
SBA's Franchise Review Process

Office of General Counsel

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New Procedures

- ▶ Lenders/CDCs will no longer have to review franchise agreement and other collateral documentation for affiliation between the franchisor and franchisee or eligibility of the franchise eliminating inconsistent decisions and backlogs.
- ▶ Lenders/CDCs will continue to be responsible for ensuring the applicant business is eligible (e.g., SBA Forms 912, etc.) and the use of proceeds are eligible.

FTC Definition

While a relationship established under a license, jobber, dealer or similar agreement is not generally described as a “franchise” relationship, if such relationship meets the Federal Trade Commission’s definition of a franchise, it is treated by SBA as a franchise for purposes of affiliation determinations in accordance with
13 CFR 121.301 (f) (5)

FTC Definition

Franchise means any continuing commercial relationship or arrangement, **whatever it may be called** in which the terms of the offer or contract specify, or the franchise seller (franchisor) promises or represents, orally or in writing, that:

1. The Franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
2. The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
3. As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

An Agreement must meet all three of the above elements of the FTC definition in order to be considered a “franchise”

FTC Exemptions

- ▶ Fuel Agreements

- ▶ Although exempt from the FTC disclosure requirements, all agreements and relationships that are covered by the Petroleum Marketing Practices Act (PMPA), 15 U.S.C. 2801 (e.g. gas stations, dealer/jobber agreements), are included within the FTC definition of a “franchise”

Dealer Agreements with New Car Manufacturers

- ▶ SBA is no longer excluding dealer agreements with new car manufacturers from affiliation determinations. Therefore, applicants that are or will be operating under a dealer agreement with a new car manufacturer that meets the FTC definition are subject to the new procedures.

SBA Franchise Directory

SBA has created the SBA Franchise Directory which includes all franchise and other brands reviewed by SBA that are eligible for SBA financial assistance. The Directory will:

- ▶ Be maintained on SBA's website at <https://www.sba.gov/document/support-object-object-sba-franchise-directory>.
- ▶ Determine if a brand meets the FTC definition of a franchise
- ▶ Determine if the business model for the brand is eligible under SBA regulations.
- ▶ Provide an SBA Franchise Identifier Code if the brand meets the FTC definition
- ▶ Determine if an addendum is needed, and if so whether the franchisor will use the SBA Addendum (SBA Form 2462) or has an SBA Negotiated Addendum.

Use of the Directory

For applications involving a franchise or similar relationship that meets the FTC definition of a franchise, before submitting the application to SBA for non-delegated processing or requesting an SBA Loan Number for delegated processing the Lender must check the Directory to determine if it includes the Applicant's brand

- ▶ If the Applicant's brand is on the Directory, Lender may proceed with submitting the application to SBA or requesting an SBA Loan Number through E-Tran or SBA One
- ▶ If the Applicant's brand is not on the Directory, for non-delegated loans, Lender cannot submit the application to the LGPC, or for delegated loans, Lender cannot submit a request for a loan number and must follow the process to add a brand to the Directory.

Multiple Agreements

When an applicant operates under multiple agreements:

1. CDCs must check the Directory to ensure that all of Applicant's agreements that meet the FTC definition of a franchise are on the Directory. If any of the agreements that meet the FTC definition are not on the Directory, **THE APPLICATION CANNOT PROCEED.**
2. If all agreements that meet the FTC definition are on the Directory, the CDC must determine which agreements are **critical** (agreement or products, services or trademarks covered by it – account individually or together with other agreements for more than 50% of the applicant's revenues).
3. CDC need only follow the Directory (i.e. obtain an addendum) for agreements that meet the FTC definition of a Franchise **AND** are critical.
4. If one of the Applicant's brands or agreements has been determined by SBA to be ineligible for SBA financial assistance, the loan cannot be processed, regardless of whether the brand or agreement meets the FTC definition of a franchise or is critical to the Applicant's business.

Single, Non-Critical Agreements

- ▶ Exception for Applicants Operating under a Single, Non-Critical Agreement:
 - ▶ CDC must first check the Directory to ensure that, if the agreement meets the FTC definition of a franchise, it is on the Directory before processing the application. If the agreement meets the FTC definition of a franchise, but is not on the Directory, THE APPLICATION CANNOT PROCEED.
 - ▶ If the agreement is not listed on the Directory and the CDC determines that the agreement does not meet the FTC definition of a franchise, the CDC must determine the brand is eligible (e.g. does not have discriminatory hiring practices) before proceeding with the application.
 - ▶ SBA will review this decision at the time of application for non-PCLP applications and prior to closing for PCLP applications.
 - ▶ SBA (the SBA Franchise Team) will make the final determination for non-PCLP applications.
 - ▶ PCLP CDC bears the risk of an incorrect determination and the loan not able to close on a PCLP application.

Procedure to Add Brands to the Directory

Franchisor must submit the agreement, Franchise Disclosure Document (FDD) if applicable, and all other documents the franchisor requires the franchisee to sign to franchise@sba.gov

- ▶ If someone other than the Franchisor submits the documents to SBA for a brand to be added to the Directory, contact information for the Franchisor (name and email address) **MUST** be included.

Review Process for Placement on the Directory

- ▶ If the franchisor agrees to use SBA Form 2462 (SBA Standard Addendum) SBA will only conduct an eligibility review and will not review affiliation.
- ▶ If the franchisor elects not to use the SBA Form 2462, SBA will work with the franchisor to resolve any affiliation issues, including through the use of an SBA Negotiated Addendum, if necessary.

Review Process for Placement on the Directory

- ▶ Upon completion of SBA's review and a determination by SBA that the brand is eligible, SBA will list the brand on the Directory, along with an indication of whether the brand meets the FTC definition of a franchise, the type of Addendum being used, if necessary, and will assign an SBA Franchise Identifier Code.
- ▶ If SBA determines that the brand does not meet the FTC definition of a franchise, SBA will list the brand on the Directory but will indicate that it is not a franchise and SBA will not assign an SBA Franchise Identifier Code

Franchisor Certification (SBA Form 2464)

- ▶ For those franchises listed on the Directory that either do not need an addendum or are using an SBA Negotiated Addendum, in order to continue using no addendum or an SBA Negotiated Addendum, the franchisor must submit to SBA each year the “Annual Franchisor Certification” (SBA Form 2464).
- ▶ **This certification is provided by the Franchisor to SBA annually. CDCs do not need to obtain SBA Form 2464 or provide it to SBA.**

Issues that Result in Affiliation

Transfer or Change of Ownership

- ▶ Franchisor has the option or right of first refusal (ROFR) to purchase an interest in the franchise and become a partial owner of the Franchisee.
- ▶ Franchisor's consent to the sale or transfer of any interest in the franchise (full or partial) is based on the Franchisor's "sole discretion" or the agreement is silent on the standard for consent.
- ▶ Franchisee remains liable for the actions of the transferee after transfer of the franchise

Affiliation

Sale of Assets

- ▶ Franchisor or an appraiser selected by the Franchisor solely controls the valuation of assets when the Franchisor has the option or ROFR to purchase assets, including real estate, upon default or termination of agreement.
- ▶ Franchisor has the right to force the Franchisee to sell the Franchisee's real estate upon default or termination of agreement.

Affiliation

Covenants or Use Restrictions

- ▶ Franchisor has recorded or has the right to record against the Franchisee's real estate any restrictive covenants, branding covenants or environmental use restrictions (e.g., restricting the use of the property upon sale).
- ▶ If there are any restrictions recorded against the franchisee's real estate, they must be removed before the loan can be approved/closed.

Affiliation

Control of Employees

- ▶ Franchisor has the authority to directly control (hire, fire or schedule) Franchisee's employees.
- ▶ For temporary personnel franchises, Franchisor (not the Franchisee) employs the temporary employees.

7a Procedure to Submit Franchise Application

For non-delegated loans:

- ▶ if the Applicant's brand meets the FTC definition of a franchise, Lender must identify the name of the franchise and the SBA Franchise Identifier Code when entering the application into E-Tran or SBA One.
- ▶ **No other franchise documentation must be submitted to the LGPC with the application.**
- ▶ The LGPC will confirm that the brand is listed on the Directory.
- ▶ If the Lender determines that the Applicant's brand does not meet the FTC definition of a franchise, and it is not on the Directory, then the Lender needs to explain its determination in its credit memorandum when submitting the application to the LGPC and provide the agreement and any additional documentation required by the brand for SBA's review and final determination.

Procedure

For delegated loans:

- ▶ If the applicant's brand meets the FTC definition of a franchise, Lender must document in its file that the applicant's brand is on the Directory and identify the name of the franchise and SBA Franchise Identifier Code when entering the application into E-Tran or SBA One
- ▶ Lender will need to submit the documentation showing that the Applicant's brand is on the Directory with any guaranty purchase request.
- ▶ If the applicant's brand is not on the Directory and the delegated lender determines the brand does not meet the FTC definition and proceeds with approving the loan under its delegated authority, SBA will review this decision at time of purchase or when conducting Lender oversight activities and the delegated Lender bears the risk of an incorrect determination.

Procedure

- ▶ When an Applicant operates under multiple brands, the Lender must enter the name of the franchise and the SBA Franchise Identifier Code for the brand that generates the largest amount of the Applicant's revenue in E-Tran or SBA One.
- ▶ The Lender must identify all other brands and their SBA Franchise Identifier Codes (if applicable) in the Lender's credit memorandum.
- ▶ For non-delegated loans, the LGPC will confirm that all brands are eligible and those brands that meet the FTC definition of a franchise that are critical to the Applicant's business operation are on the Directory.
- ▶ Delegated Lenders must document in their file that all brands are eligible and those brands that meet the FTC definition of a franchise that are critical to the Applicant's business operation are on the Directory, and will be required to submit that documentation with any guaranty purchase request.

Procedure

- ▶ If the applicant franchisee has multiple locations and each location operates under a separate franchise agreement, each location (i.e., each agreement) must have its own SBA Form 2462 or an SBA Negotiated Addendum, if applicable.
- ▶ If the applicant applies for further assistance under an agreement that already has an executed addendum, Lender will not need to obtain a new addendum in connection with the subsequent application for financial assistance. (Lender will still need to document its file with the executed documents.)

Procedure

- ▶ For all 7 (a) loans, prior to any disbursement of loan proceeds, the Lender must obtain a copy of the executed franchise agreement, the executed SBA Form 2462 or SBA Negotiated Addendum (if applicable), and any other document the franchisor requires the franchisee to sign.
- ▶ In order to ensure the Lender obtained the required documents and the documents were properly executed, SBA may review these documents when conducting Lender oversight activities and they must be provided with any request for SBA to honor the guaranty on a defaulted 7(a) loan.

504 Procedure to Submit Franchise Applications

- ▶ If the non-PCLP CDC determines that the Applicant's brand does not meet the FTC definition of a franchise and it is not on the Directory, then the CDC needs to explain its determination in its credit memorandum when submitting the application to the SLPC and provide the agreement and any additional documentation required by the brand for SBA's review and final determination. *The SLPC will submit the documentation to the SBA Franchise Team for review and the final determination. Alternatively, the CDC can submit the documentation directly to the SBA Franchise Team before submitting the application to the SLPC.*
- ▶ If the Applicant's brand is not on the Directory and the PCLP CDC determines the brand does not meet the FTC definition, the PCLP CDC must submit the documents to franchise@sba.gov for a final determination by SBA. After receiving SBA's final determination, the PCLP CDC may proceed with approving the loan under its PCLP authority.

Non-PCLP Closing Process

- ▶ For all 504 loans, **PRIOR TO CLOSING**, the CDC must obtain a copy of the executed franchise agreement, the executed SBA Form 2462 or SBA Negotiated Addendum (if applicable), and any other document the franchisor requires the franchisee to sign.
- ▶ CDCs obtain the SBA Negotiated Addendum from the franchisor (not SBA). *NOTE: A Franchisor may choose to use SBA Form 2462 even if it has an SBA Negotiated Addendum unless there is a note on the Directory stating the Franchisor can only use a Negotiated Addendum.)*
- ▶ While it is prudent for the CDC to review the FDD, as it contains financial information on the franchise brand, it is not necessary for the CDC to retain a copy in its file.
- ▶ CDC must provide the executed documents to and receive approval from the SLPC **PRIOR** to submitting the closing package for debenture funding on a 504 loan.
- ▶ Prior to issuing their approval, the SLPC will send the documents to SBA closing counsel in the District Office for review.

PCLP Closing Process

- ▶ The PCLP CDC will need to submit documentation showing that the Applicant's brand is on the Directory to SBA Counsel for approval PRIOR to submitting the closing documents to SBA Counsel.
- ▶ For all 504 loans, prior to closing, the PCLP CDC must obtain a copy of the executed franchise agreement, the SBA Form 2462 or SBA Negotiated Addendum (if applicable), and any other document the franchisor requires the franchisee to sign.
- ▶ PCLP CDC obtains the SBA Negotiated Addendum from the Franchisor (not SBA).
- ▶ PCLP CDC is encouraged to review the FDD, if applicable, but is not required to obtain or retain a copy in its file.

PCLP Closing Process

- ▶ PCLP CDCs must submit the executed documents to and receive approval from SBA Counsel PRIOR to submitting the closing package for debenture funding on a 504 loan.
- ▶ The documents must go directly to SBA closing counsel in the District Office, not to the SLPC.

Development Agreement

Ineligible Franchise Development Agreements contain the following:

- ▶ Provide the developer with a geographic area with which to establish additional franchise units which are owned and operated by other franchisees.
- ▶ Developer's income is derived from the royalty payments from each franchisee in the developer's geographic territory.

SBA has determined these are passive and, therefore, an applicant operating under this type of Franchise Development Agreement is not eligible for SBA financing.

Development Agreements

- ▶ If an applicant franchisee has an affiliate that operates under an ineligible Franchise Development Agreement, the applicant franchisee may be eligible for SBA financial assistance, provided that the applicant and its affiliates are small and no SBA loan proceeds are used for the benefit of the ineligible affiliate franchise developer.

Area Development Rights

- ▶ An applicant franchisee that is or will be operating under a franchise agreement that provides the franchisee with the right to develop additional units that the franchisee or its affiliates own and operate within its territory (“area development rights” or “Multi-Unit Franchise Agreement”), however, may be eligible provided that the applicant and its affiliate franchise units is small.

Franchisor Applicant

- ▶ A Franchisor's relationship with its franchisees under a franchise agreement must be considered when making a size determination for an applicant franchisor.
- ▶ If affiliation is found based on the franchise agreement, the Franchisor may execute a global addendum to resolve any affiliation issues.
- ▶ If the applicant is a franchisor, to request a determination of affiliation and, if necessary, obtain a franchisor global addendum, please contact franchise@sba.gov.

Questions on SBA Franchise Policy

- ▶ For Questions on SBA's Franchise Policy: franchise@sba.gov.
- ▶ Franchisors that would like to appeal SBA's decision not to place them on the Directory may do so by forwarding a copy of the decision, along with an explanation of how the determination is perceived to be inconsistent with this SOP, to franchise@sba.gov. Franchise appeals will be reviewed by the SBA Franchise Committee comprised of OFA and OGC personnel.
- ▶ Certain issues involving businesses that may be engaged in promoting religion, that may have activities of a prurient nature, that involve any activity that is illegal under federal, state, or local law (such as a marijuana dispensary), or that appear to discriminate may be referred to the Associate General Counsel for Litigation for a decision. **THERE IS NO RIGHT OF APPEAL TO THE FRANCHISE COMMITTEE**

Management Agreements

- ▶ Businesses that have entered into a management agreement with a third party that gives the management company sole discretion to manage the operations of the business, including control over the employees, the finances and the bank accounts of the business, with no involvement by the owner(s) of the Applicant business, are considered passive and are not eligible.

Management Agreements

- ▶ Management agreements that give the management company sole discretion over the business operations with minimal oversight of the decision-making by the Applicant business, while not passive, create affiliation between the management company and the Applicant business.
- ▶ SBA has determined, however, that affiliation is not created between the Applicant business and the management company if the management agreement includes meaningful oversight by the Applicant business over the management company's activities.
 - ▶ “Meaningful oversight” by the Applicant business means involvement in the decisions made concerning the operation of the business, which include a management agreement that provides for the Applicant business to do all of the following: approve the annual operating budget, approve any capital expenditures or operating expenses over a significant dollar threshold, have control over the bank accounts, and have oversight over the employees operating the business (who must be employees of the Applicant business).

Process for Review of Management Agreements

- ▶ If the applicant will be using a management agreement, for non-delegated loans, Lender must submit the management agreement to the LGPC to determine if it creates affiliation between the Applicant and the management company.
- ▶ If a delegated Lender is processing the loan under its delegated authority, the Lender must review the management agreement to determine if it creates affiliation between the Applicant and management company.
- ▶ Par II D.7 of Chapter 2 provides guidance on affiliation based on management agreements.

Management Agreements

- ▶ The SLPC, not the SBA Franchise Team, reviews management agreements.
 - ▶ Non-PCLP CDCs submit the management agreement to the SLPC
 - ▶ PCLP CDCs review the management agreement to determine if it results in affiliation between the applicant and management company or results in a passive business. PCLP CDC bears the risk of its incorrect determination.
- ▶ Management agreements are not listed on the SBA Franchise Directory.
- ▶ If an Applicant franchisee is operating under a management agreement where the management company is the Franchisor or is affiliated with the Franchisor, then the Applicant is NOT eligible. SBA has determined that such a relationship does not result in the franchisee operating as an independent small business