR FRANCHISORS AND FRANCHISEES

I. INTRODUCTION

The growth of any franchise system depends heavily on the ability of the system's franchisees to obtain adequate financing to develop and operate their businesses. Particularly for new franchisors or new franchisees in existing systems, United States Small Business Administration ("SBA") guaranteed loans may be an important source of financing.

The use of SBA financing within a franchised system requires the franchisor to face a number of important issues and tradeoffs. These include a consideration of whether provisions in the system's franchise agreement will violate SBA's affiliation policies and procedures; whether the franchisor should participate in the Franchise Registry; the nature and extent of financial information regarding corporate and franchised locations to be included in Item 19 of the franchisor's franchise disclosure document; the importance of careful preparation of the estimated initial investment figures in Item 7 of the franchise disclosure document and the location summaries information in Item 20 of the franchise disclosure document; and the nature and extent of the financial information the franchisor will share with potential lenders—including information not shared with prospective franchisees. Determining how to assist a new franchisee in obtaining financing can also raise a more fundamental issue of franchisee selection—does a proposed franchisee have the financial resources, business acumen and practical experience necessary to have a significant likelihood of succeeding as a franchisee? The perspectives of the SBA and of lenders to franchisees described in this paper can help franchisors, franchisees, their financial advisors and franchise lawyers in addressing these issues.

II. OVERVIEW OF SBA LOAN PROGRAMS USED BY FRANCHISED BUSINESSES

An applicant for an SBA loan must be an active business, organized for profit, located in, and planning to use the loan proceeds in, the United States, its possessions or territories, meet the SBA size definition and demonstrate its need for the credit for which it is applying.¹ The SBA does not make these loans to franchisees; it guarantees loans made by banks and other qualified lenders. SBA loans are made to eligible small businesses; however, under certain loan structures and circumstances, loans may be made to individuals or entities who hold property leased to the small businesses or to individuals as co-borrowers. The loan applicant must show that the financing it seeks is not available from other sources. The personal resource test noted in 13 CFR Section 120.102 has recently been eliminated by the SBA.² The lender also must certify that credit is not otherwise available to the borrower under reasonable terms.³ Two of the most common SBA loan programs utilized by franchised businesses are Section 7(a) loans and Section 504 loans.⁴

¹ 13 C.F.R. § 120.100 (2014).

² 13 CFR §120.102 (2014) (*reserved by* Small Business Administration, 79 Fed. Reg. 15641, 15649 (March 21, 2014)). This test had required potential borrowers to show that they could not obtain financing from other sources, including the personal resources of the principals of the borrower.

³ 13 CFR §120.101 (2014).

⁴ This section is intended to provide only a general overview of SBA loan programs of interest to franchised companies. For more detailed information regarding eligibility for these loans, SBA rules concerning these loans and matters considered by lenders, see David Hoppenworth, Stephen Olear, Kimberly Sikora Panza & Edith Wiseman, *Understanding and Utilizing the SBA Financing Process*, INT'L FRANCHISE ASS'N at 2-12 (MAY 6, 2013), <http://emarket.franchise.org/2013Is/Understanding%20and%20Utilizing%20the%20SBA%20Financing%20Process.P>

Section 7(a) loans are popular with franchise companies, as the maximum loan amount is \$5,000,000 and the loan proceeds can be used for a variety of purposes. Loan proceeds may be used for working capital; to fund the purchase of equipment, furnishings and fixtures; to purchase or construct land and buildings and to pay franchise fees. They may not be used to pay franchise development fees or to perform obligations under area development agreements.⁵ The SBA may guarantee up to eighty-five percent of loans up to \$150,000 and seventy-five percent of loans over \$150,000. The duration of a Section 7(a) loan depends on the use of its proceeds. Real estate loans may be for up to twenty-five years. Loans for equipment can be for the longer of ten years or the useful life of the equipment, not to exceed twenty-five years. Working capital loans can extend up to ten years.⁶

All entities and individuals that own twenty percent or more of an applicant for a Section 7(a) loan must provide an unlimited full guaranty. In addition, SBA loans are intended to be secured by collateral. Lenders must obtain collateral sufficient to fully secure the loan, to the extent such collateral is available. The SBA will not deny approval for an SBA loan solely due to lack of collateral, but the absence of collateral can be a factor in determining loan eligibility and impact a lender's willingness to make loans to franchise companies not secured by collateral.⁷ In addition, lenders are required to obtain a perfected security interest in all available collateral to ensure compliance with SBA's requirements and to protect their ability to collect under an SBA guaranty.⁸ On loans in excess of \$350,000 the SBA requires the lender to obtain a lien on the personal and investment real estate assets of the principal owners of the loan applicant where the liquidation value of the collateral does not fully secure the loan.⁹

Section 504 loans finance commercial real estate and equipment, and are made through a Community Development Company ("CDC"). A CDC is a not-for-profit corporation certified and regulated by the SBA to make Section 504 loans.¹⁰ These loans allow franchisees to acquire commercial real estate, finance construction and to purchase long-term capital equipment. Although Section 504 loans generally are larger than Section 7(a) loans, the eligibility criteria are the same and they are subject to the same SBA size standards.¹¹ The maximum loan amount under a Section 504 loan is \$5,000,000, but there is no maximum project size. The financed assets typically serve as collateral for the loan, and owners with a twenty percent or more ownership interest must provide a personal guaranty. Because Section 504 loans are intended to promote economic development objectives, they often require the borrower to agree to create or retain a certain number of jobs in connection with the project.¹²

DF [hereinafter "*SBA Financing Process*"] (presented at the 46th Annual Legal Symposium), from which much of the information described in this section was derived.

⁵ *Id.* at 3.

⁶ *Id.* at 4-5.

⁷ *Id.* at 7.

⁸ *Id.* at 7-8.

⁹ U.S. SMALL BUS. ADMIN., OFFICE OF FIN. ASSISTANCE, LENDER AND DEVELOPMENT COMPANY LOAN PROGRAMS, SOP 50 10 5(F) Subpart B, Chapter 4, II (page 166) (January 1, 2014) [hereinafter "*SOP 50 10 5(F)*"], available at <http://www.sba.gov/sites/default/files/sops/SOP-50-10-5F-June-18-2014-Updated-for-Credit-Score-final-highlightedl-Clean.pdf>.

¹⁰ *SBA Financing Process*, *supra* note 4, at 11.

¹¹ *Id.*

¹² *Id.* at 12.

Applicants for SBA loans must be active businesses. This precludes entities, such as real estate developers and landlords that derive income from renting property to others, from obtaining an SBA loan.¹³ An exception is made by the Eligible Passive Company (“EPC”) rule,¹⁴ but it is interpreted strictly.¹⁵ An EPC must use its SBA loan “to acquire or lease, and/or improve or renovate real or personal property (including eligible refinancing) that it leases to one or more Operating Companies (OC) for conducting the OC’s business.”¹⁶ Under the EPC rule, a franchisee may establish a separate entity that acquires and develops real estate with an SBA loan and leases it to an operating company, so long as the EPC meets the requirements of the EPC rule and the operating entity meets the operating company requirements.

A prospective applicant (including any affiliates), must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher.¹⁷ For most retail businesses, the applicant and its affiliates cannot exceed \$7,000,000 million in gross sales averaged over the last three fiscal years.¹⁸ An alternative to the industry size standard exists where the proposed borrower, with its affiliates, has a tangible net worth of not more than \$15,000,000; and the average net income after federal income taxes (excluding any carry-over losses) of the proposed borrower and its affiliates for the two full fiscal years before the date of the application is not more than \$5,000,000.¹⁹

III. SBA AFFILIATION STANDARDS FROM THE SBA’S PERSPECTIVE

SBA’s business loan programs are available only to independent small businesses as defined by the Small Business Act²⁰ and Parts 120 and 121 of Title 13 of the Code of Federal Regulations (“CFR”).²¹ A key step in determining whether an applicant is independent and small is to determine whether the applicant is affiliated with any other parties. Lending to small business franchise applicants presents challenges due to the contractual relationship between the franchisor and the franchisee. The relationship is a unique relationship that by its nature provides for an inherent level of control. It is when this level of control becomes excessive, that the affiliation policy becomes an issue.

Currently, when a small business loan applicant has or will have a franchise, license, dealer, jobber or similar relationship and such relationship (or product, service or trademark covered by such relationship) is critical to the applicant’s business operation, affiliation is determined by reviewing the agreement governing the relationship (or product, service or trademark) and any related documents, and identifying any areas of control that could cause the

¹³ 13 C.F.R. § 120.110(c) (2014).

¹⁴ 13 C.F.R. § 120.111 (2014).

¹⁵ SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 104).

¹⁶ *Id.*

¹⁷ SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 76).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ 15 U.S.C. §§ 631 to 657s (2013).

²¹ SBA loan requirements are described in 13 C.F.R. pt. 120 (2014); the SBA loan size regulations are described in 13 C.F.R. pt. 121 (2014).

applicant to not be considered independent. If this review leads to a determination that the parties are affiliated and therefore not independent, the size (e.g., revenues, employees, net worth or net income) of the applicant and the franchisor/licensor etc. will be combined when determining whether the applicant is small for purposes of SBA's business loan programs.

The use of SBA financing within a franchised system requires the franchisor to consider the requirements of participating in the SBA loan programs. The restraints imposed on a franchisee or licensee by its franchise or license agreement relating to standardized quality, advertising, accounting format and other similar provisions generally will not be considered in determining whether the franchisor or licensor is affiliated with the franchisee or licensee; provided the franchisee or licensee has the right to profit from its efforts and bears the risk of loss commensurate with ownership.²² Affiliation may arise, however, through other means such as common ownership, common management, or excessive restrictions upon the sale of the franchise interest. If, based on the relationship between the franchisor and franchisee under the operative agreement, the franchisor is found to have the power to control the franchisee's operations, then the franchisor and franchisee will be found to be affiliates of each other causing the size of the franchisor (including its franchisees) to be taken into consideration in determining if the small business applicant is small.

By its nature, the relationship between a franchisor and franchisee necessarily provides for some level of control of the franchisee by the franchisor. For ease of discussion, all license, jobber and dealer relationships will be referred to in this paper as franchise relationships and the parties as franchisor and franchisee.

A. Discussion of Franchise Agreement Provisions.

Currently, SBA has identified a number of common provisions in franchise agreements that the Agency believes evidence "excessive control" (i.e. a degree of control that results in affiliation) by the franchisor.

1. Restrictions on the Ability of the Franchisee to Transfer the Business or an Interest in the Business.

SBA has long considered the business owner's ability to transfer ownership of the business as a fundamental feature of an independent small business. In the context of a franchise relationship, however, SBA has also recognized that the franchisor needs to have some ability to approve the franchisee's proposed transferee. When a franchise agreement requires the consent of the franchisor in order for the franchisee to assign or transfer his or her interest in the business, SBA has determined that the parties are considered affiliated unless the franchise agreement provides that such consent will not be unreasonably withheld. The SBA permits the franchisor to list or require specific issues or items that must be met, provided that the final overall decision is made under a reasonableness standard. SBA believes that this ensures that the franchisee has the ability to sell the business, provided the new owner meets reasonable requirements established by the franchisor.

Similarly, franchise agreement provisions that require the franchisee upon transfer to remain liable for the actions of the transferee (continuing liability) are also evidence of "excessive control". SBA believes that once a franchisor provides its consent to the transfer and

²² SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 78).

accepts the new transferee, a truly independent small business franchise owner should not be liable for the actions of the new transferee. However, non-compete provisions and other provisions that may cause a franchisee to be liable for his or her own actions post transfer have been considered acceptable by the SBA.

2. Franchisor Billing and Collecting from Franchisee's Customers.

A basic indicator of an independent business is that its owners should have responsibility for running the business operations, including control over billing and collections. Therefore, provisions in a franchise agreement that give the franchisor the ability to manage the billing or collections function for a franchisee have been considered evidence of excessive control. It should be noted that SBA has accepted direct billing by a franchisor when such practice is standard and accepted practice for that industry. For example, in the fitness industry many franchisees are part of a network of franchisee-owned businesses and the gym members are provided access to the entire network of fitness centers. SBA believes that franchisor billing for that industry is necessary to enable sharing of other facilities in the network. SBA also has found acceptable situations where the franchisee is given a choice to provide the billing on their own or choose a service recommend by the franchisor.

3. Establishing a Price for the Sale of Assets upon Termination, Expiration, or Non-Renewal of the Agreement.

SBA has determined that a franchisor's option to purchase the business assets upon termination, expiration or non-renewal of the franchise agreement does not create excessive control over the franchisee. SBA believes that the franchisee, however, must maintain the ability to make a profit from its efforts and therefore, a franchisor's right to purchase the franchisee's assets should not unduly restrict the ability of a franchisee to sell the assets at market prices. Therefore, agreements that contain provisions which allow the franchisor to control the appraisal process have been found to be examples of excessive control. SBA has accepted situations where both parties are able to choose an appraiser.

4. Directly Assuming Control of Franchised Operations or Employees (Step-In Rights).

The nature of the franchise relationship requires the franchisor to have the ability to protect the interest of the brand; therefore, SBA understands that a franchisor may need to step in and assume operations of the franchisee's business under extreme circumstances. Such provisions have been deemed acceptable (i.e. not excessive control) where the franchise agreement limits the ability of the franchisor to step in and operate the business only in response to a specific type of critical incident and includes opportunities for the franchisee to demand review of the incident that led the franchisor to exercise these step-in rights. However, a franchisor's right to step in and take over the franchisee's operation for an unlimited amount of time is considered excessive control. Provisions in a franchise agreement that give the franchisor the ability to control the employees of the franchisee (other than key managers) are deemed to result in excessive control.

5. Pricing.

SBA believes that an independent business should maintain the ability to set its own pricing, which enables it to make a profit or risk a loss from its own actions. Franchise agreements that include language giving the franchisor the ability to set both minimum and maximum prices that a franchisee may charge for its products or services or allows the franchisor to dictate prices have been found to be evidence of excessive control. However, SBA believes that franchisors that have the ability to set ranges for pricing in order to manage national accounts or national advertising promotions do not have excessive controls as long as the pricing model is not applied randomly or in a way that would target a particular franchisee or location.

6. Right of First Refusal (ROFR) on a Partial Assignment or Change of Ownership.

SBA believes that it is not excessive control for a franchisor to have a ROFR on a sale of the franchise business or the real estate where the business is operating. Some franchise agreements extend those ROFR provisions to other types of transfers, including a transfer of an ownership interest between existing owners of a franchise entity (i.e., a sale of stock by one owner of a franchisee entity to another existing owner) or a transfer of an ownership interest by one of several existing owners to a third party. These “partial change of ownership” transactions do not contemplate a sale of the business entity but rather a sale of an interest in the business entity. SBA believes that the unfettered right of the owners of a franchisee entity to change ownership percentages or control of the business entity among themselves is a basic feature of an independent business.

7. Option to Purchase/Lease Real Estate Owned by the Franchisee.

An independent business must have the ability to freely control the real estate that it owns or is purchasing in connection with the establishment of a franchise. If the franchisee is the owner of the real property, SBA believes that provisions in a franchise agreement that force the franchisee to sell the property to the franchisor upon expiration, termination or non-renewal of the franchise agreement are evidence of excessive control. In many cases, the provisions provide for payment of the “fair market value” of the real estate, but that amount is not always sufficient to pay off the franchisee’s debt, leaving the franchisee responsible for the remaining balance. Many franchise agreements give the franchisor this option to purchase not only on default/termination but also upon the expiration of the franchise agreement. SBA believes that an independent franchisee that has met its obligations under the franchise agreement and that owns the real property, should not be forced to sell the property and should be able to make a profit from the operation of a subsequent business on the real estate, subject to any non-compete provisions or de-identification requirements.

SBA however, recognizes the need of franchisors to protect their brand and to have the ability to have some control over the sites from which franchised units operate. SBA has considered a “benefit of the bargain” analysis as a way to approach these situations. If one party does not fulfill its obligations under the franchise agreement, the other party should have the right to receive the benefit of its bargain. In other words, if there is a default by the franchisee under the terms of the franchise agreement, and the real estate is owned by the franchisee, the franchisor should have the right to lease the property (for itself or a third party franchisee) up to and including the full term of the original franchise agreement. Upon expiration of the franchise

agreement, a franchisor would not have the ability to force an independent business to continue leasing the property or to force any renewal rights under the franchise agreement.

Under its current procedure, the SBA has defined a number of control factors that can be found in franchise agreements, including those discussed in this section, that it uses to determine if the relationship between the franchisor and franchisee provides for excessive control over the small business by the franchisor, resulting in affiliation between the parties.²³ The SBA continues to evaluate the issues that relate to control and affiliation to ensure that the current policy is capturing the issues necessary to ensure compliance with the applicable regulations.

IV. THE LENDER'S PERSPECTIVE IN MAKING FRANCHISE LOANS

Because of the unique nature of franchised businesses and concerns regarding the SBA affiliation issues that impact franchised businesses when selecting a lender, franchisees should choose one with franchise lending experience. The SBA maintains a list of the top 100 national lenders who make SBA loans.²⁴ SBA District Offices also maintain lists of active SBA lenders in their areas, so readily accessible information is available to franchisees seeking to find an experienced SBA lender.

After selecting a lender, a prospective franchisee borrower must ensure it understands the documentation the lender requires to complete the loan application, and should provide these documents to the lender as soon as possible. Not surprisingly, one lender has indicated that "an incomplete application is the most common cause of delays in the approval process."²⁵

To qualify for either a Section 7(a) or Section 504 loan the applicant must be both creditworthy and reasonably able to assure repayment of the loan.²⁶ The SBA requires lenders to analyze applications in a commercially reasonable manner consistent with prudent lending standards.²⁷ Additionally, when contemplating an SBA loan request, lenders are required, and expected, to apply credit and underwriting criteria consistent with the lender's similar non-SBA loans. Lenders will generally consider an applicant's actual or pro-forma cash flow as the primary source for repayment of the loan, rather than the value of the collateral.²⁸ The SBA also requires the lender to consider factors that include: the applicant's character, reputation and credit history; experience and depth of management; strength of the business; the adequacy of the applicant's equity investment (often ten to twenty percent or more); and the nature and value of the collateral.²⁹

²³ These control factors are described in SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (pages 79-84).

²⁴ See U.S. Small Business Administration, *100 Most Active SBA 7(a) Lenders*, SBA.gov, <http://www.sba.gov/lenders-top-100> (last visited July 23, 2014).

²⁵ *SBA Financing Process*, *supra* note 4, at 14.

²⁶ *Id.* at 15; 13 C.F.R. § 120.150 (2014).

²⁷ SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 4, I. (page 157).

²⁸ *SBA Financing Process*, *supra* note 4, at 15.

²⁹ *Id.* at 15-16.

A. Factors Considered by Lenders in Franchisee Loan Decisions.

In addition to the creditworthiness of the applicant, understandably, the lender's experience with a particular franchise system will be a major consideration in determining whether to make loans to other franchisees in the system. As such, it may be very helpful for franchisors to understand the many factors that lenders analyze when contemplating making a franchise loan, whether SBA guaranteed or conventional. The following represents a list of the most common factors:

1. Industry.

Every lender is prone to avoiding certain industries, and there are not necessarily any identifiable or predictable norms. Comfort with certain industries is entirely subjective to the lender. For example, a particular lender may have an internal acceptance for service industry or hotel systems, while not accepting gas stations or convenience stores. Accordingly, it is important for the franchisee to understand the proposed lenders' accepted industries. Franchisors likewise should become aware of at least those large lenders that avoid entirely, or have expressed reluctance to make loans to, franchisees in the franchisor's industry.

2. Geographic Scope of Franchised System.

Lenders will consider whether the franchise system is global, national, regional or local. For most lenders, the wider the reach and presence of the franchise system, the more acceptable the system.

3. Franchisee's Territory.

Lenders will also take into consideration the geographic territory being offered to the applicant franchisee. The lender will want to understand factors such as how the franchisee's territory is defined by the franchisor and what type of safeguards are provided by the franchisor to protect the franchisee's territory. From the franchisor's perspective, a well drafted disclosure in Item 12 of the franchise disclosure document will assist lenders in understanding how franchise territories are defined and protected by the franchisor. Finally, it is important for the lender, franchisee and franchisor all to understand whether the geographic territory being offered to the franchisee is within the lender's geographic lending territory. Many lenders, especially community banks, are traditionally averse to lending outside of their geographic footprint. Franchisors can save prospective franchisees time and money by making them aware of the lenders that are reluctant to lend outside this established footprint.

4. Brand Establishment and Trends.

Lenders are concerned with the brand establishment and trending of the franchise system as a factor to assess whether the franchisee will be benefited or burdened by general market awareness. Of course, lenders are looking for franchise systems whose brand establishment in the marketplace is positive and growing, and not negative or diminishing. The following are factors that lenders commonly review when determining brand establishment and trending:

- Number of franchisee owned units;
- Number of franchisor owned units;
- Number of new units opened in the most recent fiscal year;

- Number of units closed in the most recent fiscal year, and the causes (retirement, change in competitive or market conditions, etc.);
- Number of units subject to change of ownership in the most recent fiscal year;
- Number of multi-unit owners as a percentage of total owners;
- Minimum demographic and/or location requirements;
- Continuity rate of the brand; and
- Average unit revenue and profitability.

It is important that franchisors understand that lenders must rely on disclosure by franchisors to determine most, if not all, of the aforementioned factors, typically by way of the information provided as part of the franchise disclosure document. From the franchisor's perspective, much of the information sought by lenders on unit openings and closings will be covered in Item 20 of the franchise disclosure document. Information concerning the percentage of multi-unit owners will likely be found in the list of franchised locations included in the franchise disclosure document. Demographic and location requirements and continuity rates may be readily available in publicly disseminated information of the franchisor. To the extent this information is not publicly available, franchisors may consider providing it to lenders with appropriate confidentiality agreements. Average unit revenues and profitability information may be found in a financial performance representation in Item 19 of the franchise disclosure document or may be made privately available to the lender.

5. Cost Per Unit.

Lenders analyze the franchise system's cost per unit and its deemed reasonableness in relation to the demographics and size of the system. Certainly, lenders prefer situations where the subject unit cost is within the average for the applicable industry. In certain circumstances, lenders may approve subject unit costs which exceed industry average, but are supported by system-wide projections that indicate that the unit will still achieve financial success and growth. Lenders typically rely on unit start-up cost and averages data provided in the applicable franchise disclosure document and assurances that the franchisee applicant will conform to the franchisor's formulae.

6. Franchisor Management Team.

While the lender underwrites the creditworthiness of the franchisee applicant, the composition and experience of the franchisor management team is a key consideration as well. Certainly, the more experience the franchisor management team has with the applicable franchise system and/or industry, the more comfortable the lender. That is not to say, however, that lenders are not willing to consider loans to franchisee applicants in a new franchise system, but proven experience and success of the franchisor management team in a prior franchise system is critical to gain the confidence of the lender with the new system. Franchisors may want to ensure that Item 2 of their franchise disclosure documents and their websites contain detailed information on the background and experience of key members of their management teams to provide comfort to lenders regarding the experience of the management team.

7. Franchisor Financial Strength.

Similar to the experience level of the franchisor management team, lenders closely review the financial strength of the franchisor. Lenders typically set internal benchmarks for what they deem to be acceptable franchisor revenue trends. For example, a lender may determine that it is comfortable if up to forty percent of the franchisor's revenue is generated by

royalties, while in other circumstances, a lender may determine that it is acceptable that the franchisor's royalty revenue represents less than forty percent of the franchisor's total revenue, as long as the franchisor's revenues are supported by company owned units. Some key franchisor financial strength indicators measured by lenders are percentage of revenue generated from royalties, percentage of revenue generated from franchisee fees, whether the franchisor is "franchise fee independent" meaning the franchisor is profitable without franchise fee revenue, and the current financial trending of the system, franchisor and franchisees.

From the franchisor's perspective, franchisors may have discretion within the parameters of generally accepted accounting principles as to the level of detail they will provide regarding revenue sources in their audited financial statements, which are a part of the franchise disclosure document. In consultation with their inside and outside accountants, franchisors may be able to develop revenue source information consistent with generally accepted accounting principles that is helpful to prospective lenders to franchisees. Franchisors may decide for competitive reasons not to include detailed revenue source breakdowns in their audited financial statements. In such cases franchisors may want to provide such breakdowns privately to prospective lenders.

8. Failure and Charge-Off Rates.

Any lender that does a substantial amount of franchise lending, whether SBA guaranteed or conventional, typically will set its own acceptable failure and charge-off rates for the industries and/or systems to which it lends. For example, a lender may determine that it is comfortable making a loan to a franchisee applicant in a franchise system with a failure rate of fifteen to twenty percent, and a charge-off rate of four to six percent. Typically, system failure rates are defined as the total number of units within a franchise system that have gone through, or are in the process of, a liquidation or charge-off by current lenders. Similarly, charge-off rates are commonly defined as the total number of units within a franchise system that are subject to a charge-off by lenders. Lenders are dependent on franchisors and SBA to provide accurate failure and charge-off data to accurately calculate these rates.

9. Franchisee Support.

Lenders assess the support provided by franchisors, not only to the franchisees, but also the system. For example, lenders measure whether the franchisor consistently demonstrates support for its franchisees, as well as the franchisor's general willingness to repurchase a failed or failing unit. The lender's analysis of these factors can have a direct impact on underwriting or collateral requirements. Under certain conditions, a lender may be willing to reduce its standard equity requirement if there is measurable and established strong program support. Conversely, if the franchisor lacks a general willingness to repurchase failed or failing units, the lender may require a strong secondary source of collateral for the loan (whether or not required by SBA regulations). Lenders commonly rely on the franchise disclosure document and franchise analysis reports to determine the level of applicable program support.

From the franchisor's perspective, Item 20 of the franchise disclosure document provides important information for lenders concerning the number of units the franchisor has repurchased from franchisees within the past three years. However, it is difficult to ascertain from this information whether the franchisor purchased successful or failing units. Franchisors may want to consider supplementing this information by providing information to lenders on the franchisor's approach toward supporting and in some cases purchasing the locations of struggling franchisees.

10. Franchise Agreement.

Certainly, with respect to SBA guaranteed loans, the applicable franchise agreement must meet the SBA eligibility requirements. However, lenders also rely on compliance with many, if not all, of the SBA eligibility requirements for non-SBA loans. Additionally, it is important for franchisees and franchisors to understand any other requirements of the applicable lender which may not be required by the SBA.

V. THE FRANCHISOR'S PERSPECTIVE ON AFFILIATION ISSUES IN FRANCHISE AGREEMENTS

A description of affiliation issues in franchise agreements and the SBA's perspective on these issues are discussed elsewhere in this paper.³⁰ Viewing these issues from the franchisor's perspective, the franchisor must make an initial determination whether it is willing to make the changes to its standard form of franchise agreement required to address these issues. If the franchisor is unwilling to make these revisions, then in most cases SBA will find that the franchisor and franchisee are affiliated and if there are size standard violations, SBA financing may not be an option for the company's franchisees. Franchisors should keep in mind that the changes to their franchise agreements required to address the SBA affiliation issues may be made through the use of an addendum to the franchise agreement used only for franchisees who use SBA financing. Thus, these changes need not be system-wide changes. In many instances the franchisor's SBA addendum is included in the franchise disclosure document, so all prospective franchisees will see the revisions to the franchise agreement the franchisor is willing to make to address SBA affiliation concerns. This may lead franchisees who are not using SBA financing to ask why they are not afforded the opportunity to have the changes contained in their franchise agreements. This issue can be avoided if the franchisor makes its franchise agreement fully compliant with SBA requirements or does not include the SBA addendum in the franchise disclosure document.

If a franchised system wants SBA financing to be available to its franchisees, the franchisor must determine if its franchise agreement contains any of the provisions that will raise affiliation issues with the SBA.³¹ Counsel to franchisors who represent start-up franchisors should be aware of franchise agreement provisions that raise these affiliation issues. This will enable counsel to discuss with new franchisors whether inclusion of these provisions in the franchise agreement is necessary when preparing the first franchise agreement for a new system. This discussion may be particularly helpful to new franchisors whose initial franchisees may have difficulty securing conventional financing, and may be more likely to seek an SBA loan. Whether the franchisor is a start-up or an existing franchisor the inquiry regarding franchise agreement language that causes SBA affiliation issues will be the same—is the presence of this provision in the franchise agreement necessary to achieve an objective of the franchisor that is important enough to outweigh the franchisees' ability to obtain SBA financing? Several examples may help illustrate the analysis the franchisor must make.

³⁰ See *supra* Section III.

³¹ For a more detailed discussion of franchise agreement provisions that raise SBA affiliation issues, see Dennis E. Wiczorek, "Franchise Agreement Provisions That Affect Eligibility for SBA Loans," 15 THE FRANCHISE LAWYER 2 (Spring 2012).

A. Transfer Restrictions.

One franchise agreement provision that causes affiliation issues is a clause that allows the franchisor to exercise its sole discretion in deciding whether to permit the transfer of an interest in the franchisee.³² A provision that gives the franchisor the right to withhold its consent in its reasonable discretion is permitted. This reasonable discretion language still enables the franchisor to consider such factors as the proposed transferee's financial strength, operating experience, overall business acumen and character—factors often included in franchise agreement transfer provisions. Some franchisors favor sole discretion language because they view reasonable discretion language as an invitation to disputes over the reasonableness of the franchisor's transfer decisions. Other franchisors are willing to utilize a reasonable discretion standard while identifying a number of factors that can be considered in making a determination of reasonableness. These franchisors may believe they have sufficient latitude with a reasonable discretion standard to forego having a sole discretion standard.³³ In all cases, SBA requires that the agreement or an addendum include this reasonableness language.

B. Franchisor Purchases of Franchisee Real Estate and Personal Property.

The SBA's Standard Operating Procedure also places limitations on the ability of the franchisor to purchase the real property of a franchisee at the end of the term of the franchise agreement.³⁴ The Standard Operating Procedure precludes having a provision in the franchise agreement that requires the franchisee or an applicable EPC owner to sell the real property to the franchisor upon the expiration, breach or termination of the franchise agreement.³⁵ The franchisor may require the franchisee to lease the property to the franchisor upon termination for a period up to the remaining term of the franchise agreement before the termination.³⁶ The Standard Operating Procedure also precludes the franchisor from having an option to repurchase personal property of the franchisee upon expiration or breach of the franchise agreement where the franchisor has the ability to control the price. The franchise agreement may include a right of first refusal in favor of the franchisor under commercially reasonable terms.³⁷ While these provisions place limits on the franchisor's legitimate desire to control the real estate of a prime location in the franchised system and to acquire certain personal property of the franchisee, they do not prevent the franchisor from obtaining access to the franchisee's real estate for the remainder of the term of the franchise agreement where the franchisor satisfies the conditions of the Standard Operating Procedure.

C. Controls Over Franchisee's Employees.

Another area of concern to the SBA is the inclusion of franchise agreement provisions that permit franchisor control over the hiring and termination of a franchisee's employees.

³² SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 80).

³³ Some state franchise relationship laws will limit the reasons for which a franchisor may reject a transfer for all franchisees covered by these statutes. See, e.g., NEB. REV. STAT. § 87-405 (2013) and N.J. STAT. ANN. § 56:10-6 (2013).

³⁴ SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 80).

³⁵ As discussed above an EPC permits a franchisee to have a separate entity own its real estate and lease it to an Operating Company if certain requirements are satisfied.

³⁶ SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 80).

³⁷ *Id.*

Issues regarding whether the franchisor has excessive controls over the employees of franchisees are very important and troublesome issues in franchising today.³⁸ SBA does, however, allow limited step-in rights on the part of the franchisor designed to protect the brand from a temporary inability of the franchisee to operate the business.³⁹ A franchisor's evaluation of its franchise agreement provisions to determine the level of control, if any, it has over the hiring of employees of the franchisee will not only facilitate compliance with SBA requirements; it could also be beneficial to the franchisor from a risk assessment and management perspective.

A franchisor may believe that there are special circumstances related to its franchise that place great importance on retaining a provision in its franchise agreement not permitted by the SBA's Standard Operating Procedure.⁴⁰ In that case the franchisor's counsel may want to have a discussion with SBA counsel to determine if a mutually agreeable solution can be negotiated to permit the continued use of the provision, or a modified version of the provision may be used in the franchise agreement of franchisees with SBA financing. Under the Standard Operating Procedure, questions regarding the SBA's Franchise Policy may be directed to local field counsel, center counsel in the 7a processing center in Citrus Heights, California or SBA's Chief Franchise Counsel. Franchisors or franchisor counsel should be encouraged to contact the SBA's Chief Franchise Counsel when they have questions regarding issues in franchise agreements. They can also send an email to franchiseappeals@sba.gov.

The Franchise Registry process, discussed in Section VII of this paper, is a process to assist a lender with its review, but it is not a mandatory required process. As with the decision to facilitate the process of franchisees obtaining SBA loans, the decision to participate in the Franchise Registry has costs and benefits. One benefit is that the SBA will evaluate the franchisor's agreement to determine compliance with SBA requirements and recommend revisions where necessary and list the agreement and supporting documents as approved on the Franchise Registry site. This helps ensure the franchise is SBA compliant, which will save time for the lender during the loan underwriting process. Franchisors who utilize multiple versions of their franchise agreements will need to register each different version of the franchise agreement and franchise disclosure document.

VI. FRANCHISE DISCLOSURE DOCUMENT ISSUES IN FRANCHISE FINANCING

A. Item 7 and Item 20

As discussed elsewhere in this paper, a well-prepared franchise disclosure document can provide significant assistance to the lender in franchisee financing matters. Franchisors and their counsel should keep in mind that lenders are evaluating both the franchisor and the franchisee when making lending decisions regarding the franchisee. One active SBA lender to the franchise community has stated that developing a relationship with the franchisor is crucial

³⁸ For a recent discussion of lawsuits brought against franchisors alleging franchisor liability for employment law violations at franchised locations, see Natalma M. McKnew & Erik B. Wulff, *That Was the Year That Was*, INT'L FRANCHISE ASS'N at 88-96 (May 2014), <http://emarket.franchise.org/d/2014-legal-attendees/Judicial%20Udate%202014%20Paper.pdf> (presented at the 47th Annual Legal Symposium).

³⁹ These step-in rights may be for 90-120 days provided that control by the franchisor does not exceed 365 days of the entire term of the Franchise Agreement. SOP 50 10 5(F), *supra* note 9, Subpart B, Chapter 2, III. (page 80).

⁴⁰ In some service related franchise systems the franchisor bills and collects from the franchisee's clients for services performed by the franchisees. This practice may not be permitted under the SBA Standard Operating Procedure for some industries, but as discussed in Section III of this paper, is allowed in some industries.

for the lender and that the crux of this relationship is a process of information sharing to enable the lender to evaluate the performance of the franchise brand. This lender also has stated that factors relating to the franchisor often account for sixty percent of the loan underwriting process, while factors concerning the prospective borrower make up the other forty percent of the underwriting process, at least for the first several units of a franchisee.⁴¹

Consequently, lenders look to the franchise disclosure document for information on the franchisor, particularly in Items 7, 19 and 20. Because many loans to franchisees are used for building out and equipping the franchised location, lenders look for detailed initial investment information in Item 7. Item 7 can provide both the prospective franchisee and its lender with a realistic assessment of the equity and debt amounts that franchisee will need to begin operations. Franchisors normally use footnotes to the information contained in these tables. Particularly helpful to lenders is the requirement to include an estimate of certain operating costs during the first three months of the operation of a franchise.⁴² Franchisors have strong incentives to provide timely and accurate Item 7 information, as inaccurate information has served as a basis for lawsuits by franchisees against franchisors.⁴³ Many brick and mortar franchise companies, such as food service companies, establish locations in both traditional retail locations and such non-traditional locations as convenience stores, malls, college campuses and stadiums. These different types of locations can have widely differing capital requirements, which should be separately described in Item 7 of the franchise disclosure document.

The tables contained in Item 20 of the franchise disclosure document regarding the size of the franchise system are another source of information for prospective lenders. Tables in Item 20 provide information for each of the past three fiscal years, including the number of company and franchised stores opened and closed, transfers and terminations.⁴⁴ This information gives lenders a useful three year snapshot of trends and the overall health of the system.

B. Item 19

Some of the most difficult issues facing franchisors in preparing franchise disclosure documents relate to the use of financial performance representations in Item 19. A financial performance representation is defined as “any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.”⁴⁵ The guidelines for preparing franchise disclosure documents do not require franchisors to provide financial

⁴¹ Sean McCabe, Vice President and Director of SBA Lending, M&T Bank, Remarks at the 47th Annual International Franchise Association Legal Symposium (May 6, 2014), verified in email to author (July 1, 2014) (on file with Gary Batenhorst).

⁴² 16 CFR § 436.5(g)(1)(iii) (2014).

⁴³ See, e.g., *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 795 F. Supp. 2d 365, 376-77 (D. Md. 2011) where the court determined that a franchisee’s allegations related to start-up costs were not mere statements of opinion but were sufficiently specific and material to state a fraud claim where there was an eighty-five percent difference between the franchisor’s estimate and the franchisee’s actual costs.

⁴⁴ 16 CFR § 436.5(t) (2014).

⁴⁵ 16 CFR § 436.1(e) (2014).

performance representations. Many franchisors do not provide them, relying instead on their existing franchisees to communicate operating history information to prospective franchisees. Historically, the number of franchisors who provided financial performance representations was low, but in recent years that number has been increasing. In 2012, the Maryland Assistant Attorney General reported that in 2012 52% of franchisors registered in Maryland made some type of financial performance representation.⁴⁶

Franchisors who make financial performance representations may provide a wide variety of information to prospective franchisees. Financial performance representations can be based on company locations, franchised locations or both; include sales information only or sales and profitability information; and include historical information, projected future information or both. The information provided in a financial performance representation obviously is of great interest to lenders in the loan underwriting process, so providing timely and accurate financial performance representations constitutes a significant part of what franchisors can do to facilitate the financing process for their franchisees. Even more so than Item 7, the information provided (or not provided) in Item 19 of the franchise disclosure document has been at the heart of a number of disputes between franchisors and franchisees, so franchisors must assess the accuracy of the information that goes into a financial performance representation.⁴⁷

It is important for franchisors to understand there are exceptions to the requirement that providing information regarding franchise system performance must be made in compliance with Item 19.⁴⁸ Most importantly in the financing context, the requirements in Item 19 for the preparation of financial performance representations do not apply to information provided directly by the franchisor to lenders of prospective franchisees. Franchisors who do not provide financial performance representations to prospective franchisees but want to provide information to prospective lenders, or who wish to provide additional information to these lenders, are free to do so.⁴⁹ This provides franchisors the opportunity to give valuable information to facilitate the financing of its franchisees without being bound by the requirements of Item 19. However, this can introduce a new set of risks the franchisor must be prepared to manage.

First, any information provided to lenders should only be provided after obtaining a confidentiality and non-disclosure agreement from the lender. This is intended to prevent the lender from serving as a conduit for providing information to a prospective franchisee that the franchisor has chosen not to provide through the use of financial performance representations in

⁴⁶ E-mail from Dale Cantone, Assistant Attorney General, Maryland Securities Division, and Chair, NASAA Franchise and Business Opportunity Project Group, to Charles Modell (July 17, 2012) (on file with Charles Modell).

⁴⁷ See, e.g., *Carousel's Creamery LLC v. Marble Slab Creamery, Inc.*, 134 S.W.3d 385 (Tex. Ct. App. 2004), where a franchisee alleged that the franchisor made negligent misrepresentations in Item 19 by not disclosing that food sales of company owned locations disclosed in Item 19 included catering revenues, and understated labor costs by not including the labor of corporate employees and franchise trainees. In *Team Tires Plus Ltd. v. Heartlein*, No. Civ. 01-1197JGL, 2004 WL 3406090 (D. Minn. Apr. 19, 2004) the court denied the franchisor's motion for summary judgment on a fraud claim where the franchisor enhanced three year demographic information provided to prospective franchisee using a multiplier factor, without disclosing that the multiplier came from the franchisor and not from the third party who provided the demographic information.

⁴⁸ For a discussion of some of the exceptions to the Item 19 requirements, see Gary R. Batenhorst and Charles S. Modell, *Tips, Traps and Techniques for Drafting and Using Financial Performance Representations*, 35th ANNUAL ABA FORUM ON FRANCHISING W-4 (2012) at 6-12.

⁴⁹ *Id.* at 7-8.

the franchise disclosure document.⁵⁰ Such a requirement may present issues for the lender, particularly when information provided directly to the lender by the franchisor serves as the basis for turning down a loan and the franchisee wants to know the basis for the rejection.⁵¹ It is helpful for the franchisor to indicate in its transmittal letter or email to the lender accompanying this information that the information is being provided at the lender's request. Seasoned SBA lenders will likely be aware of the restrictions on the use of financial performance information, and should have no problem complying with reasonable conditions established by the franchisor.

Franchisors should also be aware of other means of providing information to their prospective franchisees and lenders beyond the information provided in a financial performance representation in Item 19. Franchisors may provide information to prospective franchisees regarding the performance of a specific company operated unit the franchisor is attempting to sell without providing a financial performance representation under Item 19.⁵² Franchisors that make general financial performance representations under Item 19 may also make supplemental financial performance representations to address specific locations or other factual scenarios.⁵³ Franchisors also should be aware that the amendments to the FTC Rule in 2008 provide that information about estimated costs alone do not constitute a financial performance representation.⁵⁴ However, the Compliance Guide to the amended FTC Rule states that cost data coupled with sales or earnings figures from which a prospective franchisee can readily calculate net profits constitutes a financial performance representation.⁵⁵ For this reason providing information on operating costs as a percentage of sales to a prospective franchisee will constitute an improper financial performance representation unless the information is disclosed in Item 19. The information provided to prospective franchisees under site specific disclosures, supplemental financial performance representations and disclosure of cost information is likely to be of benefit to prospective lenders as well.

One active franchise lender has stated that there is a proactive effort by some lenders to identify and foster strategic partnerships with franchisors. Obviously, a key element of these relationships would be the sharing of information, some of which might be more readily accessible for franchisors that are public companies. This lender indicated that franchise brands of all sizes need to be willing to share information that allows the bank to underwrite the brand. Otherwise, a franchisee with a marginal credit profile may be trying to get a loan from a bank whose credit underwriters have no familiarity or experience with the brand. The lender further stated that absent any performance information regarding the brand itself or information

⁵⁰ See Informal FTC Staff Advisory Op. 97 3, Bus. Franch. Guide (CCH) ¶ 6,483 (Feb. 4, 1997), advising that the delivery of earnings information to a prospective franchisee to provide to a lender constitutes an improper earnings claim, the term previously used for what is now referred to as a financial performance representation.

⁵¹ See the discussion of the *Villano* case, *infra* Section C, in which the franchisee claimed he was entitled under the terms of his franchise agreement to see information provided by the franchisor to the franchisee's lender.

⁵² 16 CFR § 436.5(s)(4) (2014).

⁵³ *Id.* § 436.5(s)(5).

⁵⁴ This is not the case in Maryland and California, which include cost information within the definition of a financial performance representation. See MD. CODE REGS. § 02.02.08.13(C) (2012); CAL. CODE REGS. tit. 10, § 310.114.1(6) (2010).

⁵⁵ Federal Trade Commission, *Franchise Rule 16 C.F.R. Part 436 Compliance Guide* at 131 (2008), <http://www.business.ftc.gov/documents/bus70-franchise-rule-compliance-guide> (follow "Franchise Rule Compliance Guide" PDF hyperlink).

from a third party provider, the likelihood of a marginal borrower receiving an approval goes down significantly.⁵⁶

Franchisors historically have been reluctant to share performance information regarding the franchised system with persons outside of the system for a variety of reasons—including concerns for the quality of operating information received from franchisees, fear of liability if the information is inaccurate and competitive reasons. These may be valid reasons but they are likely to impair the ability of their franchisees to obtain financing—both conventional and SBA financing. Developing good relationships with lenders, who are experienced in franchise lending, can be an important component of the services a franchisor can provide to potential and existing franchisees. Such relationships can only be developed when the franchisor is willing to provide the kind of financial information that lenders find important in their underwriting of franchise loans.

C. Claims Against Franchisors and Lenders

While franchisors may provide different information to lenders than they provide to franchisees, the information provided to the lenders should be prepared with the same degree of care as information provided to prospective franchisees. Information provided by a franchisor to a lender leading to a loan to a franchisee that failed has served as a basis for claims against at least one franchisor and the franchisee's lender.

In *Villano v. TD Bank*, David Villano III, a Matco Tools franchisee and his father David Villano, Jr., who had guaranteed his son's loan, sued the franchisor, its parent company and the lender in the U.S. District Court for the District of New Jersey over issues related to an SBA loan obtained by the franchisee to acquire his franchise.⁵⁷ Plaintiffs brought claims for common law fraud and civil conspiracy against all defendants and claims under the New Jersey Consumer Fraud Act⁵⁸ and the New York Deceptive Acts and Practices Act⁵⁹ against TD Bank. Plaintiffs alleged that Matco secretly supplied inflated income projections to TD Bank regarding the franchisee's business, which TD Bank allegedly accepted although it knew or should have known the loan was likely never to be repaid.⁶⁰

Among other information it provided to TD Bank, Matco provided the bank with a three year annual income projection based on sales averages for the region where the franchisee's franchise was to be located. The Villanos claimed they were not made aware of these projections, and argued that disclosure to them was required under the distributorship agreement.⁶¹ The Villanos alleged that Matco told TD Bank not to disclose these projections to the Villanos as Matco "cannot legally make representations regarding potential sales unless they are expressly set forth in the franchise offer to the prospective franchisee."⁶² Although, not discussed in the opinion, Matco may have been relying on the fact it was not making these

⁵⁶ Information from email exchange with Sean McCabe, Vice President and Director of SBA Lending, M&T Bank (July 1, 2014) (on file with Gary Batenhorst).

⁵⁷ No. 11-cv-6714, 2012 WL 3776360 (D.N.J. August 29, 2012)

⁵⁸ N.J. STAT. ANN. §§ 56:8–1 to 56:8-195 (West 2014).

⁵⁹ N.Y. GEN. BUS. LAW §§ 349 to 350-f-1 (McKinney 2014).

⁶⁰ *Villano*, 2012 WL 3776360, at *1.

⁶¹ *Id.*

⁶² *Id.* at *2.

disclosures to a prospective franchisee, so they did not fall within the ambit of the Item 19 requirements.

The court granted the request by Matco and its parent company for a stay of the litigation to enable them to seek arbitration of the disputes with the Villanos in Ohio under the terms of the distributorship agreement. The court also stayed the litigation against TD Bank, although it was the one party the court ruled was not subject to arbitration.⁶³ In commenting on TD Bank's motion to dismiss, the court questioned the viability of plaintiffs' claims and took note of a recent New York case, which it did not cite, dismissing "nearly identical claims" against TD Bank.⁶⁴ The Villanos settled with the franchisor and its parent company, but it is unclear whether the claims against the bank are still pending.⁶⁵ Regardless of the outcome of this case, it points to the importance of franchisors exercising due care in preparing financial information disseminated to lenders. Cases such as this also raise the issue of whether the franchisor, the lender, or both should seek to include indemnification language in documents that contain disclosures of financial information to the lender that is not provided to the franchisee.⁶⁶

D. GAO Report on SBA Loans

Franchisors and franchise lenders should be aware of a recent report by the United States Government Accountability Office ("GAO") on SBA loans to franchisees of one franchise company.⁶⁷ The GAO indicated it undertook this study because it was asked to examine SBA guaranteed loans made to franchisees. The GAO also investigated allegations that a loan agent provided exaggerated revenue projections to franchisees in this franchise system to help them receive SBA loans.

The GAO reviewed 170 loans to franchisees totaling over \$38.4 million dollars made from January 1, 2000 to December 31, 2011 by fifty-four lenders. Borrowers defaulted on seventy-four of these loans. The GAO study focused on four lenders. Of the eighty-eight loans made by these lenders, sixty-three percent defaulted, compared to a twenty-three percent default rate for loans made by the other fifty lenders.⁶⁸

The four lenders focused on by SBA accounted for fifty-five of the seventy-four loans in default. As a result, the study may say more about the lending practices of these lenders or the overall health of the single system studied than it does about lending to franchise companies in general. In addition, the GAO study came out not long after the U.S. had been through its most significant economic downturn since the Great Depression.

⁶³ *Id.* at *9.

⁶⁴ *Id.*

⁶⁵ Villano III v. TD Bank, No. 3:11-cv-06714-FLW-DEA, 2012 WL 6613962 (D.N.J. October 25, 2012) (Stipulation of Dismissal with Prejudice of Defendants NMTC, Inc., D/B/A Matco Tools and Danaher Corporation).

⁶⁶ Such indemnification language could require the franchisor to indemnify the lender against claims by the franchisee if information supplied to the lender only by the franchisor is proven to be false or inaccurate. Similarly, franchisors could seek indemnification from the lender for damages arising from improper disclosure of the information by the lender.

⁶⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-759, SMALL BUSINESS ADMINISTRATION REVIEW OF 7(a) GUARANTEED LOANS TO SELECT FRANCHISEES (2013).

⁶⁸ *Id.* at 8.

Many financial performance representations do not include information on units in operation for less than one year. The GAO study, while noting that franchisors are not required to provide financial performance representations, appeared to attach great significance to projected first year sales information.⁶⁹ This may lead more prospective franchisees and lenders to seek this information. Franchisors may want to consider whether to expand financial performance representations to include sales from first year operations.

The GAO report describes GAO's interviews with franchisees of the studied system, who said challenges in the early stages of their operations included insufficient working capital and unexpected expenses.⁷⁰ Franchisors should consider whether their Item 7 disclosures adequately inform prospective franchisees of the equity they need and what types of expenses they should expect to incur in the early stages of operating their franchised business. Franchisors also will want franchise application processes in place that analyze whether franchise candidates have the financial resources and operational and general business expertise necessary to successfully navigate the initial stages of operating a franchised business.

Another issue noted in the GAO audit was the reliability of franchise data. The GAO indicated there were issues with the data SBA kept regarding the status of loans made to franchisors. The data collected by the SBA was based on information that was provided by lenders when making a franchise loan; however, if a lender did not have the correct data there was no system in place to ensure that the correct data was reported.

As a result of the issues noted in the GAO audit, SBA along with FRANdata developed a franchise data numbering system to ensure the correct data is reported when making loans to franchises. The numbering system is called Franchise Registry Unique Numbering System (FRUNS). Each franchise system is given a specific FRUNS number and SBA has included a dropdown box in the e-tran loan application system for lenders to use when making loans to franchises. This new system will ensure that if a lender is making a loan to a franchise, the franchise information is tracked correctly for the life of the loan. SBA believes that with the implementation of this system, the SBA data will be more accurate and reliable for use by franchisors and lenders.

VII. USE OF THE FRANCHISE REGISTRY BY FRANCHISORS

Once a franchisor has decided to make the SBA required revisions to its franchise agreement by using an addendum for SBA loan financed franchisees, the franchisor should consider whether to register its franchise with the Franchise Registry, which is currently hosted by FRANdata.⁷¹ The Franchise Registry includes a listing of all franchises agreements the SBA has reviewed and approved.⁷²

It should be noted that SBA does not require that a franchise system be listed on the Franchise Registry in order to be able to qualify for SBA assistance. The SOP process for review of franchise documents is as follows:

⁶⁹ *Id.* at 13-15.

⁷⁰ *Id.* at 11.

⁷¹ For more detailed information regarding the Franchise Registry, its operation and the services it provides see *SBA Financing Process*, *supra* note 4, at 30.

⁷² The Franchise Registry may be accessed at www.franchiseregistry.com (last visited July 23,2014).

1. **SBA Review:** SBA will review all documentation for loans processed through the Loan Guaranty Processing Center – where loan eligibility is determined by the SBA.
2. **Delegated Lenders:** SBA has designated certain lenders as delegated lenders where the lender makes the eligibility determination prior to submitting the loan to the SBA for approval. These lenders are required to make the affiliation determination based on a review of the franchise documents.
3. **Delegated Franchise Review Process:** This is a new process that SBA put into place effective January 1, 2014. Under this process, a delegated lender can submit franchise documents to the SBA and the SBA will provide the lender with an affiliation determination. The lender can then proceed to process the loan under its delegated authority, making the overall eligibility determination after taking into consideration the affiliation determination provided by the SBA.

The costs of participating in the Franchise Registry range from \$2,500 to \$3,500, depending on the number of agreements and exhibits reviewed, for the initial registration, and annual renewal fees range from \$450 to \$1,000. The primary advantage for franchisors who participate in the Franchise Registry is the ready access it provides to prospective lenders seeking information on the franchisor and the franchised system. Franchisees in new systems may seek SBA financing because they are unable to get conventional loans. For that reason start-up franchisors may consider participating in the Franchise Registry, which also provides the franchisor access to prospective franchisees seeking information on the franchise system.

The new SBA delegated review process, which is available at no cost to lenders, allows a lender to submit a franchise agreement directly to the SBA for an affiliation review. Once the review has been completed and the lender has a non-affiliation determination, they can move forward and continue to process their loan under their delegated authority.

The delegated review process has been in place since January 2014 and as of July 2014 there were over 700 reviews conducted. This process allows lenders to seek a review of a franchise system that is not listed on the Franchise Registry, as well as a specific year of a franchise agreement that is not listed on the Franchise Registry.

Franchisors often have their franchise agreement listed on the Franchise Registry in the year the franchisor adopts a specific form of franchise agreement. If a franchisee seeking an SBA loan has a franchise agreement for a year not listed on the Franchise Registry, SBA will review that franchise agreement and work with the franchisor to make changes that will enable the franchise agreement for that year to meet SBA requirements.

The delegated process provides lenders and franchisors with the ability to continue to make loans to eligible small business even if the franchise agreements are not listed on the registry.

VIII. ADDITIONAL ACTIONS BY FRANCHISORS TO FACILITATE FRANCHISEE FINANCING

Franchisors that wish to facilitate the ability of their franchisees to obtain financing should consider several additional steps to develop better relationships with franchise lenders.

Securing SBA financing can be a complex process involving interaction among the franchisor, the franchisee, the lender and the SBA. The franchisor should identify within its organization one person to coordinate its franchise financing efforts with SBA lenders. This person would be responsible for staying current on SBA franchise lending policies and procedures, the information typically requested by franchise lenders, and information about the franchisor, particularly the franchisor's franchise disclosure document. In large franchise organizations a small group can be assigned these responsibilities, including representatives of the franchisor's finance, franchise development and franchise operations functions. The individual or small group will take the lead in providing information on SBA financing to prospective franchisees, making sure the prospective franchisees understand that the franchise disclosure document contains information helpful to franchise lenders, making the prospective franchisee aware of the franchisor's franchise agreement addendum for SBA financed franchises, and answering franchisees' inquiries regarding the SBA loan application process.

Franchisors should also consider the benefits of developing good working relationships with active SBA lenders in one or more markets in which the franchisor is actively seeking new franchisees. Connecting prospective franchisees with franchise lenders who are familiar with business format franchising, the information contained in the franchise disclosure document and the SBA policies and procedures related to franchise lending, as well as with the franchisor's system, will help streamline the loan application process. Identifying one or more lenders with a footprint in the franchisor's significant markets can be an important part of this process.

The lenders sought by franchisors will be primarily concerned with establishing policies and procedures for receiving timely and accurate information from the franchisor. Anything the franchisor can do to facilitate this information flow will benefit its franchisees seeking financing. Developing good lender franchisor relationships will also make the franchisor more comfortable sharing information beyond the franchise disclosure document with the lender. The franchisor can rely on the fact that an experienced SBA franchise lender will better understand the confidentiality requirements attached to providing such information. The franchisor can also consider including selected lenders on the distribution list for annual reports, press releases, media reports and other information and lender outreach activities concerning the franchisor and its system.

IX. CONCLUSION

Ready access to financing is critical to the growth of all franchised systems. Loan programs administered by the U.S. Small Business Administration are designed to provide financing to companies that are not able to obtain conventional financing, so these programs provide important sources of financing for new and growing franchise systems. The franchise financing process involves a complex interaction among the SBA, lenders, franchisors and franchisees.

The SBA has developed its size and affiliation standards in an effort to ensure that SBA financing goes to the small businesses for which it is intended. However, compliance with these standards often requires franchisors to make revisions to their franchise agreement they would prefer not to make. Lenders are seeking strategic alliances with franchisors to provide financing to their franchisees. These lenders seek as much information as possible concerning both the franchisor and its franchisees to make sound loan underwriting decisions—information that franchisors are often reluctant to provide. By providing perspective on these issues from counsel for the SBA, lenders, franchisors and franchisees this paper is intended to give counsel for franchisors and franchisees a better understanding of this process.

Franchisors can take the actions described in this paper to facilitate the efforts of their franchisees to obtain financing. However, these actions involve risks, particularly when franchisors share information with lenders regarding the financial performance of company-owned and franchised locations—including information the franchisor does not share with its current and prospective franchisees. Like other risks encountered by franchisors, these risks can be managed with careful planning and execution by franchisors. The reward for this planning and execution can be strong relationships with knowledgeable lenders who can provide franchisees with the financing necessary to start and grow their businesses and ultimately the franchisor's brand.

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