

August 27, 2013

The Honorable Sam Graves
Chair
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Thank you for your recent letter regarding the financing of franchise businesses in SBA's business loan programs and the process and standards for reviewing franchisees (and their franchise agreements) for compliance with the definition of a small business in Section 3 of the Small Business Act.

As you stated in your letter, SBA has a responsibility to ensure that financial assistance through its business loan programs is available only to small businesses that are independently owned and operated and not dominant in their field. It is clear from your letter that you recognize and understand the particular challenge this responsibility entails when SBA analyzes the relationship between a franchisor and one of its franchisees. The very nature of the franchisor/franchisee relationship assumes some level of control by the franchisor in order to protect the franchise brand. The degree of control, however, can convert what would otherwise be an independent small business into a mere division of the franchisor, and a small business owner into the franchisor's employee. In these cases, the franchisee is considered affiliated with the franchisor organization for purposes of determining the size of the business and eligibility for SBA financial assistance.

SBA regulations and guidance from SBA's Office of Hearing and Appeals (OHA) developed over the years identify the key issues that distinguish an independent franchisee from a franchisee that is not independent. See 13 CFR 121.103(i) and SOP 50 10 5 (E) at 94. These issues include (a) control over the franchisee's employees, (b) control over the franchisee's receipts including billing and bank accounts, (c) ability of the franchisor to operate the franchisee's business, (d) control over the franchisee's pricing, (e) control over the transfer process, (f) control over the franchisee's real estate including the option to purchase, and (g) ability of the franchisor to purchase a partial interest in the franchisee's business.

A review of the franchise agreement and attachments reveals whether the relationship between the franchisor and franchisee involves these issues. If SBA reviews a franchise agreement that contains these types of control provisions, we are able in most cases to suggest alternate language in the form of an addendum that would result in the franchisee being an independent business. Of course, even if a franchisee is found to not be independent, it may, nevertheless, be eligible for financial assistance through SBA's business loan programs if the franchise organization as a whole (i.e., the franchisor and all franchisees together) qualifies as "small".

Many SBA lenders have the delegated authority to determine whether a franchise agreement contains control issues that create affiliation between the franchisor and franchisee. To assist our lending partners in making these determinations, SBA has reviewed franchise agreements submitted by lenders and franchisors and identified those agreements that do not contain control issues. We communicate the results of our review to the party who submitted the franchise agreement to us. In many cases, that party is the lender (i.e., in connection with a loan application from a franchisee); in other cases it is the franchisor or FranData, a private company that submits requests on behalf of franchisors. SBA has made available the results of its reviews, and FranData has posted on its website a listing or Registry of franchise agreements that SBA has determined do not involve control issues. SBA also now posts this Registry listing on the SBA website, at www.sba.gov/for-lenders, for those who prefer to access the list through our website. The updated version of the SOP 50 10 5, currently under development, will direct interested parties to the SBA website in order to find SBA's franchise Registry.

To further assist our lenders and small businesses, we also make available to the public a listing of franchise agreements we have reviewed that contain the types of issues discussed above -- provisions affording the franchisor a level of control over the franchisee such that the franchisee is not considered an independent small business. We believe these efforts to assist our lenders and small business applicants, and to work with franchisors, have saved them time and money and have improved franchise small business lending by significantly speeding up and easing the SBA loan process.

The SBA is not alone in its efforts to distinguish an independent franchisee from one that is not independent. There are a number of cases pending in various state courts, for example, regarding the "cleaning model" franchise concept that present the issue of whether a franchisee is an independent small business or an employee of the franchisor. The American Bar Association's Forum on Franchising also tackled this issue at their Conference in October 2012 with a session titled "Independent Contractor or Employee? Minimizing Exposure from the Gray Areas of the Franchise Relationship". In that session the panelists discussed the franchisor/franchisee relationship, including the risk that franchisees are considered to be merely leasing a business from the franchisor company and the related employment and tax implications.

The SBA has also worked extensively with the International Franchise Association (IFA) in order to assist the franchisor community with understanding the SBA regulations and guidance for review of franchise documents. The IFA is the oldest and largest organization representing franchising worldwide. IFA's mission is to protect, enhance and promote franchising through government relations, public relations and educational programs. The SBA, through its Chief Franchise Counsel, has participated in a task force formed by the IFA's Legal Legislative Committee, to discuss SBA regulations as they apply to review of franchise agreements. The results of this collaboration have enabled franchisors to better understand these issues and to draft their agreements so as to ensure that their franchisee small businesses will be independent.

Currently there are 1,592 franchise brands that are listed on SBA's Registry. We are pleased that we are able to include so many approved franchise systems, which translates into thousands of potential small business borrowers. Of course, it is not necessary for a franchise to be listed on the Registry in order to be eligible for SBA financial assistance. If a franchise agreement is not found on the Registry, a review will be performed by SBA or the lender to determine whether the franchisee is an independent small business.

We are grateful to have the opportunity to explain and clarify our franchise review process for the Committee as we agree that franchising plays a significant role in the American economy.

Please find the following information requested:

1. Enclosed as Attachment 1 please find a list of all franchisors that requested a review of their franchise agreements from October 1, 2008 through July 31, 2013.
2. Enclosed please find the following:
 - a. Approvals – For all franchise systems listed on the Registry, the franchisor has received the enclosed approval letter (see Attachment 2a) – this approval was sent to all franchise systems in the list above other than the 26 franchise systems that were not approved.
 - b. Denials – Please find enclosed as Attachment 2b the email sent to the franchisor for the 26 franchise systems in the list above that were not approved.
3. You have asked about the procedures by which a franchisor can obtain review of its franchise agreement in order to be placed on the Registry. Although the current SOP does not specifically address the process for review of franchise agreements submitted by franchisors rather than lenders, the updated version of SOP 50 10 5 (~~which is currently under development~~) will clarify the process for franchisors, including franchisor appeal rights.

4. SBA now has a listing of all approved Franchise Registry brands on its website at www.sba.gov/for-lenders.

We appreciate your continued support of SBA and America's small business community. If you and your staff have additional questions, please contact Nicholas Coutsos, Assistant Administrator for Congressional and Legislative Affairs, at (202) 205-6335.

With warmest regards,

Karen G. Mills

Enclosures