April 7, 2015

U.S. Small Business Administration
Attn: Mary Frias
409 Third Street, SW., 8th Floor
Washington, DC 20416

Re: Docket Number: SBA–2014–0014, 79 Fed. Reg. 72748 (2014)
Franchise Agreement Reviews, Affiliation and Eligibility for Financial Assistance

Dear Sir or Madam:

I appreciate the opportunity to submit this comment in response to the SBA's request for comments made in the notice published on December 8, 2014 in the Federal Register, at 79 Fed. Reg. 72748 (the "Notice"). In particular, I wish to address portions of Parts III and IV of the Notice. For the sake of convenience, my comments below correspond to the formatting of the Notice, and address only certain portions of the Notice as to which I believe I may be able to offer useful input.

By way of background, from 1983-87, I served the Federal Trade Commission as an enforcement attorney in the Division of Enforcement within the Commission's Bureau of Consumer Protection. Since then, I have been engaged in the private practice of law with firms that been leaders in the field of representing franchisors, including the firms that combined their practices to become DLA Piper and, since 2007, with Plave Koch. In that capacity, I have had the privilege of representing, with my colleagues, hundreds of franchisors and considering how a wide range of companies operate in this important sector of American and international commerce.

Comments

Part III - Examples of Common Affiliation Issues Found in Franchise Agreements

A. Restrictions on the Ability of the Franchisee To Transfer the Business or an Interest in the Business

The Notice indicates that SBA would consider a franchisor and a franchisee to be "affiliated" if SBA has determined that the parties are considered affiliated unless the

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franchise agreement contains language stating the franchisor's consent will not be "unreasonably withheld or delayed." [1]

As SBA recognizes, franchisors have legitimate reasons why they would want to have the right to review and approve of a proposed transferee. Chief among these are brand protection, which serve not only the franchisor - but also the franchisees in the system that depend upon the franchisor's ability to evaluate, screen, and approve only appropriate parties to become franchisees - which of course includes transferees. There are no parties that stand to benefit from the franchisor having to accept an unqualified transferee because of an ambiguous review standard. While the concept of "reasonableness" is not inherently troublesome, leaving to a third party (e.g., a court) the right to determine whether a franchisor acted reasonably may inherently diminish a franchisor's ability to make a business judgment over whether a particular proposed transferee would be a good operator, a worthy steward of the brand, and a proper candidate to sell goods and services to the consuming public under the same mark as other parties. I urge that the SBA consider allowing franchisors the discretion "to approve or reject proposed transferees for reasons of legitimate business considerations." If a franchisor oversteps such a contractual basis, it will invariably be challenged and courts will review the decision in the context of that standard, which would allow the franchisor more flexibility to reject proposed transferees in appropriate circumstances.

C. Franchisor Billing and Collecting from Franchisee's Customers

In the Notice, SBA indicates that it will often look askance at a franchisor's billing and collecting from a franchisee's customers on the presumption that "its owners should have responsibility for running the business operations, which SBA has interpreted to include control over billing and collections." [2]

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[1] A franchisor and its franchisees are generally independent contracting parties that have no affiliation in the corporate sense. The fact that franchisees are independent entities in most instances was recognized by FASB when it adopted FIN 46R in 2003, after careful and thorough consultation with the SEC (and its Chief Accountant), the International Franchise Association, and various subcommittees of Congress.

[2] Conceptually, a franchisee does not have these standards imposed by a franchisor; rather, it is precisely the opposite.

Every business must develop and operate under some standards (e.g., when do I open, what do I sell, how should I market, what prices should I charge, what quality of products should I offer, etc.). In a franchise system, the prospective franchisee reviews its options and decides that instead of operating independently – and developing and adopting its own standards – she or he chooses to sign a franchise agreement and join a franchise system precisely in order to take advantage of that system's already-developed operating standards. Prospective franchisees make that choice because they understand that in order to take advantage of the benefits of being a franchisee, they

The presumption that a franchisor is intruding upon the franchisee-customer relationship neglects to consider the utility of modern and centralized ordering and payment systems to all parties - including not just the franchisor, but also franchisees and customers. Among the systems that we have seen are centralized order-taking sites, mobile apps, reservation systems, booking sites, and the like - a prime component of which is an engine to facilitate secure payment (typically via credit card). To ban centralized billing and collecting would be to run counter to the growing usefulness of these systems, which would be to the detriment of the franchisor, customers, and (ironically) the very franchisees that the SBA is seeking to protect.

The growing attention to cybersecurity priorities make it that much more important that adequate resources are dedicated to developing and implementing secure payment systems. Reliable and secure ordering and payment systems that inspire consumer confidence are expensive to design, develop, implement, maintain, upgrade, etc., and those important functions are most efficiently carried out by means of a centralized system, which by necessity must be operated (and financed) through the franchisor.

I strongly recommend that the SBA eliminate this standard from its consideration of "affiliation."

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

In my experience, franchisors and franchisees have most often contractually agreed to a formula for determining the fair price of assets upon termination. That is typically the best method, as it also reflects the parties' agreement as to the proper valuation. (For example, a five-year straight line depreciation of assets with a floor value equal to 10% of the cost for an item.)

In some instances, the parties choose to use appraisal instead - but as a practical matter, that method may often impose time delays and costs that make it burdensome to implement. For example, requiring the appointment of an appraiser to evaluate the fair market value of *in situ* business assets that have depreciated may lead to delay (selecting the appraiser, arranging for a site visit, having the appraiser provide a report) as well as cost (the appraisal fee). Requiring a three-party appraisal is an even less efficient process in terms of time and money, which leads to interruption in serving customers at the location.

The franchisor's goal in the process is to keep the business operating under the system with as little interruption as possible to consumers. Doing so smoothly benefits not only the franchisor but also other franchisees (who depend upon the system's ongoing vitality and customers' ongoing ability to access the brand's goods and services) and also customers (who wish to obtain authentic goods and services under the franchisor's brand).

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also must accept that there are limitations inherent in being part of a system rather than operating on their own.

IV. New Issues That May Indicate Affiliation or Excessive Control

A. Pricing

In a 1997 ruling, State Oil Co. v. Khan, 522 U.S. 3 (1997), the U.S. Supreme Court made clear that in some instances, a party such as a franchisor may establish a maximum resale price for the products that its franchisees sell. In those instances, the franchisee may choose its own price up to the maximum. The Supreme Court Khan ruling does not permit a franchisor to set a maximum price subject to no standard at all - rather, the Supreme Court concluded that the price, while not automatically illegal, would still be reviewed under the "rule of reason" standard.

The "rule of reason" standard is very well-established and interpreted by the federal judiciary. The SBA has indicated that nonetheless, it is concerned that a franchisor may "single out" a franchisee for unfair treatment by imposing upon that franchisee a maximum price. In the Notice, the SBA noted that "[we have] taken the position that franchisors that have the ability to set ranges for pricing in order to control national types of accounts or national advertising promotions are not affiliated with their franchisees as long as the pricing model is not applied in a way that would target a particular franchisee or location."

The standard that SBA enunciates in its Notice is more appropriate than the standard language often requested of franchisors, which include a clause to the effect that the franchisor's establishment of a maximum price is the same for the entire system. That approach does not permit flexibility to have a regional maximum price, or a maximum price that applies in different settings (e.g., free-standing locations but not airport locations). Moreover, the "systemwide" language in the standard SBA franchise amendment leaves open the possibility that a franchisee would challenge the maximum price on the basis that a franchisee in a remote market - whether in the United States or abroad - is not subject to the same requirement. While that may work an absurd result, the language currently used in practice does just that.

Maximum prices, of course, are meant to foster inter-brand competition, and therefore, as recognized by the Supreme Court, they are meant to benefit franchisees and the franchisor by making the brand more attractive to the consuming public. Anyone who has seen advertising for "dollar menus" at various restaurants knows that they are a main staple of attracting consumers to patronize businesses.

Finally, if a franchisor applied a maximum resale price to "target a particular franchisee or location," that action would be highly unlikely to pass muster under the rule of reason standard as well as state franchise relationship laws barring discrimination in commercial terms among franchisees.

For all of these reasons, I note the following. First, the courts are best equipped to address concerns under the well-developed body of federal antitrust law that a particular franchisee was singled-out for discriminatory treatment. Second, the language used in the Notice should be used in franchise amendments - recognizing that franchisors have a legitimate reason to exercise their right under antitrust law to set a maximum resale

price to foster inter-brand competition, including (but not necessarily limited to) maximum prices for a region, a class of businesses that are similarly situated, and other reasonable distinctions.

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I genuinely hope that these comments are useful to the SBA and its staff in considering the issues that are identified in the Notice, and would welcome the chance to answer any questions and continue this dialogue with the Agency.

Respectfully submitted,

Lee J. Plave