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“The Regulation of Franchising in the European Union”

Philip Mark Abell

Queen Mary, University of London

PhD

4 July 2011
I confirm that the work presented in this thesis is my own work.

.................................

PHILIP MARK ABELL

4 July 2011
“The strictest law often causes the most wrong”

*Marcus Tullius Cicero – 106-43 B.C*
Abstract

Business format franchising is a specific, distinct and uniform type of commercial activity with significant economic impact in the European Union. It stimulates economic activity by offering significant advantages to all those involved, improving distribution and giving business increased access to other member states. It comprises nearly 10,000 franchised brands, which account for over €215 billion (US$300 billion) turnover per annum. However, compared to its scale in the USA and Australia, franchising is not realising its full potential in the EU. Its disproportionate concentration in the UK, Germany, France, Italy and Spain also evidences that franchising is not promoting trade between member states as much as it could and should do.

Applying a comparative law approach and drawing upon member states’ existing statutory laws, this thesis seeks to show that this underdevelopment of franchising in the EU is, in part, due to the regulatory environment it is subject to. This is primarily because of two distinct factors. Firstly, a failure by the member states’ regulatory eco-systems to adequately govern franchising. They fail both to adequately reinforce the economic drivers that attract franchisors and franchisees to franchising and to reduce to an appropriate level the inherent consequential risk to which both parties are exposed. Secondly, there is a lack of homogeneity between the different legal eco-systems which amounts to a barrier to trade between member states.

It is proposed that the adoption of an appropriately drafted directive will not only harmonise the approach of the EU’s legal eco-systems towards franchising but will also re-enforce the relevant economic drivers and reduce the inherent consequential risks to an appropriate level. It is suggested that the directive does this by accentuating the influence of three commercial imperatives on the EU’s legal eco-systems. These are promoting market confidence in franchising, ensuring pre-contractual hygiene and imposing a mandatory taxonomy of rights and obligations on to the franchise relationship.
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Abbreviations

BAG: Bundesarbeitsgericht (Federal Supreme Court for Labour law)

BB: Betriebsberater (Business Advisor)

BFA – British Franchise Association

BGB: Bürgerliches Gesetzbuch (Civil Code)

BGH: Bundesgerichtshof (Federal Supreme Court for Civil law)

CA – Court of Appeal


DStR: Deutsches Steuerrecht (German Tax Law)

EFF – European Franchise Federation

FCA – Franchise Council of Australia

FFF – French Franchise Association

FSMA – Financial Services and Marketing Act 2000 (UK)

FTC – Fair Trade Commission (USA)

GWB: Gesetz gegen den unlauteren Wettbewerb (Anti-trust law)

HGB: Handelsgesetzbuch (Commercial Code)

HL – House of Lords

IFA – International Franchise Association (USA)

KG: Kammergericht (Court of Appeal in Berlin)

KSchG: Kündigungsschutzgesetz (Termination Protection Act)

LG: Landesgericht (Lower Court)

NGO: Non Governmental Organisation
NJW: Neue Juristische Wochenzeitschrift (New Judicial Weekly Journal)

NJW-RR: Neue Juristische Wochenzeitschrift Rechtsprechungsreport (New Judicial Weekly Journal Case Reports)

OECD – The Organisation for Economic Co-operation and Development

OJ – Official Journal of the European Community

OLG: Oberlandesgericht (Court of Appeal)

SME – Small and Medium Sized Enterprise

TFEU – Treaty of the Functioning of the European Union

TPA – Trading Practices Act (Australia)

UNIDROIT – The International Institute for the Unification of Private Law

VerbrKrG: Verbraucherkreditgesetz (Consumer Protection Act)
Chapter 1  Introduction

1.1  Problem Review

1.1.1  The under development of Franchising the Single Market

Franchising substantially contributes to the GDP of a number of EU member states. In the
UK in 2009 it contributed £11.8 billion\(^{1}\), in Germany €48 billion\(^{2}\) and France €47.6 billion\(^{3}\).
The estimated turnover of franchising in the EU is over €215 billion (US$300 billion)
generated by over 9,971 franchises\(^{4}\).

Franchising normally stimulates economic activity by improving the distribution of goods
and/or the provision of services as it gives franchisors the possibility of establishing a
uniform network with limited investment, which may assist the entry of new competitors in
the markets particularly in the case of small and medium sized enterprises. It allows
independent traders to set up outlets more rapidly and with a higher chance of success than if
they were to set up without the franchisor’s experience and assistance. Franchisors therefore
have a better opportunity to compete with larger distribution undertakings\(^{5}\).

Franchising also generally allows consumers and other end users a fair share of the resulting
benefits, as they combine the advantage of a uniform network with the existence of traders
personally interested in the efficient operation of their business. The homogeneity of the
network and the constant co-operation between the franchisor and the franchisees ensures the
constant quality of the products and services. The favourable effect of franchising on inter
brand competition and the fact that consumers are free to deal with any franchisee in the
network guarantees that a reasonable part of the resulting benefits will be passed on to
consumers\(^{6}\).

It is therefore a significant economic activity in the EU. However, a comparison with the
level of franchising activity in the US\(^{7}\) and Australia\(^{8}\), suggests that it is markedly

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\(^{1}\) The NatWest/BFA 2010 Franchise Survey – The British Franchise Association.
\(^{3}\) French Franchise Federation Report, 2010
\(^{4}\) European Franchise Federation Statistics – [www.eff.franchise.com](http://www.eff.franchise.com) (viewed 23/12/2010) See Section 2.2.2 below
\(^{6}\) Ibid
\(^{7}\) 600,000 franchised businesses generating an estimated total turnover of US$12 trillion in 2005 according to Iuliana. S and Mihaela. M, 2009, "The High Impact of Franchising on Economic Affairs in Some of the EU Members" by, Annals of Faculty of Economics, volume 1, issue 1, pages 251-256 (Published by the University of Oradea, Faculty of Economics) The turnover of franchised businesses in the USA is estimated at US$868.3 billion, in Australia US$130 million and the EUS$300 billion see 2.2.3 below for fuller analysis.

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underdeveloped in the EU. This in turn suggests that franchising has potential for substantial further growth in the EU.

1.1.2 The Under-Development of the Regulatory Environment

A mixture of economic, cultural and historical factors account for much of this comparative under development of franchising in the EU. The lack of a supportive pan EU, homogenous regulatory environment is also a contributory factor. It is suggested that a uniform and supportive regulatory environment would help to facilitate and encourage the further growth of franchising in the EU, particularly between member states and so support the single market in a significant manner.

As stated in existing EU legislation\(^8\), the differing approaches to regulating commerce found in EU member state laws are detrimental to the functioning of the single market and substantially reduce its ability to stimulate trade between member states by improving the distribution of goods and provision of services within the EU. This heterogeneous regulatory environment is detrimental to both the protection available to franchisors and franchisees vis-à-vis each other and to the security of commercial transactions. These differences substantially inhibit the conclusion and operation of franchise agreements where franchisor and franchisee are established in different member states.

1.1.3 Re-engineering the Environment

The trade in goods and services between member states should be carried on under conditions which are similar to those of a single market. There is therefore a need to approximate the legal systems of the member states to the extent required for the proper functioning of franchising in the common market.

In pursuing the goals of economic growth, job creation, consumer satisfaction and commercial innovation such as franchising needs to be encouraged. Franchising contributes to the establishment of a single European Market. It facilitates cross-frontier development as it is based on the leverage which an established name or idea can give a relatively small investment to enable the product or service involved to spread quickly, far and wide\(^10\).

Franchising is a commercial phenomenon particularly well suited to the challenges of the single market. The combination of a franchisor’s know-how and a franchisee’s enterprise can boost economic activity and employment, while enlarging the range of goods and services on

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8 An estimated turnover of US$130 billion in a country with a GDP that is less than 10% of that of the EU (Franchise Council of Australia – www.franchise.org.au)
offer to the public. Franchising makes products and services available to a wide public and does not have to stop at national frontiers. The regulatory environment should therefore be re-engineered to enable franchising to fulfil this potential.

Given the heterogeneous policy legacies in the EU member states as well as the diverse preferences of national governments and other domestic actors, a one-size-fits-all approach is neither politically feasible nor normatively desirable. A certain amount of flexibility and variation will therefore be needed to successfully re-engineer the regulatory environment. It is therefore suggested that a directive would be the appropriate catalyst for the required re-engineering.

1.2 Existing Research on the Regulation of Franchising in the EU

There is a rich seam of commentary on the regulation of franchising but there is little work which considers franchising’s under-contribution to the EU’s economy or the extent to which the EU regulatory environment contributes to this and could be re-engineered to increase cross border business by promoting the use of franchising in the EU.

Books such as “Franchising. Practice and Precedents in Business Format Franchising”\(^{11}\), “Business Franchise Guide”\(^ {12}\), “International Franchising”\(^ {13}\) and “European Franchising – Law and Practice in the European Community”\(^ {14}\) are practitioner focused setting out relevant law in appropriate jurisdictions but giving little if any analysis of the bigger picture within the EU or the general principles of regulation.

The International Journal of Franchising Law (IJFL)\(^ {15}\) has published a small number of more scholarly works although the articles are generally restricted to analysis of franchise specific laws in an individual jurisdiction\(^ {16}\) and the impact of general law upon franchising in a specific jurisdiction\(^ {17}\). Only a few focus on wider, less parochial issues. Baer, Metslaff and Weinberg\(^ {18}\) consider how international treaties, conventions and agreements impact upon franchising. However, this wide ranging and rather meandering work touches upon the likes of the Berne Convention on Copyright, The Paris Convention on the Protection of Industrial Property, TRIPS, WTO, the UN Convention on Contracts for the International Sale of Goods

\(^{12}\) CCH, Business Franchise Guide.
\(^{15}\) Edited by Martin Mendelsohn and published by Richmond
\(^{16}\) See Appendix 13 for a list of articles on franchise specific laws.
\(^{17}\) See Appendix 13 ibid.
and the North American Trade Agreement in a rather superficial and disjointed manner delivering no conclusion or recommendations.

In “International Franchise Agreements – Research, Risk and Reward”19 Zaid considers key clauses in international franchise agreements but does not focus on general or specific principals of regulation and makes no observation or recommendations as regards the regulation of franchising. In “Stranger in a Strange Land: Contrasting Franchising Alternatives in International Franchising”20 Wormald and Scott consider the impact of varying franchise structures but do not deal with regulatory issues.

“Disclosure in International Franchising”21 by Baer, Flohr, Polsky and Hero delivers what is perhaps the most thoughtful overall consideration of franchise disclosure laws in a number of different jurisdictions. However, this again mostly catalogues regimes in different jurisdictions rather than identifying trends and seeking to analyse their success, failure or appropriateness. The only general questions addressed are essentially pragmatic ones such as “How does a lawyer in a non-disclosure country cope with the disclosure laws in other countries?”

In “Franchise Sector Regulation: The Australian Experience”22 Terry relates the Australian experience of regulation. His conclusion that “a healthy franchising sector requires adequate and appropriate infrastructure to which the legal environment is central”, remains at a very general level but lays the ground for more detailed consideration of franchise regulation and the principles underlying it.

In “The Importance of Cultural Differences When Expanding a Franchise Internationally” Schulz and Kozuka23 explore the need for localisation of a franchise concept in order to increase the chances of commercial success. They raise doubts over the success of UNIDROIT’s attempt to improve understanding of franchising through the publication of “A Guide to International Master Franchise Agreements”24. This is a theme taken up later in

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24 UNIDROIT, Guide to International Master Franchise Arrangements.
this study. The UNIDROIT publication’s lack of original thinking and failure to make any innovative recommendation is as striking as it is disappointing.

Much academic research into the role of franchising in inter state trade within the EU has focused upon its vertically integrated nature and potential to prevent, restrict and distort competition between member states. This line of analysis focuses upon the Pronuptia decision of the European Court of Justice\textsuperscript{25}, the various decisions of the Commission on the impact of what was then Article 85 of the Treaty of Rome\textsuperscript{26}, the Franchise Block Exemption\textsuperscript{27} the two Vertical Restraint Block Exemptions that superseded it\textsuperscript{28} and relevant member state decisions such as Crehan\textsuperscript{29}.

Crossick and Mendelsohn\textsuperscript{30}, Schmitz and Hamme\textsuperscript{31}, Ritter and Braun\textsuperscript{32} and a long catalogue of other commentators have gone into great detail about the need for franchisors to be able to impose certain restrictions on their franchisees to protect their image and reputation, grant exclusive territories, tie in goods and services and so on. Korah\textsuperscript{33} and Mendelsohn and Rose\textsuperscript{34} in particular have produced long, valuable and detailed texts. However, all of these commentaries are concerned solely with the Vertical Restraints that exist in a franchise relationship and how and in what circumstances they can, or should be seen as, being pro-competitive. They do not consider how the differing legal provisions of EU member state law or typical provisions found in franchise agreements support or undermine the economic drivers of franchising or reduce the consequential risks.

This thesis analyses the way in which competition law protects the public interest in franchising by preventing distortion of the market but in contrast to existing works, looks beyond the technical way in which anti-trust laws are applied to franchising. It places the regulation of vertical restraints in franchising into the bigger picture of how franchising can

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\item \textsuperscript{25} Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schullgallis (Case 161/84) [1986] 1CMLR 414
\item \textsuperscript{27} Regulation (EEC) 4087/88
\item \textsuperscript{28} Regulation (EC) No. 2790/1999
\item \textsuperscript{29} Case C-453/99 Courage Ltd v Bernard Crehan [2002] QB507, [2001] ALLER CEC886
\item \textsuperscript{34} Mendelsohn. M and Rose. S, 2002, Guide to the EC Block Exemption for Vertical Agreements, Kluwer law International
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be best regulated. It concludes that the “per se” approach adopted by the European Commission is inappropriate. Instead it recommends one more in line with the Chicago School’s “rule of reason” approach – as recommended by the OECD and evidenced in the Leegin decision of the US Supreme Court. This would mean focusing less on intra brand competition and allowing franchise chains to compete on a level playing field with corporate chains in terms of retail price maintenance, and harmonised multi channel strategies, including use of the internet. This “Exchange of Benefits” approach will help promote and encourage the use of franchising and be pro-competitive.

The UNIDROIT Study of Franchise Regulations\footnote{UNIDROIT Model Franchise Disclosure Law – September 2002} is not restricted to the EU but is applicable to it. Unlike this thesis it is limited to pre-contractual disclosure and does not analyse the contents of franchise agreements and how they might be regulated. Its consideration of the issues involved in disclosure is somewhat shallow and its conclusions are little more than a patchwork based upon the preferences of the individual practitioners involved in the study\footnote{http://www.sgecc.net accessed 14 August 2009}. This study is not restricted to consideration of pre-contractual disclosure. Its consideration of disclosure is based upon how it can be formulated to best protect the interests of both franchisor and franchisee. Its conclusions on disclosure are far more radical than those of UNIDROIT, recommending for example franchisee disclosure at the request of the franchisor and considering whether liability for non-disclosure should be strict or dependent upon ‘defective consent’.

The Report of the Study Group on a European Civil Code (“the Study Group”) seeks to identify how to overcome obstacles to the functioning of the internal market. It, inter alia, proposes a way in which to harmonise the regulation of franchising in the EU. It does so based upon its stated objective to produce “a set of codified principles which constitute the most suitable private law rules for Europe wide application”\footnote{Communication from the Commission to the European Parliament and the Council, A More Coherent European Contract Law, An Action Plan, COM (2003) 68 final.}.

Since the Commission on European Contract law (led by Professor Ole Lando) in 1982, the European Parliament’s first resolution on private law in 1989 and the Commission’s subsequent communication on European contract law in 2001 there has been a good deal of academic debate about the development of private law. This led to the establishment of various research projects\footnote{Such as the Trento Common Core Project of European Private Law and the Research Group on the Existing European Community Private law (Acquis Group)} and the European Commission’s Action Plan for a more coherent European Contract law\footnote{Such as the Trento Common Core Project of European Private Law and the Research Group on the Existing European Community Private law (Acquis Group)}}. Reactions to the Action Plan were summarised in “European
Contact Law and the revision of the acquis: the way forward”40 (“The Way Forward”). The second part of The Way Forward dealt with the preparation of a common frame of reference (CFR) to “improve the quality and consistency of the acquis in the area of contract law”41. Academics have played a central role in elaborating the CFR42. The so-called “Network of Excellence”43.

This produced specific recommendations for the regulation of franchising in the EU. This study group (“the Study Group”) has stated that the principles impacting upon franchising have not been drafted with a specific protection aim, but to save transaction costs for the parties by providing for “possible problems, solutions which parties would presumably agree to”44. Nevertheless the Study Group aimed to achieve a balance between the competing interests of the parties and so did not only seek to reflect the common core of solutions in the EU member states as regards franchising but other sources such as the UNIDROIT model disclosure law45 and the International Chamber of Commerce’s model for International Franchising Contract46.

The “Amsterdam Group” was established to work with national reporters who were asked to answer several questionnaires concerning the main legal issues as regards commercial agency, franchising and distribution47. After formulating its proposals the Amsterdam Group discussed them with an Advisory Council consisting of various academics48. The Working Party’s recommendations were then reviewed by the Co-ordinating Committee which comprises some 50 professors from around the EU.

The recommendations can therefore be seen as an authoritative academic work on the regulation of franchising in the EU. However, it is not free of political influence and some

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41 The Way Forward, pp9-13
42 The Acquis Group and the Insurance Group
43 See www.copecl.org. The Network of Excellence was funded by the Commission in May 2005 under the Sixth Framework Programme for Research
47 The Dutch group of reporters consisted of researchers of different European jurisdictions who provided information on their own legal systems: Georgios Arnokourous (Greek Law), Odavia Bueno Diaz (Spanish Law), Rui Miguel Patricio Cascao (Portuguese Law), John Dickie (Common Law), Christoph Jeloschek (Austrian Law), Roland Lohnert (German Law), Andrea Pinna (French Law), Manola Scotton (Italian Law), Hanna Sivesand (Swedish Law), Muriel Veldman (Dutch Law), Aneta Wiewiorowska (Polish Law).
48 The members of the Advisory Council on Commercial Agency, Franchise and Distribution Contracts are Professor Johny Herre (Stockholm), Professor Jérôme Huet (Paris), Professor Ewan McKendrick (Oxford), Professor Peter Schlechtriem (Freiburg i.Br.), Professor Hugh Beale (London/Warwick) and Professor Christina Ramberg (Stockholm)
commentators feel that its exclusion of other stakeholders coupled with the Commission’s clear political agenda of “Europeanisation” undermines its objectivity and value. The Amsterdam Group’s proposal can be seen as little more than a distillation of existing jurisprudence in EU civil law jurisdictions. It fails to consider the valuable insights offered by non legal academic analysis of the nature of franchising. This results in an extremely narrow understanding of how legal regulation can support and encourage the efficient exploitation of the single market by companies through the medium of franchising.

However, some commentators believe that applying the recommendations of the Amsterdam Group will “most probably lead to a win-win situation for the parties on franchising …” Bueno Diaz’s consideration of Franchising in European Contract Law is a prime example. It is focused on the Study Group’s proposals for commercial agency, franchising and distribution contracts. It restricts itself to comparing it with the provisions of the French Loi Doubin (Article 330 of the Civil Code) and the Spanish Retail Law (Article 62 of Law No. 7/1996). It compares the policies that underpin the respective laws in franchising in France and Spain and identifies the Study Group’s proposals as the rational choice for parties involved in franchising in the EU. This study takes a much broader focus. It identifies the reasons for franchising’s popularity, analyses the way it is currently regulated in the EU, recommends the re-engineering of the regulatory environment so that the legal eco-systems more closely reflect the impact of three commercial imperatives – market confidence, pre-contractual hygiene and protecting the interests of franchisors and franchisees through a mandatory taxonomy for franchise agreements.

The most fundamental difference is that whereas the Study Group does not meaningfully distinguish franchising from commercial agency and distribution, this thesis argues that franchising is markedly different to them and should be recognised as a “type-agreement” in its own right. This study also identifies good faith as an important “doctrinal tool” in dealing with the franchise relationship and disputes that arise out of it. After considering the influential German approach to good faith based on BGB 242, the French concept of Bonne Fois and England’s ad hoc approach, it recommends a more refined approach based upon prohibiting unconscionable conduct and misleading and deceptive behaviour.

In contrast to the Study Group’s proposal for a European Commercial Code, this study proposes the enactment of a Directive, that will harmonise EU member state law by making

51 ibid
franchising a recognised “type-contract” with mandatory, non mandatory and essential rules. By dealing with detailed obligations and rights of the parties this approach will allow a level of flexibility that is likely to promote the use and sustain the success of franchising within the context of each member state’s legal tradition. This contrasts with the technocratic and politically driven agenda of the Study Group.

In several member states there is a wealth of commentary on franchising and how it is and should be regulated. In Germany commentators such as Skaupy52, Geisler53, Flohr54 and Martinek55 have produced prodigious amounts of work on franchising. However, these are mostly somewhat parochial in nature and focus almost entirely upon the underlying nature of a franchise agreement and how it should be treated under German law – as a licence, a business management contract, a service agreement, a lease, a sale of goods agreement or a mixed agreement. Martinek also focuses upon the impact of the relative economic bargaining power of the parties involved, and hypothesises that these lead to there being two distinct types of franchise activity, which he labels “subordination franchising” and “partnership franchising”, the latter of which breaks down into three sub-categories “co-ordination”, “coalition” and “confederation” franchising. This study suggests that this analysis is not reflected in the franchise agreements considered by it and so questions its validity.

There appears to be little appetite in Germany for a homogenised European approach to the regulation of franchising, as articulated by Giesler, who believes that franchise specific legislation could hinder the development of franchising and that, so far, Germany has done well without it56.

In France there are numerous studies by scholars such as Ghestin57, Guyon58, Huet59, Collart Dutilleul and Delebecque60, Malaurie, Aynés & Gautier61, Le Tourneau62, Ferrier63 and

52 Skaupy, Franchising, 2 Auflage 1995
53 Giesler, Handbuch Franchiserecht, 2 Auflage 2007
54 Eckhard Flahr, Franchisevertrag, 4 Auflage 2010
55 Martinek/Semler/Habermeyer/Flohr, Handbuch des Vertriebretachts, 3 Auflage 2010
56 Giesler, “Geisler/Nauschütz” Chapter 5, Rn 6c
57 Ghestin J, 1993, Traité de Droit Civil, la formation du Contrat, 3 ed, LGDJ, p. 200
58 Guyon, Y, Droit des affaires, T.I, Droit Commercial General et Sociétés n.835 Economica 1996
60 Collart Dutilleul and Delebecque 2002
61 Malaurie & Aynès & Gautier 2005
Leloup\textsuperscript{64}. These focus upon the way in which franchise agreements should be treated under French law and analysing France’s abundant case law on franchising. They do not tackle the case for the regulation of the entire franchise relationship at EU level or consider the difficulties that such an approach creates.

In Spain there is far less consideration of the regulation of franchising and what does exist is concerned mostly with the disclosure law and the way in which Spanish law impacts upon franchising. It does not consider broader European issues relating to franchising\textsuperscript{65}.

This study therefore breaks new ground in the consideration of the regulation of franchising in the EU. It endeavours to place a proposal for a single EU franchise law into an economic, commercial and legal context. It argues that franchising promotes the establishment of the single market but its effectiveness in doing so is reduced by the heterogeneous nature of relevant law in the EU.

1.3 Objectives and Scope of Study

This thesis studies the regulation of Business Format Franchising in the European Union. As the UK, Germany and France together accounted for 50% of the €215 billion (US$300 billion) franchising turnover in the EU in 2009\textsuperscript{66}, it focuses on these three member states. It contextualises this focus by a comparative reference to the US and Australia, (both of which are Federal States with highly developed regulatory regimes\textsuperscript{67}). It also tests its conclusions against empirical research amongst the relevant stakeholders, including franchisors, franchisees, potential franchisees and professionals engaged in franchising. The desirability of protecting the rights of franchisees is not disputed within the thesis. However, it will be underlined how this should not be the only purpose of regulation and that a balance must be struck between the protection of the rights of franchisees and the need to re-enforce the economic drivers that encourage both franchisors and franchisees to become involved in franchising in the first place. It is suggested that excessive protection of franchisees can have detrimental effects on both franchising and on the Single Market. This thesis suggests that such a critical balance can be achieved through a directive which re-engineers the regulatory environment in the EU by accentuating the impact of three commercial imperatives (market

\textsuperscript{63} Ferrier 2003 Droit de la distribution, 3 ed, Litec, 2002
\textsuperscript{64} J.-M. Leloup 2004, La franchise, droit et pratique, 4 ed, Delmas, Paris, 2004
\textsuperscript{65} Echebarria Saenz 1995
A. Hernando Giménez 2000
\textsuperscript{66} See page 26
\textsuperscript{67} And (mostly in footnotes) to the other 24 EU jurisdictions and the 21 jurisdictions outside of the EU that have franchise specific laws
confidence, pre-contractual hygiene and a mandatory taxonomy of rights and obligations) upon the various legal eco-systems. These commercial imperatives re-enforce the economic drivers that attract franchisors and franchisees to franchising and reduce the inherent consequential risk to an appropriate level.

The hypothesis of this thesis is that franchising has failed to fulfil its potential in the EU, that this is in part due to the regulatory environment and that this failure can be remedied by re-engineering the legal eco-systems that comprise the regulatory environment in the EU.

This thesis has three primary objectives.

The first objective is to establish that although franchising is a specific distinct and uniform type of commercial activity with positive influence in the EU, which stimulates economic activity by offering economic advantages to all those involved and improving distribution and giving businesses increased access to other member state markets, it is not fulfilling its full potential to contribute to the realisation of the single market. In order to do that it must first establish what franchising is. It does this by reference to franchising’s basic architecture, its historical development, its rationale and its contextualisation, differentiating it from other business models and identifying why franchisors and franchisees are attracted to franchising and are prepared to accept the inherent consequential risks. It then benchmarks the contribution of franchising in the EU against its contribution in the USA and Australia and concludes that it is not fulfilling its potential in the EU.

The second objective is to establish whether the regulatory environment in the EU is in any way responsible for this under achievement of franchising in the single market. It seeks to establish that regulation of franchising in some form is required and considers the difficulties encountered by member states in seeking to regulate it. It does this by considering the differing approaches of EU member states to constructing franchising’s contractual environment, its impact on the risks to which franchisors and franchisees are exposed and the commercial drivers that attract them to franchising. It considers the impact of the self regulatory system in the EU and then considers both the lack of homogeneity between the legal eco-systems that comprise the regulatory environment within the EU and the failure of those legal eco-systems to re-enforce the economic drivers that attract franchisors and franchisees to franchising or to reduce the inherent consequential risk. It analyses the nature of these shortcomings and the difficulties they impose upon franchising.

The third objective of this thesis is to consider how the regulatory environment in the EU can be re-engineered to enable franchising to better fulfil its potential in the EU. It proposes that this should be done by re-engineering the regulatory environment so that it imposes a harmonised approach across the EU which aims to accentuate the impact of three commercial
imperatives; promoting market confidence, pre-contractual hygiene and imposing a mandatory taxonomy of rights and obligations on to the franchise relationship. The harmonisation of laws within the EU has always been difficult. This thesis considers whether the trend amongst some academics and the EU “technocracy” to advocate the abandonment of the traditional methods of achieving this (Directives and Regulations) in favour of a European Civil Code is an appropriate way in which to re-engineer the regulatory environment for franchising.

In achieving these three objectives, this thesis will analyse, compare and criticise the solutions to the difficulties identified that have been proposed by academics and NGOs. It is then anticipated that a solution, both logically sound and politically acceptable, will emerge. It will be the author’s contention that the heterogeneous approach of member states to protecting franchisees is at odds with the political and economic desirability of encouraging the use of franchising in the single market. It is suggested that the solution will be based upon accentuating the impact of three commercial imperatives upon the legal eco-systems in the EU. These are the need to re-enforce market confidence, the need to ensure an appropriate level of pre-contractual hygiene and the need to impose a mandatory taxonomy of rights and obligations upon the franchise relationship. A draft EU Franchise Directive is proposed in Appendix 1.

This thesis will explore whether and how such a new regulatory environment could solve the problems under consideration, and how it could be implemented on an EU wide basis. This will involve analysis of the contractual architecture, economic drivers, commercial interests and, most importantly, the EU member state and other legal eco-systems.

This thesis aims only at providing a feasible theoretical tool in order to address the use of franchising in cross border trade within the European Union. It does not purport to provide technical or empirical guidelines concerning how to test such a theoretical tool.

1.4 Methodology, Sources and Limitations

In developing the arguments and recommendations set out in the thesis, the work had to draw upon several economic, technical and social propositions, all of which serve as a theoretical justificatory basis. However, the recommendations made within the thesis have, at all the times, been primarily inspired and influenced by the inherent trends that exist within statutory law (franchise specific laws and other laws that impact upon franchising) and case law. The theoretical tools of economics merely provide the explanatory basis of the law.
An applied comparative law approach is deemed appropriate for analysing and interpreting the existing international, regional and national laws. Accordingly, the analysis adopted in the thesis is based on three main sources of reference:

1. Legislative statutes and reported judicial decisions from various jurisdictions: References to statutes and judicial decisions from the jurisdictions of several countries have been made. However, due to the superfluity of referencing every country’s national law, the thesis has concentrated on the law of countries which have a mature franchise law, which have offered considerable legal thought and jurisprudence to franchising, and which also distinctly advocate different approaches to the solution. These countries are the UK, Germany, France, the USA and Australia. References have also been made to the sources of European Union Law. Furthermore, passing references have also been made, mostly by way of footnotes, to the relevant law in Spain, Italy, Belgium, Sweden, Romania, Latvia and Estonia (all of which are members of the EU and have franchise specific laws) and other countries outside of the EU which have franchise specific laws.

2. Legal literature, legislative reports and consultation documents: A wide range of public sources were consulted in the writing of this work. Legal literature, commentaries, treatises, committee reports, legislative reports and consultation documents from the various jurisdictions have all been relied upon as basis of comparison and upon which recommendations can be made. Recommendations and measures adopted in relation to these jurisdictions have been used, where appropriate, to fill any apparent lacunae in the existing law.

3. Empirical research: seven different pieces of empirical research have been undertaken to test propositions raised in this thesis. These include analysis of franchise agreements used by franchisors in the EU, disputes between franchisors and their franchisees, surveys of relevant stakeholders and interviews of other

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68 ‘Experience shows that this is best done if the author first lays out the essentials of the relevant foreign law, country by country, and then uses this material as basis for critical comparison, ending up with the conclusion about the proper policy for the law to adopt which may involve a reinterpretation of his own system’. Zweigert, K and Kötz, H, 1998, An Introduction to Comparative Law, 3rd edition, Clarendon Press, 6, 12

69 Citations and references to statutes which are currently in forces have been based on the official WIPO translations. References to repealed legislation have been based on such statutes, legal commentaries and treatises.

70 Here sober self-restraint is in order, not so much because it is hard to take account of everything as because experience shows that as soon as one tries to cover a wide range of legal systems, the law of diminishing returns operate’. Zweigert and Kötz [1998], op.cit. 39-40.
stakeholders. The empirical research does not pretend to be exhaustive or sufficiently authoritative to form the basis for any proposal in its own right. However, the research does help to test the validity of certain propositions in an appropriate manner.

3.1 A survey of Potential Franchisees was conducted during 2008 through interviews with individuals attending franchise exhibitions in London, Paris and Madrid who stated that they had an interest in buying a franchise. The aim was to try to identify the profile of potential franchisees and their reasons for considering purchasing a franchise. The questions asked were based upon the reasons identified by Stanworth and Kauffman and other academic commentators referred to in Chapter 2. 60 potential franchisees were surveyed at the British Franchise Exhibition at Olympia on 4 April 2008. 60 at the Salon de Franchise in Paris at Porte de Versailles on 16 March 2008. 60 potential franchisees at the Spanish Franchise exhibition at EXPO FRANQUICIA ’08 on 22 June 2008.

3.2 A survey of Franchisors was conducted in four EU member states. 25 Franchisors were interviewed in the UK, 25 in Germany, 25 in France and 25 in Spain. They were chosen because they are all undertaking business in more than one EU Member State or have stated their intent to do so. The interviews were conducted by way of a mixture of face to face and telephone interviews. All of the face to face interviews in Paris were conducted at the Salon de Franchise in Paris on 16 March 2008. All of the face to face interviews in Spain were conducted at Expofranquicia ’08 on 22 June 2008. Some of the face to face interviews in the UK were conducted at the British Franchise Exhibition at Olympia on 4 April 2008. All other interviews were conducted at a variety of meetings and through telephone interviews. All of the interviews with German franchisors were conducted by way of telephone in May 2008. The aim of the interviews was to (1) to understand the risks and advantages franchisors perceive in franchising their business (the questions reflect the reasons proposed by academics such as Blair and La Fontaine cited in Chapter 2 of this thesis) and (2) to understand their views of the regulation of franchising in the EU.

3.3 A survey of Franchise Lawyers was conducted. The interviewees are all listed as experts in franchising in the International Who’s Who of
Franchising, published by Law Business Research Ltd. An e-mail survey of the 25 lawyers detailed was conducted in June 2008. This was to obtain the view of highly experienced and reputed, international franchise practitioners on issues raised by academic research, in order to benchmark how those issues are reflected in practice.

3.4 A survey of Franchisees was conducted. The sample comprised UK franchisees who were then running a franchised business. This survey of 30 franchisees was conducted through a mix of telephone and face to face interviews between January 2004 and April 2007. Lack of an appropriate database and geographical proximity plus linguistic barriers meant that it was not possible to conduct a similar survey in any other EU member states. In order to encourage a candid response, anonymity of the respondents was essential. The aim was to understand the view of franchisees on self regulation and the reason they became franchisees. The questions were based upon the reasons outlined by Stanworth and Kauffman and other academic commentators referred to in Chapter 2 in the thesis.

3.5 A survey of Franchise Executives was conducted. Members of the sample were all senior executives in companies that franchise in the EU. They were interviewed either face to face or by telephone, sometimes complemented by written questions and answers. The aim was to obtain a better understanding of the commercial realities of the issues considered in this thesis. The Executives were interviewed by the author during the period March – July 2006.

3.6 An analysis of Franchise Disputes was conducted. 40 franchise disputes in the UK advised upon by the law firm, Field Fisher Waterhouse, during the period 2006-2010 were considered. Field Fisher Waterhouse is rated the UK’s leading franchise law firm by the Chambers Legal Directories from 2006 to 2010 and Europe’s foremost franchising practice in the Chambers Europe Director 2011. Lack of an appropriate database meant that it was not possible to conduct a similar survey in any other EU member state. The term “Dispute” is not limited to litigation, but includes disagreements which result in the involvement of legal advisers by at least one side. It is important to note that these grounds of dispute are those raised by the parties, not always proved to the satisfaction of a court. Face to face interviews
were conducted with the individuals involved in the disputes. The aim was to understand the reason for disputes between franchisees and their franchisor.

3.7 An analysis of Franchise Agreements was conducted. The agreements analysed are those of franchisors doing business in the three largest franchise markets in the EU (the UK, Germany and France) and two other jurisdictions in which franchising is common (the USA and Australia). The sample therefore includes agreements drafted under both civil and common law. The sample includes franchises in the retail, service, food and hotel sectors. It includes small scale “man in a van” job franchises and large scale hotel and restaurant franchises. It includes franchises that require a large upfront payment and those that require only a modest one. This is sufficient to give an appropriate understanding of the scale of investment and therefore the type of franchisee involved in each franchise as well as the general architecture of franchise agreements across different jurisdictions and commercial sectors.

4. There is a paucity of reliable and up to date information about the size of franchising in the EU, which in itself suggests that franchising is underdeveloped in the EU. The European Franchise Federation’s figures for 2009 only deal with 18 member states and contain a number of inaccuracies and inconsistencies. The most recent figures for the EU as a whole were published by Franchising Europe in 2005, but are incomplete and give no breakdown of how they are comprised. It has therefore been necessary to estimate the current turnover of franchising in the EU. Three different approaches have been adopted to produce a range of figures from which a mid-range figure has been taken to produce an estimated turnover for 2009 of €215 billion (US$300 billion). The three approaches are as follows; (1) increasing the Franchise Europe 2005 figure of US$200 billion by the same percentage as the number of outlets are reported to have increased over the same period by the 2009 EFF Survey; (2) increasing the 2005 figure by the same percentage as the turnover of France has increased of the same period; (3) comparing the number of outlets in the seven EU member states that had a turnover of US$250.4 billion in 2009 according to the EFF figures with those in the other 11 member states referred to in the 2009 EFF survey and increasing the turnover figure by the same percentage. None of these figures give a totally reliable figure. However, they do enable a logically justifiable estimate to be
The subject matter at hand has been approached from the perspective of (1) the law impacting upon the use of franchising as a way of doing business across European Union member state borders and so promoting the single market, and (2) the business efficacy of the regulatory environment of the EU as it relates to franchising.

The issues relating to intellectual property and the constitutional law of the European Union reach beyond the scope of this thesis, and are therefore mentioned throughout the work, but are not deeply analysed. Where deemed necessary, various references have been made to contract law, the duty of good faith, anti-trust law, commercial agency law, distribution law, unfair competition law, consumer protection law, employment law, private international law, and other member state law. Nevertheless this study does not purport to deliver a broad in depth or authoritative analysis of any of these. This study does not purport to provide a full and in depth analysis of German or French law.

All German language commentaries, case law and statutes have been translated into English by Babette Marzheuser-Wood, Rechtsanwälten and Solicitor of the Supreme Court of England and Wales and Vicky Reinhardt, Rechtsanwälten and Solicitor of the Supreme Court of England and Wales.

1.5 Terminology

In this thesis, the terms below will be employed with the following meanings:

“Franchising”: generally means business format franchising. When appropriate, a distinction will be drawn between business format franchising and other forms of franchising.

“Franchisor”: The entity that grants the use of the brand and business format to the franchisees.

“Franchisee”: The entity that is granted the use of the brand and business format by the franchisor.

“Business Format Franchise”: a package of intellectual property rights relating to trade marks, trade name and know-how to be exploited for the resale of goods or the provision of services to end users. A fuller definition is detailed in Chapter 3.

“Business Format”: the know-how of the franchisor. A package of non-patented practical information resulting from experience and testing by the franchisor, which is Secret, Substantial and Identified.

“Secret”: means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily assembled. It is not limited in the narrow
sense that each individual component should be totally unknown or unobtainable outside of the franchisor’s business.

“Substantial”: means that the know-how includes information which is of importance for the sale of goods or the provision of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services, methods of dealing with customers and administration and financial management; the know-how must be useful for the franchisee by being capable, at the date of conclusion of the agreement, of improving the competitive position of the franchisee, in particular by improvising the franchisee’s performance or helping it to enter a new market.

“Identified”: means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality the description of the know-how can either be set out in the franchise agreement or recorded in the manual.

“Manual”: means any type of written record which detailed the franchisor’s know-how. It is increasingly taking an on-line form. It is updated on a regular basis. Copyright in the manual is generally reserved to the franchisor.

“Franchise Agreement”: means an agreement whereby the franchisor grants to the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise.

1.6 Outline of Chapters

The thesis is divided into six Chapters.

Chapter One – This chapter states the thesis that although franchising makes a substantial contribution to the single market, it has failed to fulfil its potential in the EU. It suggests that this under performance is in part due to the regulatory environment in the EU and that this failure can be remedied by re-engineering the Regulatory environment in the EU.

It briefly considers the Regulatory environment in the EU and establishes the objectives and scope of this study.

The methodology, sources and limitations of the thesis are detailed, terminology considered, the approach of each chapter outlined and existing research on the regulation of franchising in the EU considered.

Chapter Two – This chapter deals with the first objective of the thesis. It seeks to show that although business format franchising has developed over the centuries into a specific, distinct and uniform form of commercial activity that is well established in the European Union and can assist businesses to expand their networks within and beyond member states, so contributing to the further development of the Single Market, it is under contributing
compared to its role in the USA and Australia. In order to understand the reasons for this under performance in the EU and the way in which the regulatory environment might be re-engineered to improve franchising’s contribution to the single market, it endeavours to better understand what franchising is by examining both the economic and legal features of the architecture of franchising, distinguishing it from agency and distribution, identifying the tensile stresses that arise within franchising. It deconstructs both the economic and sectoral contextualisation of franchising and its economic rationale and risks. It concludes that, despite the impact of variable determinants such as the value of the investment required from franchisees and the commercial sectors in which the business operates, the architecture of franchising comprises six fundamental features that are always present. These are independence of the parties, economic interest, use of a brand, use of a business format, control of the franchisee by the franchisor and assistance provided to the franchisee by the franchisor. This architecture withstands the tensile stresses placed upon franchising by its long term and dynamic nature.

It also suggests that those economic drivers that constitute the commercial rationale for franchisors using franchising as part of their business strategy are distinct from those which attract franchisees to buy a franchise and that the risks inherent in franchising also differ between the parties.

Chapter Three – This chapter deals with the second objective of the thesis. It considers whether the regulatory environment of the EU is in any way responsible for the under achievement of franchising in the single market. It does this by first considering the different approaches of EU member states to constructing the contractual environment and whether that resulting contractual environment adequately supports and re-enforces the economic drivers in the franchise relationship and reduces its inherent consequential risks to an appropriate level. The reasons for and consequences of the contractual asymmetry in the architecture of franchise agreements are examined. The self regulatory environment and the legal regulatory environment of the EU are considered in detail as regards their support of the relevant economic drivers and reduction of the consequential inherent risks in the precontractual, contractual and termination stages of the franchise relationship.

It suggests that the economic determinants and the interparty dynamics of the franchisor/franchisee relationship lead to a contractual environment that transcends sectoral divergence and the differing legal traditions of EU member states. This contractual environment tends to support and re-enforce the economic drivers that encourage franchisors to become involved in franchising and reduces their consequential inherent risk to a reasonable level. However, although it tends to re-enforce some of the economic drivers that
encourage franchisees to become involved in franchising it does not re-enforce them all and it fails to reduce all the consequential inherent risks for franchisees to an adequate level.

It then suggests that the regulatory environment in the EU within which franchising operates (which comprises a series of legal eco-systems), does not adequately protect and reinforce the economic attractions that drive franchisors and franchisees to become involved in franchising. Nor does it adequately reduce the consequential risks. It concludes that the regulatory environment is therefore to some extent responsible for the under achievement of franchising in the EU.

Chapter Four – This chapter considers through which catalyst the regulatory environment can be best re-engineered. It considers the precedent set by commercial agency in harmonising member state laws and then compares and contrasts the relative advantages and disadvantages of some form of European Civil Code. Having considered the proposals of the Amsterdam Group for a Common Frame of Reference, it proposes the adoption of a directive instead. It then considers the problems likely to be encountered in re-engineering the EU’s regulatory environment and what lessons can be learned from the USA and Australia.

Chapter Five – This chapter deals with the third objective of the thesis. It discusses how best to define franchising and what the foundations for re-engineering the regulatory environment should be. It concludes that the EU’s regulatory environment should be re-engineered in accordance with three commercial imperatives. These are maintaining market confidence, ensuring pre-contractual hygiene and incorporating certain mandatory terms in the franchisor/franchisee relationship which will re-enforce the relative economic drivers and reduce the consequential inherent risks to an appropriate level.

Maintaining market confidence leads to several proposals. The adoption of an “Exchange of Benefits” approach to regulation seeks to encourage companies to franchise their business in return for certain benefits; pre-contractual disclosure by potential franchisees, exempting certain types of franchise from pre-contractual disclosure and allowing franchisors to impose both a pricing policy and a multi channel sales strategy on their franchisees. Pre-contractual hygiene leads to proposals for the education of potential franchisees about franchising, the need for them to take and follow quality professional advice, the imposition of a pre-contractual disclosure regime and the prohibition of misleading or deceptive behaviour. The imposition of mandatory terms on to the franchise relationship lead to the identification of relevant terms and the prohibition of unconscionable conduct. It proposes a draft Franchise Directive (the text of which is detailed in Appendix 1) that would enable the EU Commission to implement these recommendations.
Chapter Six – This chapter summarises the conclusion of the thesis. It concludes that this study proves the hypothesis that franchising has failed to fulfil its potential in the EU, that this is in part due to the regulatory environment and that this failure can be remedied by re-engineering the legal eco-systems that comprise the regulatory environment in the EU by accentuating the impact of three commercial imperatives; market confidence, pre-contractual hygiene and a mandatory taxonomy of rights and obligations.

The thesis is based on the law and materials available as of 19 February 2010.
Chapter 2  Deconstructing the Contextualisation, Architecture, Rationale and Risks of Franchising

This chapter seeks to achieve the first objective by showing that although franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU which stimulates economic activity by offering economic advantages to all those involved, improves distribution and gives business increased access to other member states, it is not fulfilling its full potential to contribute to the realisation of the single market.

In order to understand the reasons for this under performance in the EU and the way in which the regulatory environment might be re-engineered to improve franchising’s contribution to the single market, it endeavours to better understand what franchising is. It does this by analysing both the economic and legal features of the architecture of franchising, distinguishing it from agency and distribution, identifying to tensile stresses that arise within franchising and deconstructing the economic and sectoral contextualisation of franchising and its economic rationale and risks. It concludes that, despite the impact of variable determinants such as the value of the investment required from franchisees and the commercial sectors in which the business operates, the architecture of franchising comprises six fundamental features that are always present. These are independence of the parties, economic interest, use of a brand, use of a business format, control of the franchisee by the franchisor and assistance provided to the franchisee by the franchisor. This architecture withstands the tensile stresses placed upon franchising by its long term and dynamic nature.

It also suggests that those economic drivers that constitute the commercial rationale for franchisors using franchising as part of their business strategy are distinct from those which attract franchisees to buy a franchise and that the risks inherent in franchising also differ between the parties.

2.1  Deconstructing the Contextualisation of Franchising

This is critical analysis towards the first objective. It considers the development of franchising as a specific, distinct and uniform commercial activity and its role in national economies.

2.1.1  The Historical Contextualisation of Franchising in the EU

Business format franchising has evolved over many centuries to what is now a distinct and commercially impactful way of doing business.
## Chronology of the Historical Development of Franchising

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<tr>
<th>DATE</th>
<th>MILESTONE</th>
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<tbody>
<tr>
<td>The Middle Ages(^{71})</td>
<td>Source of Franchising’s Historical DNA</td>
</tr>
<tr>
<td>1215</td>
<td>Magna Carta “enfranchises” Barons to collect taxes until ended by Council of Trent in 1562</td>
</tr>
<tr>
<td>1600 onwards</td>
<td>“Norenkai” system of restaurant chains developed in Japan during the Tokugawa Shogunate(^{72})</td>
</tr>
<tr>
<td>1700’s</td>
<td>Need for Distribution Channels Promotes early form of Franchising</td>
</tr>
<tr>
<td></td>
<td>“Tied House” system develops to secure the distribution of beer by brewers in the UK</td>
</tr>
<tr>
<td>1800’s(^{73})</td>
<td>Technical Demands Promote use of Primitive Forms of Franchising</td>
</tr>
<tr>
<td></td>
<td>US Manufacturers such as Singer, Coca-Cola and McCormick adapt franchising as method of distribution</td>
</tr>
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</table>

\(^{71}\) Early references to franchising include “All franchises and liberties of the bishshopericks……..deryvid from the crowne 1559. and Fairs, Markets and other franchises c.1630” (Oxford English Dictionary, 1933). The origins of franchising lie in the mercantile codes and common law of the Middle Ages when the crown offered feudal lords the right to maintain civil order, determine and collect tax revenues, and make other special tax assessments. The barons paid the crown a specified sum from the tax revenues collected. In 1562 the Council of Trent ended this system of patronage.

\(^{72}\) The “Norenkai” system in Japan has existed for several hundred years. It involves a long term employee of a restaurant being allowed by the employer to set up an restaurant in a different location under the same name and using the same menu. “Noren” is the Japanese word for the small curtain that lies across the entry of traditional Japanese restaurants and houses. “Kai” is the Japanese word for club or association. “Mai Toi” or table rent agreements have long existed in Chinese communities around the world. These enable individuals to run a small number of tables in a restaurant owned by another party.

\(^{73}\) One of the earliest examples of franchising in the United States was the McCormick Harvesting Machine Company. This manufacturer commissioned local agents to sell and service its machinery around 1850 (Mendelsohn, M, 2004, The Guide to Franchising, 6th Edition, Cassell). This gave birth to what the US Department of Commerce calls “traditional franchising”. The Singer Sewing Machine Company (Ibid Mendelsohn and Stanworth, J and Smith, B, 1991, Barclays Guide to Franchising for Small Businesses, Blackwell) was another early franchise business that sprang up in the US during the 1850’s. Agents working on commission demonstrated, sold, and repaired the Singer sewing machines. Both the McCormick and Singer franchises were after some years replaced by a company owned network. Coca-Cola was conceived in 1886 as a non-alcoholic alternative to “hard” drink such as beers and spirits. It was dispensed from a soda fountain by mixing syrup with carbonated water. It was not potable and so this severely limited the size of its market and growth (Felsted, A, 1993, The Corporate Paradox: Power and Control in Business Franchise, Routledge, p 41). The advent of bottling technology changed all that and the rights to bottle and sell Coca-Cola everywhere in the US (other than New England, Mississippi and Texas, where prior arrangements where in place), were granted to two traditional franchisees – Messrs Thomas and Whitehead in 1899. The franchisees were granted the rights to make up and bottle Coca-Cola from
<table>
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<th>DATE</th>
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<tr>
<td>Franchising Develops as a distinct Retail Channel</td>
<td>• Harper Beauty Shops (US) (1920)</td>
</tr>
<tr>
<td></td>
<td>• US automobile manufacturers adopt franchise model</td>
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<tr>
<td>1900-1950</td>
<td>• Rexell pharmacy (US) (1902)</td>
</tr>
<tr>
<td></td>
<td>• Howard Johnson Ice Cream Parlours (US) (1925)</td>
</tr>
<tr>
<td></td>
<td>• Pingouin Stores (France) (1930)</td>
</tr>
<tr>
<td>1950s</td>
<td>Classic Franchise Structures Developed in the US and a few expand into Europe</td>
</tr>
<tr>
<td></td>
<td>• McDonalds (USA) (1955)</td>
</tr>
<tr>
<td></td>
<td>• KFC (USA) (1955)</td>
</tr>
<tr>
<td></td>
<td>• Service Master (USA) (1958)</td>
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<tr>
<td></td>
<td>• IHOP (USA) (1959)</td>
</tr>
<tr>
<td></td>
<td>• Wimpy master franchisee opens in UK (1955)</td>
</tr>
<tr>
<td></td>
<td>• Service Master master franchisee opens in UK (1958)</td>
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syrup provided by the franchisor which also provided them with bottles, labels and advertising matter. Whitehead soon after sold out to John Thomas Lupton, after realising that he did not have sufficient capital to set up the bottling plants. In due course the franchisees were granting sub franchises across the US (Ibid Felsted). Pepsi-Cola followed suit and by 1910 had 280 bottlers across the USA (Ibid Felsted), US Department of Commerce (USDOC). Various years, “Franchising in the Economy” ed – Kosteka.

74 At the turn of the century, William E. Metzger of Detroit became the first franchisee of the General Motors Corporation. Ford, and then other manufacturers followed suit. Similar trends developed in the Petroleum industry (Op cit Felsted A. – Ibid pp 42).

75 The first true business format franchise was created by Martha Mathilda Harper, who developed her network of Harper Beauty Shops at the turn of the century into over 500 shops in the USA, Canada and Europe by the mid-1920s. Plitt. J. R, 2000, “Martha Matilda Harper and the American Dream: How One Woman Changed the Face of Modern Business,” New York: Syracuse University Press. Other businesses followed suit. Rexall drugstores began in 1902 as a co-operative of some 40 druggists organised by Louis Ligget who set up a company to manufacture private-label drugs which would be distributed and sold exclusively by these druggists under a franchise (Alan A. – Ibid pp 42). In 1925, Howard Johnson established an ice cream business in Massachusetts and expanded it by franchising it to a group of restaurants on the East Coast. By 1940 the first Howard Johnson Restaurant appeared, and in 1954 the first motor lodge opened. The Howard Johnson franchise system has since grown internationally to over 200 restaurants about 500 motor lodges (Alan A. – Ibid pp 42). Hertz Car Rental and A&W Restaurants are just two of the businesses that began franchising in the 1920s and are still doing so (Blair. R and La fontaine. F, 2005, “The Economics of Franchising” Cambridge University Press, p.7).

76 Love. J. F, 2008, MacDonalds: Behind the Arches, p45
77 Op cit, Felsted. A, p.42
78 Ibid Felsted. A, p.42
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<tr>
<th>DATE</th>
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<tbody>
<tr>
<td><strong>First Wave of Business Format Franchising Growth</strong></td>
<td></td>
</tr>
<tr>
<td>• Franchising flourishes in the USA</td>
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</table>
| 1960’s | • In the UK - Golden Egg Restaurants (1965); Dyno Rod (1966) open\(^\text{81}\)  
| | • In Germany\(^\text{82}\) - Ihr Platz (drugstore), Nordsee (fish restaurant) and OBI (D-I-Y Store) open  
| | • More US concepts begin to enter Europe  
| | • Regulatory problems arise in the UK\(^\text{83}\) |  
| **Second Wave of Business Format Franchising Growth** |  
| • First Franchise Regulation adopted – California (1971)\(^\text{84}\) |  
| 1970’s | • 14 US States adopted franchise relationship laws  
| | • FTC Disclosure Rules implemented  
| | • European Franchise Federation founded (1972)\(^\text{85}\)  
| | • French and German Franchise Associations founded (1973) |  

\(^{80}\) ServiceMaster, the carpet and upholstery cleaning franchise, was another American import which came to the UK in 1958 when Raymond Crouch bought the master licence for Europe from ServiceMaster Industries Inc, a Chicago based company (ibid). Mr Softee and Lyons Maid are also credited with offering franchises during the 1950s (ibid).

\(^{81}\) “Ihr Platz” (drugstore), “Nordsee” (fish restaurant) and “OBI” (do-it-yourself-store) were established.

\(^{82}\) Between 1970 and 1985, franchising grew steadily and the number of franchise systems increased from a mere 40 to 200. Over the last 25 years the rate of growth has accelerated, reaching a number of some 980 franchisees in 2009. This growth can be attributed in part to German Reunification, even though many in the East suffered from a lack of capital with which to invest in franchise systems (Giesler, Nauschütz, Franchiserecht, 2.ed. 2007, p.10-11. According to Köhler, NJW 1990, p.1689, there have been 140 franchising systems with 7750 franchisees in 1986).

\(^{83}\) Events in the UK slowed the growth of franchising in the 1960s. The public linked franchising with pyramid selling, a fraudulent marketing scheme (Franchising – Adams and Jones, Franchising: Practice and Precedents business format franchising). Pyramid selling involves the sale of distributorships to purchasers, who are encouraged with financial incentives to subdivide their distributorship to ‘sub-distributors’ and so on. The system can be likened to the chain letter principle. At one end of the chain, a door-to-door sales force found the unknown product very difficult to sell, while at the top of the pyramid a fortune had been amassed from the effective sale of multi-level distributorships rather than products.

\(^{84}\) The California Franchise Investment Law (California Corporations Code, Division 5, Parts 1 through 6, Sections 31000 through 31516) was adopted in 1970 to be effective January 1, 1971 Code of Federal Regulations, Title 16, Chapter 1, Subchapter D, Part 436 (16 CFR 436), promulgated December 21, 1978, effective October 21, 1979 (effective date extended from July 21, 1979, 44 Federal Register 31170, May 31, 1979). Cited as “FTC Rule.”
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<tr>
<th>DATE</th>
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<tr>
<td></td>
<td>• British Franchise Association founded (1978)(^{86})</td>
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<tr>
<th>1980’s</th>
<th>First Wave of Franchise Legislation Outside of USA</th>
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<tbody>
<tr>
<td></td>
<td>• EU Franchise Block Exemption adopted (1988)</td>
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<td></td>
<td>• French “Loi Doubin” adopted (1989)</td>
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<th>1990’s</th>
<th>Second Wave of Franchise Legislation Outside of USA</th>
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<tr>
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<td>• Romania (1992)</td>
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<td>• Brazil (1993)</td>
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<td>• Russia (1997)</td>
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<td>• Indonesia (1997)</td>
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<td>• Mexico (1998)</td>
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<td>• Spain (1988)</td>
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<td>• Australia (1998)</td>
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<tr>
<th>2000’s</th>
<th>Third Wave of Franchise Legislation Outside of the USA</th>
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<tr>
<td></td>
<td>• Kazakhstan (2002)</td>
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<td>• Estonia (2002)</td>
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<td></td>
<td>• Italy (2004)</td>
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<td>• Belgium (2006)</td>
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<td>• Sweden (2006)</td>
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<td>• China (2006)</td>
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<td></td>
<td>• Vietnam (2007)</td>
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\(^{85}\) [www.eff-franchising.com](http://www.eff-franchising.com). Its purpose has been to uphold a self-regulatory approach to good and fair business practice in franchising in Europe and promote franchising in Europe by protecting the Franchise Industry by promoting the European Code of Ethics, influencing and encouraging the development of Franchising in Europe, representing the interests of the Franchise industry to international organisations such as the European Commission, the European Parliament etc., promoting and representing the European Franchise industry and its members world-wide; the exchange of information and documentation between national Associations or Federations in Europe and in the world and serving its member Associations (the EFF currently represents 16 national Franchise Associations; Belgium, France, the Netherlands, Italy, the United Kingdom, Austria, Finland, Portugal, Sweden, Denmark, Finland, Hungary, Germany, Slovenia, Greece and the Czech Republic.)

Although franchising is mentioned in historical texts dating back to the Middle Ages and the “tied house system”\textsuperscript{87} was widely used by brewers in the UK from the mid 18\textsuperscript{th} century until the mid 1980s\textsuperscript{88}, it only really came “of age” and became a popular form of doing business in the EU in the early 1970s\textsuperscript{89}.

Despite its rapid growth, for a long time there remained much suspicion of franchising in the European establishment. For example, in the Fraud Trials Committee 1986 Report\textsuperscript{90}, Lord Roskill, the Chairman, described franchising as an enterprise in which “fraudsters induce investors to buy franchises, holding out the prospect of large returns on investment. But once the payment has been made the franchise proves worthless”.

Nevertheless, franchising has continued to grow. In 2010 the estimated turnover of franchised businesses in the USA was US$868.3 billion\textsuperscript{91} and an estimated US$300 billion in the EU\textsuperscript{92}.

Its presence around the globe is evidenced by the waves of franchise specific legislation that occurred in the 1990s and the new millennium.

Business format franchising encompasses a wide range of goods and services across many sectors whilst traditional franchising is evident in automobile and petroleum distribution, US sports franchises, such as the NFL, NHL and NBA and national infrastructure with rail and TV franchises being granted to operators\textsuperscript{93}.

\textsuperscript{87} The widespread availability of alcohol was causing social concern. Legislation was introduced to restrict the sale of alcohol to those with licences and also to require innkeepers to improve the drinking environment. As a result the value of those inns with licences greatly increased. However, those with licences often had insufficient funds to improve their properties and were therefore likely to go out of business. It was out of this economic difficulty that the tied house system developed. By granting a landlord a loan or leasing its own property out to prospective landlords brewers, such as Whitbread were able to retain and expand the number of outlets for their beer (Ritchie. B, 1992, \textit{An Uncommon Brewer: The Story of Whitbread 1742-1992}, James and James). This ‘tied house’ system proved itself as an efficient business mechanism until the competition authorities undermined it in the 1980’s (“The Supply of Beer – A Report on the Supply of Beer for Retail Sale in the United Kingdom” – Mergers and Monopolies Commission).

\textsuperscript{88} Ibid Ritchie. B, 1992, p.17

\textsuperscript{89} When the British Franchise Association was established, followed by the French Franchise Federation and the European Franchise Federation.

\textsuperscript{90} Fraud Trials (Roskill Report) HMSO, 1986


\textsuperscript{92} See 2.2.2 below

\textsuperscript{93} However, whereas both forms of franchise are often considered together in the US, (so greatly inflating the figures for franchising E.g. US Department of Commerce. Various Years. Franchising in the Economy, A Kostecka), in the EU the two forms are kept separate when considering the economic importance of franchising (E.G. The BFA/National Westminster Bank Survey of Franchising in the UK. Various Years. BFA). In the EU automobile distribution is dealt with separately from business format franchising from the legal perspective.
The difference between traditional and business format franchising endures today. This thesis focuses upon business format franchising.

2.1.2 The Institutional Contextualisation of Franchising in the EU

The potential for franchising to help make the EU’s single market dream a reality for small and medium sized enterprises that might otherwise find entering other member states too daunting a prospect, has clearly been identified by the movers and shakers in the EU Commission. The International Chamber of Commerce considers that “franchising has proved over many years to be an extremely successful commercial vehicle for the distribution of products and services, making a considerable contribution to growth in business sectors that use this type of distribution channel.” Prominent member state politicians have hailed franchising as being “an important incentive for the recovery of the economy.” Indeed in Italy the government has invested over €350 million in franchising by sponsoring franchisees with investment grants and soft loans. The World Intellectual Property Organisation recognises franchising’s “rapid growth and success” and comments upon its ability to ensure that “a large and stable organisation is able to grow and develop, motivated by or indeed driven by the spirit of small business.” Yet at the same time reports of the legislature and political debate in member states in which franchising is well developed, condemn it as an enterprise in which “fraudsters induce investors to buy franchises, holding out the prospect of large returns on investment. But once the payment has been made the franchise proves worthless.” Others seek to “explode the myth that the franchise industry is a relatively safe industry in comparison with other fully fledged business.” Despite this difference of opinion however, franchising continues to grow and the International Institute for the Unification of Private law (UNIDROIT) has identified franchising as “playing an ever greater role in a wide range of national economies.”

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94 Although some believe that the difference between traditional and business format franchising is more a matter of degree and that although traditional franchising tends to be a simpler financial arrangement but there is little real difference between the two in terms of the basic legal relationship. Dnes, A, 1992, Franchising: A case study approach, Aldershot, England, Ashgate Publishing Ltd, and Klein, B, 1995, The Economics of Franchise Contract, Journal of Corporate Finance Volume 2:9-37.

95 Rt Hon Sir Leon Brittan, Q.C – President of the European Commission, Abell, European Franchising (Vol. 1).

96 Maria Livanos Cattaui, Secretary General of ICC on the ICC Model International Franchising Contract

97 Senator Asciutti commenting upon bill no. 2093 of 6 March 1997 in the Italian senate stated that “franchising has the potential to be an important element in the recovery of the economy.” He also observed that “particularly during a period of sluggish economic performance, the regulation of franchising can play a noteworthy role in the creation of new enterprises, especially in the central and southern regions of the country.”

98 Legislative Decree No. 185 of 21 April 2000 and Decree No. 295 of 28 May 2001 (Italy)

99 WIPO, Franchising Guide

100 Lord Roskill, Chairman of the Fraud Trials Committee 1986, Roskill Report

101 Brian H. Donohoe (Central Ayrshire), Hansard HC vol 450 col 1493 (24 October 2006)

102 UNIDROIT, Model Franchise Disclosure Law, Preamble
2.1.3 **Sub Conclusion**

Business format franchising has developed over many years from a response to economic and technological developments to a distinct type of economic activity with significant economic impact in a number of national economies.

2.2 **The Economic Contextualisation of Franchising in the EU**

This is critical analysis towards the first objective of the thesis. It establishes the scale of franchising in the EU and its contribution relative to that it makes in the USA and Australia.

Franchising normally stimulates economic activity by improving the distribution of goods and/or the provision of services as they give franchisors the possibility of establishing a uniform network with limited investments, which may assist the entry of new competitors in the markets particularly in the case of SMEs. It allows independent traders to set up outlets more rapidly and with a higher chain of success than if they were to set up without the franchisor’s experience and assistance. Franchisors therefore have a better opportunity to compete with larger distribution undertakings.

Franchising also generally allows consumers and other end users a fair share of the resulting benefits as they combine the advantage of a uniform network with the existence of traders personally interested in the efficient operation of their business. The homogeneity of the network and the constant co-operation between the franchisor and the franchisees ensures the constant quality of the products and services. The favourable effect of franchising on interbrand competition and the fact that consumers are free to deal with any franchisee in the network guarantees that a reasonable part of the resulting benefits will be passed on to consumers.

In pursuing the goals of economic growth, job creation and consumer satisfaction, commercial innovation such as franchising needs to be encouraged. Franchising can contribute to the establishment of a unified European Market. It facilitates cross-frontier development as it is based on the leverage which an established name or idea can give a relatively small investment to enable the product or service involved to spread quickly, far and wide.

Franchising is a commercial phenomenon particularly well suited to the challenges of the single market. The combination of a franchisor’s know-how and a franchisee’s enterprise can boost economic activity and employment, while enlarging the range of goods and services on offer to the public. Franchising makes products and services available to a wide public and does not stop at national frontiers policy making within the EU.
It is suggested that the regulatory environment in the EU should therefore support and re-enforce the economic drivers that attract franchisors and franchisees to franchising and reducing the inherent consequential risks they expose themselves to.

However, given the heterogeneous policy legacies in the EU member states as well as the diverse preferences of national governments and other domestic actors, a one-size-fits-all solution is neither politically feasible nor normatively desirable.

2.2.1 Poor Key Data

The first objective of this thesis is to establish that although franchising is a positive influence in the EU and stimulates economic activity by improving distribution and giving business increased access to other member state markets, it is not fulfilling its full potential to contribute to the realisation of the single market. The following is critical analysis towards proving this objective.

Business format franchising is “a distinct and remarkably effective method of conducting business activities that is particularly appropriate in current economic conditions, due mainly to the advantages to both parties in the contract”103.

It is a significant part of the economy of a number of EU member states. However, the economic data available is poor and incomplete. There is no up to date uniform and complete set of economic data for franchising in all or even the majority of EU member states. This in itself suggests that franchising is not achieving its full potential in the EU.

According to the 2010 NatWest/BFA Franchise Survey, franchising contributed £11.8 billion to the UK’s GDP in 2009, an increase of £400 million from 2008.104 The same publication indicates that despite the economic climate, nine out of ten franchise businesses are profitable. The survey also states that the number of individuals employed in franchising in the last twelve months stands at 465,000 across a total of 34,800 franchised units in the UK. This means that on average each unit employs 13 people.

The European Franchise Federation indicates that the total 2009 turnover of franchising in Germany was €48 billion105. A report in January 2008 by Deutsche Bank stated that the sector has tripled its nominal turnover in the ten preceding years.106 By comparison, Germany’s nominal GDP has only grown by 25% over the same period. As a result, the franchising share

103 The Belgian House of Representatives, 17 March 2004 Doc 51 0924/001
106 Deutsche Bank Research: "Franchising Coming of Age in Germany" (January 2008)
of GDP increased by nearly 1% to 1.6% between 1996 and 2006. This figure is likely to be higher now as the industry’s turnover has continued to rise. Indeed, Deutsche Bank expects the sector to grow until 2015 at a rate of 7% per annum to around €70 billion. Deutsche Bank also reported that between 1996 and 2006 the number of people working in the sector nearly doubled. By comparison the total workforce only increased by 4%. In its 2010 report, the European Franchise Federation estimates that 452,000 people are employed in 58,000 units. On average this means that each unit employs 7.8 people\textsuperscript{107}.

According to Guy Gras, Chairman of the French Franchise Federation, the 2008 total turnover of franchising in France was €47.6 billion\textsuperscript{108}. The number of franchise networks in France have doubled over the past ten years, with steady growth of 8-10% over the last four years. In 2009 693,194 people were employed by 51,600 units\textsuperscript{109} in France. This equates to 8.25 people being employed per franchise unit.

2.2.2 Estimating the Size of Franchising in the EU

Although franchising makes a substantial contribution to the economy of the European Union, in order to measure whether it is as well established as it could be and is making its full potential contribution to the single market, it is necessary to first of all examine how well developed it is in the EU member states and then to bench mark this against its development in the USA and Australia.

This is critical analysis towards achieving the first objective of this thesis.

There is a lack of full and accurate information about the scale of franchising in the whole of the EU. The most recent figures published by the European Franchise Federation are in respect of 2009, but they only deal with 18 member states\textsuperscript{110} and the information given for them is incomplete\textsuperscript{111} and in places incorrect\textsuperscript{112}. There are no other recent figures for franchising in the EU.

\textsuperscript{107} ibid
\textsuperscript{108} FFF Press Pack for the 2009 Franchise Expo in Paris. http://lb7.reedexpo.fr/Data/kmreed_franche/blocKF_23316ae8f1472bf8d16e0ce274b508624e124d19ed45d.pdf the France Franchising Association excludes company owned outlets from this figure and therefore concluded there were only 53,002 franchised outlets in 2009
\textsuperscript{109} ibid. The French Franchising Association excludes company owned outlets from this figure and therefore concluded there were only 53,002 franchised outlets in 2009.
\textsuperscript{110} Austria, Belgium, Croatia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Netherlands, Portugal, Poland, Slovenia, Spain, Sweden, Turkey and the UK. Turkey is not a member of the EU. However four of these (Belgium, Denmark, Finland and Germany) are estimates and the gross total of 11,731 is arbitrarily discounted by 15% to take into account the fact that brands that exist in several countries may be costed more than once in these statistics. The figure for Turkey is given at 1,640 and so that must be removed. Consequently the estimated figure of 8,330 is deemed to be unreliable. The statistics do not give details of even estimated turnover for franchising. The estimated number of franchised outlets in the ?? is around 405,000 but again this is unreliable as figures for Austria, Belgium, Czech Republic and Portugal are running
\textsuperscript{111} For example, no turnover figures are given for 12 member states.
The most recent figures for franchising in the whole of the EU are from 2005. “Franchising Europe” estimated that there were 5,000 franchises operating in Europe, that supported 300,000 outlets with an estimated total turnover of US$200 billion\textsuperscript{113}. Unfortunately this figure is not broken down into figures for individual member states, save for the turnover figure for France, which is given at US$51.6 billion (€38.6 billion). The premises made and data used in arriving at the estimated figure are not given. It is therefore not particularly reliable, but it is the only figure available.

In order to establish the turnover of franchising in the EU it is therefore necessary to extrapolate a figure based upon the EFF’s 2009 statistics and the Franchising Europe 2005 statistics. This paucity of current statistics about franchising in the EU of itself suggests that franchising may not be as well established in the single market as a whole, as it is in the larger member states.

In 2009 the European Franchise Federation estimates that there were 9,971 franchises accounting for 405,000 outlets.

The EFF estimates the turnover of franchising in 2009 in Germany, Italy, Spain, Portugal, the Netherlands and the UK\textsuperscript{114} at US$188.1 billion. Add to that the French Franchise Federation’s figure for France (US$62.3 billion) and it totals US$250.4 billion.

The figures below clearly suggest that franchising in the EU is underperforming when compared to those for the USA and Australia\textsuperscript{115}.

\textsuperscript{112} The turnover figure for the UK in 2009 is given as €9.42 billion rather than the €11.8 billion given by the BFA.


\textsuperscript{114} The EFF figure wrongly put the UK’s 2009 turnover at £9.4 billion rather then £11.8 billion (€14 billion or US$18.7 billion) reported by the BFA.

\textsuperscript{115} See “Price Waterhouse Coopers 2010 Franchise Business Economic Outlook” – The International Franchise Association’s Educational Foundation \texttt{www.franchise.org} (viewed 29/12/2010) and Franchise Council of Australia \texttt{www.franchise.org} (viewed 29/12/2010)
<table>
<thead>
<tr>
<th>Population</th>
<th>GDP\textsuperscript{116} (US$)</th>
<th>Estimated 2009 turnover of franchising in local currency</th>
<th>Estimated 2009 turnover of franchising in US dollars (exchange rate as at 23/12/10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The UK</td>
<td>62 million</td>
<td>2.2 trillion</td>
<td>£11.8 billion\textsuperscript{117}</td>
</tr>
<tr>
<td>Germany</td>
<td>81.7 million</td>
<td>3.3 trillion</td>
<td>€48 billion\textsuperscript{118}</td>
</tr>
<tr>
<td>France</td>
<td>64.7 million</td>
<td>2.5 trillion</td>
<td>€47.6 billion\textsuperscript{119}</td>
</tr>
<tr>
<td>Italy</td>
<td>60.4 million</td>
<td>2.1 trillion</td>
<td>€21.77 billion</td>
</tr>
<tr>
<td>Spain</td>
<td>45.9 million</td>
<td>1.46 trillion</td>
<td>€24.7 billion</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>16.5 million</td>
<td>0.77 trillion</td>
<td>€29.2 billion</td>
</tr>
<tr>
<td>Portugal</td>
<td>10.6 million</td>
<td>0.2 trillion</td>
<td>€5 billion</td>
</tr>
<tr>
<td>Total</td>
<td>341.8 million</td>
<td>12.54 trillion</td>
<td>-</td>
</tr>
</tbody>
</table>

The paucity of current complete and consistent data for all 27 EU member states means that it is impossible to definitely state the turnover of franchising in the EU. Nevertheless, it can be estimated in three ways. All three ways lead to estimates that suggest that franchising in the EU is underperforming compared to the USA and Australia.

Firstly, Franchise Europe’s 2005 figure US$200 billion can be increased by the same percentage as the number of outlets are reported to have increased by the 2009 EFF Survey. Assuming that each new outlet on average has the same turnover as the average outlet in 2005, it is logically justifiable\textsuperscript{120}. Applying this methodology the increase of outlets from 3,000 in 2005 to 4,000 in 2009 represents a 33.3% increase. If the same percentage increase is applied to the turnover of franchising the US$200 billion figure for 2005 would become

\textsuperscript{116} International Monetary Fund, Ibid
\textsuperscript{117} BFA/NatWest Survey 2010
\textsuperscript{118} European Franchise Federation – [www.eff-franchise.com](http://www.eff-franchise.com) (viewed 23/12/10)
\textsuperscript{119} FFF Press Pack, Ibid
\textsuperscript{120} However, as explained on pp 46 below this assumption is incorrect due to the differing resale prices in member states.
US$266 billion in 2009\textsuperscript{121}. This methodology produces a figure which wrongly assumes that retail prices are the same in all EU member states and ignores the number of outlets in a number of smaller member states in 2009 but it does produce a working figure.

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2009</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of outlets</td>
<td>300,000</td>
<td>405,000</td>
<td>33.3%</td>
</tr>
<tr>
<td>Turnover</td>
<td>US$200 billion</td>
<td>US$266 billion</td>
<td>33.3%</td>
</tr>
</tbody>
</table>

The second way of estimating the turnover of franchising in 2009 using 2005 figures involves increasing the total 2005 turnover figures by the same percentage as the turnover for France has increased in the same period. This assumes a uniform level of growth in all EU member states which is logically defensible. The French Franchise Federation’s 2009 turnover figure of €47.6 billion represents an increase of €9 billion on the Franchise Europe 2005 figure of €38.6 billion, which is approximately a 25% increase. If that percentage increase is applied to the US$200 billion figure it suggests that the turnover of franchising in the EU in 2009 should be approximately US$250 billion. That is more or less the same as the figure that EFF’s 2009 survey produces for the UK, Germany, France, Italy, Spain, the Netherlands and Portugal. It can therefore be concluded that it is an underestimate.

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2009</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover in France</td>
<td>€38.6 billion</td>
<td>€47.6 billion</td>
<td>c25%</td>
</tr>
<tr>
<td>Turnover in EU</td>
<td>US$200 billion</td>
<td>US$250 billion</td>
<td>25%</td>
</tr>
</tbody>
</table>

The third way of estimating the turnover of franchising in 2009 is to compare the number of outlets in the seven EU member states that have a turnover of US$250.4 billion according to the EFF figures with those in the other 11 member states referred to in the EFF’s 2009 figures. (For some reason no turnover figures are given for these 11 member states).

Six of the member states that account for a turnover of US$250.4 billion account for 283,115 outlets. There are no outlet figures given for Portugal. However, as Portugal’s turnover is approximately 25% of Italy’s, it is reasonable to assume that it may have around 25% of the outlets Italy has. That would mean that the seven EU member states account for approximately 300,000 outlets of the 405,000 – around about 75%. As the remaining eleven member states have approximately one third of the outlets of the seven EU member states which have a turnover of US$250.4 billion, it is reasonable to suggest that they also have a turnover which is roughly equivalent to one third of that figure, that is US$83.2 billion. That

\textsuperscript{121} This methodology under estimates the increase in the number of outlets in the EU in 2009, as the EFF figures do not include all EU member states – although it does include all those in which franchising is well established.
would mean that the turnover of the 18 EU member states listed by the EFF is estimated at approximately US$333.6 billion.

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Outlets in 18 EU member states in 2009 according to the EFF</td>
<td>405,000</td>
<td>100%</td>
</tr>
<tr>
<td>Less</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated number of Outlets in the 7 EU member states that had a turnover of US$250.4 billion in 2009</td>
<td>Approx 300,000</td>
<td>66.6%</td>
</tr>
<tr>
<td>Number of Outlets in other 11 EU member states</td>
<td>105,000</td>
<td>33.3%</td>
</tr>
</tbody>
</table>

Assuming that on average outlets turnover an equal amount, approximating the number of outlets in the 11 EU member states as being 33.3% of those in the 7 member states accounting for turnover of US$250.4 billion and applying that same percentage to turnover suggests a turnover figure for franchising in 2009 of US$333.6 billion.

33.3% x US$250.4 billion = US$83.2 billion

US$250.4 billion + US$83.2 billion = US$333.6 billion

There is no evidence to suggest that there is any substantial franchising in the remaining 9 member states and so for the purpose of this calculation it will be assumed that they account for no significant franchising turnover.

However, the problem with this calculation is that it is unlikely that outlets in the 11 member states for which estimates are being made will be turning over the same amount as those in Germany, the UK and France which have a much higher cost of living. The most relevant

122 The EFF gives no number of outlets for Portugal. This is calculated by reference to Italy. Italy’s turnover is €21.77 billion. Portugal’s turnover is €5.05 billion i.e. approximately 25% of Italy’s. Italy has 53,300 outlets. If Portugal has 25% of that number, i.e. 13,325
123 Malta, Cyprus, Finland, Norway, Slovakia, Ireland, Lithuania, Latvia and Estonia.
way of testing this is to consider the relative cost of a particular product sold by a franchise network in the EU.

The Big Mac Index\textsuperscript{125} gives the cost of a Big Mac in a number of different EU member states. In the UK it costs US$3.65, in France US$3.20 and in Germany US$3.96. The cost in the 8 other EU member states that are not included in the 7 that had a turnover of US$250.4 billion are considerably lower.

An analysis of the cost of a Big Mac in these 11 EU member states yields the following data;

Selection of member states included in those which had a turnover of US$250.4 billion in 2009

<table>
<thead>
<tr>
<th>EU Member State</th>
<th>Cost of Big Mac as at 2006 in US$\text{dollar}</th>
</tr>
</thead>
<tbody>
<tr>
<td>The UK</td>
<td>3.65</td>
</tr>
<tr>
<td>Germany</td>
<td>3.96</td>
</tr>
<tr>
<td>France</td>
<td>3.20</td>
</tr>
</tbody>
</table>

Selection of member states included in EFF outlets statistics for which no turnover figure is available

<table>
<thead>
<tr>
<th>EU Member State</th>
<th>Cost of Big Mac as at 2006 in US$\text{dollar}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>2.71</td>
</tr>
<tr>
<td>Poland</td>
<td>2.10</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2.67</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.76</td>
</tr>
<tr>
<td>Greece</td>
<td>2.40</td>
</tr>
</tbody>
</table>

Selection of member states for which the EFF has no statistics

<table>
<thead>
<tr>
<th>Member State</th>
<th>Cost of Big Mac as at 2006 in US$\text{dollar}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latvia</td>
<td>2.47</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2.41</td>
</tr>
<tr>
<td>Slovakia</td>
<td>2.76</td>
</tr>
</tbody>
</table>

\textsuperscript{125} The Big Mac index was introduced in the Economist in September 1986 and gave rise to “Burgernomics” (Daley, J. (2008/9/6) “Burgernomics: Why the price of a Big Mac may hold the key to better investment returns”. The Independent) \url{www.investment.com} (viewed 16/1/2011)
These figures suggest that it is unlikely that the outlets in the 11 EU member states included in the 2009 EFF Statistics (but not included in the 7 member states that account for the US$250.4 billion turnover) have a turnover of US$83.2 billion.

The above three methodologies produce a range of the estimated turnover of franchising in the EU in 2009 from US$250 billion to US$333.6 billion. None of the figures can be considered to be totally accurate, but they are all the result of a logical use of the data available.

It is therefore suggested that a figure somewhere in the middle of the range between US$333.6 billion and US$250 billion is a fair and reasonable estimate of the likely turnover of franchising in the EU during 2009. Thus, these methodologies suggest that the turnover of franchising in the EU in 2009 can reasonably be estimated at around US$300 billion or €215 billion\(^{126}\).

Further critical analysis of the figures also suggests that franchising in the EU is heavily concentrated in a minority of member states.

Those EU member states other than the UK, Germany, France, Italy, Spain, the Netherlands and Portugal probably account for a turnover of around US$50 billion (€35 billion) at most.

Estimated 2009 turnover of franchising in the EU \(\text{cUS$300 billion}\)

Less

2009 turnover of 7 EU member states identified \(\text{US$250.4 billion}\)

Estimated 2009 turnover of other 20 EU member states \(\text{US$49.6 billion}\)

This suggests that franchising is heavily focused in around a quarter of the EU member states which account for US$250.4 billion (€180 billion) out of a total estimated turnover of US$300 billion. In other words 25% of the EU member states account for an estimated 83.5% of franchising’s turnover in the EU.

2.2.3 **Comparing the Size of Franchising in the EU with that in the USA and Australia**

Having established the scale of franchising in the EU and that franchising is not well developed in the majority of EU member states, it is appropriate to benchmark its turnover in the EU against that in the USA and Australia. This is critical analysis towards establishing the first objective of the thesis.

\(^{126}\) Exchange rate as at 12 March 2011
The EU has a population of around 500 million\textsuperscript{127} compared to the USA’s 310.9 million\textsuperscript{128}. The EU’s Gross Domestic Product\textsuperscript{129} in 2010 was US$16,106,896,000,000 (16.1 trillion) compared to the USA’s GDP of US$14,624,184,000,000 (14.6 trillion), according to the International Monetary Fund\textsuperscript{130}. One might therefore expect the estimated turnover of franchising in the EU and the USA to be similar. However, this is not the case.

The estimated 405,000 franchised outlets in the EU and the generous estimated turnover of US$300 billion are dwarfed by the equivalent figures in the United States, where in 2010 there were an estimated 901,093 business format franchise outlets employing 9,558,000 and accounting for an output of US$868.3 billion\textsuperscript{131}.

Even Australia, with a population of only 22.5 million and a GDP of US$1.2 trillion has an estimated franchise turnover of US$130 billion\textsuperscript{132}.

<table>
<thead>
<tr>
<th></th>
<th>Population</th>
<th>GDP 2010</th>
<th>Estimated turnover of franchising</th>
<th>Franchising as a percentage of GDP</th>
<th>Turnover of Franchising per head of population</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>500 million</td>
<td>US$16.1 trillion</td>
<td>US$300 billion</td>
<td>1.86%</td>
<td>US$600</td>
</tr>
<tr>
<td>USA</td>
<td>310.9 million</td>
<td>US$14.6 trillion</td>
<td>US$868.3 billion</td>
<td>5.95%</td>
<td>US$2,792</td>
</tr>
<tr>
<td>Australia</td>
<td>22.5 million</td>
<td>US$1.2 trillion</td>
<td>US$130 billion</td>
<td>10.83%</td>
<td>US$5,777</td>
</tr>
</tbody>
</table>

There are no up to date figures for the number of franchisors in the USA. None are published by the IFA, which focuses instead upon the number of franchised outlets.

The figures are very stark. Although the USA has only 60% of the population of the EU and a lower GDP, franchising’s estimated turnover in the USA is considerably more than double that in the EU. Compared to both the USA and Australia, (both of which have sophisticated and well developed franchise laws), franchising in the EU is markedly underdeveloped.

\textsuperscript{127} International Monetary Fund. World Economic Database, October 2010
\textsuperscript{128} Ibid
\textsuperscript{129} The market value of all final goods and services from a nation in a given year.
\textsuperscript{130} International Monetary Fund, ibid
\textsuperscript{131} “Price Waterhouse Coopers 2010 Franchise Business Economic Outlook” – The International Franchise Association’s Educational Foundation www.franchise.org (viewed 29/12/2010).
\textsuperscript{132} Franchise Council of Australia www.franchise.org (viewed 29/12/2010)
2.2.4 Sub-conclusion

Despite a broad range of differing attitudes to business format franchising, it has developed into a channel to market that makes a significant contribution to the economy of the European Union. However, it is under performing in the single market relative to its contribution to other markets, namely the USA and Australia. Also, with some 83.5% of franchising being concentrated in just 25% of the 27 member states, franchising is clearly not promoting trade between member states as much as it could.

2.3 Deconstructing the Economic Rationale of Franchising – Why do people get involved in Franchising?

This is critical analysis towards establishing the first objective of the thesis and showing that franchising does stimulate economic activity by offering advantages to those involved in it. It is suggested that there are inherent economic advantages of franchising which attract franchisors and franchisees to become involved in it.

2.3.1 The Economic Drivers of Franchising for Franchisors

Businesses, other than sole traders, involve a relationship between a principal and the individuals he hires to provide a service or manufacture/distribute goods – his “agents”. The principal delegates decision-making authority to those agents. The interests of the principal and its agents do not always coincide, so there is potential for conflict. The agent may not always act in the principal’s best interests and under performing agents are not uncommon. In order to reduce the risk of a poor employee, a non-franchised business will need to institute a costly management system. Franchising, on the other hand, replaces much of the need for such a management system with powerful financial incentives, namely the benefit of the profits created by his/her endeavours and the risk of losing the capital that they have invested in the business. Because franchising creates a better financial synergy between the two parties, there is less need for monitoring and a greater probability for maximum performance by the franchisee. There is evidence that increased managerial

133 Klock. C, 2004, Franchising a Good Strategy for a company operating throughout Europe – Case Study Benetton, University of Abertay Dundee
136 Ibid Brickley and Dark
ownership improves performance. The corollary of the franchisee’s better performance is improved performance by the franchisor, as the franchisor’s performance depends to a large extent on its franchisees’ performance.

The relationship between principal and agent can be described or explained in mathematical models. Agents are generally assumed to be risk adverse i.e. they prefer a low but secure income whilst principals are risk neutral. Many commentators have highlighted the advantages of franchising a business using this “Agency Theory”. Another analysis proposed is that franchising is a solution to the capital, managerial and information constraints faced by expanding businesses. The so-called “Resource Scarcity Theory”. It is suggested that growing businesses use franchising as a way of accessing capital that would otherwise be unavailable to it in a cost effective way that offers fair reward to the financier (the franchisee). Support for this analysis is provided by the former president of Kentucky Fried Chicken, John Y. Brown, who estimated that it would have cost KFC $450 million to establish its first 2,700 stores, an amount of capital that was not available to KCF in the early stages of its expansion. The traditional ways for new businesses to access capital are to either sell equity or raise a loan, although raising a loan, may not be possible in the early stages of a business’s development due to lack of collateral and a proven track record. Therefore, Franchising is often a more cost effective and realistic option. Indeed, franchisees may be able to provide capital to the franchisor at a lower cost than passive investors can. In addition to capital, franchising also provides an efficient way to obtain

the managerial expertise needed to grow the business. Because a franchisee puts a significant amount of her/his assets and time into her/his unit, she/he is likely to purchase a franchise only if she/he is confident in her/his managerial abilities 146.

Several commentators stress the fact that franchising facilitates much more rapid growth for companies147, suggesting that franchisors have used franchising to secure a large market share much more rapidly than they otherwise could achieve148. The reason for this is largely the so-called “Penrose Effect”, that is managerial capacities pose a static limit to a firm’s expansion and rapid recruitment of staff raises operating costs. Franchising is a device that circumvents this constraint by externalising the management functions to the franchisee149.

Thus franchising addresses the adverse selection problem of firms hiring managers who may overstate their qualifications to secure employment. On the international front franchising also allows a firm to leverage the local market knowledge of its franchisees as it expands into new geographic areas150. Thus the “Resource Scarcity” school of thought suggests that low cost capital, motivated managerial expertise, and better local market knowledge are three key resources that should reduce a franchisor’s overall risk and have a significant positive impact on a franchisor’s financial performance.

A third hypothesis is “Value Creation” or “Transaction Cost”. Aliouche, and Sch lentrich suggest, the real value of franchising to a business is the improvement in business performance due to its choice of growing through franchising instead of growing through its own means151. Their study of the US restaurant sector over the ten year period 1993-2002, suggests that US public restaurant franchisors have created more value than their non-franchising competitors in that they have a higher propensity to create market value and economic value than non-franchisors and generate on average higher added value than non-franchisors152.

Commentators also suggest that other economic factors that cause businesses to franchise their business model are based upon its ability to give smaller, less well capitalised businesses

146 Op cit, Shane, S. A, p. 216-234
149 Op cit, Thompson, RS
152 Also see Pilat. D, 1997, Regulation and Performance in the Distribution Sector: OECD Economics Department Working Papers No 180
access to some of the commercial advantages enjoyed by their larger, better capitalised competitors. These include lower costs through bulk purchasing, economies of scale, new product development and advertising campaigns. Its ability to combine the chains’ comparative advantages in creating brand recognition and capturing economies of scale with the local entrepreneur’s local knowledge and commercial drive is seen as a key element in franchising’s success and attractiveness to growing business. This leads to a conclusion that the capacity of franchising to harness the effort of a central entity, the franchisor, and a number or local entrepreneurs, the franchisees explains much of franchising’s prevalence and popularity as a way of organising certain economic activities.

All three of these analyses are cogent and in practice combine to produce a powerful reason for businesses choosing franchising. A survey of 25 franchisors in the UK, Germany, France and Spain supported the theories with the majority of the sample surveyed identifying elements of the Agency theory, Resource Scarcity theory and the Transaction Cost theory together with other economic drivers as the reasons that they franchised their businesses.

2.3.2 The Economic Drivers of Franchising for Franchisees

Whilst some franchisees become substantial multi-unit operators or operate high investment businesses such as hotels, most franchisees are small, family owned and family run businesses. All franchisees, regardless of their size are attracted to franchising by certain common factors.

Regardless of the scale and type of the franchisee, research suggests that the economic reasons for a franchisee buying a franchise include access to a national brand, franchisor support such as ongoing operational assistance, marketing/advertising and bulk purchasing, use of a proven business format (that is continually developed) and independence. All of which, regardless of the franchisee’s size, increase its chances of success compared to those of an independent start up business.

153 Op cit, Blair and La Fontaine, p.1
155 Op cit, Blair and La Fontaine, p.2
156 Appendix 3
The BFA states that one reason that franchisees buy a franchise is that 95% of franchises are in profit after 5 years compared to only 45% of other independent small firms. The other reason given is that franchisors are benevolent business partners with 86% of franchisees are satisfied with their franchisor relationship\textsuperscript{162}. The European Franchise Federation\textsuperscript{163} agrees with this analysis. Mendelsohn also agrees and adds improved product sourcing, advertising and marketing and increased access to funding as the banks tend to regard franchisees as lower risk than independent operators\textsuperscript{164}.

There are clear economic reasons for franchisees investing in a franchise, but it must be borne in mind that “non-institutional” franchisees (i.e. individuals rather than corporations) are also subject to a “large number of situational, personality and economic correlates…. likely to influence their perceptions”\textsuperscript{165}.

The situational, personality and economic correlates referred to by researchers include a desire to own and operate one’s own business and lack of other attractive options (for example redundancy)\textsuperscript{166}.

There is much support for the belief that the franchisee has the incentive of owning his own business with the additional benefit of continuing assistance from the franchisor\textsuperscript{167}. The franchisee is an independent businessman operating within the framework and structure of the franchise system. This provides the opportunity to the franchisee though hard work and effort to maximize the return from his business and the value of his investment\textsuperscript{168}.

In order to test the persuasiveness of the commercial advantage and proprietorship theories a selection of 30 UK franchisees representing eight different franchises were surveyed\textsuperscript{169} as part of this thesis. The responses suggest that both theories detailed above are correct as they are cited by all members of the sample as reasons that they bought a franchise.

\textsuperscript{162} www.british-franchise.org/casestudies.asp
\textsuperscript{163} www.eff-franchise.com accessed 3 February 2009. A franchisee's principal motive in joining a franchise network is “to improve his chances of success during the initial start-up period, and to ensure his business’s rapid expansion by virtue of the fact that he: buys into a brand-name, has immediate access to a market via the right to utilise the parent company’s trademark or brand name, and benefits from both the transfer of know-how (professional, management and marketing skills) and on-going assistance. In return for which the franchisee pays the franchisor a fee or royalty, or a combination of fees, which often includes an entrance fee and/or a fixed percentage of annual turnover for the period of the contract”.
\textsuperscript{164} Mendelsohn – ibid
\textsuperscript{166} Op cit, Kaufman and Stanworth
\textsuperscript{167} Op cit Mendelsohn
\textsuperscript{168} Mendelsohn – ibid
\textsuperscript{169} Appendix 5.
2.3.3 **Sub-conclusion**

There are inherent advantages which attract franchisors and franchisees to franchising. Franchisors are attracted by the access to quality management resource, capital and economic advantages such as access to volume discount and economies of sale. Franchisees are attracted to enhanced chances of commercial success.

2.4 **Deconstructing the Risks Inherent in Franchising**

This is critical analysis towards establishing the first objective of the thesis and better defines and places into perspective the advantages that franchising offers to the economy by identifying the risks that it gives rise to. It is suggested that there are inherent and different risks which the franchisor and franchisee are exposed to as a consequence of their involvement in franchising.

2.4.1 **Inherent Risks in Franchising to which the Franchisor is Exposed**

It is suggested that both parties to a franchise agreement expose themselves to certain risks that are inherent in franchising. The risks to which the franchisor is exposed are different to those to which the franchisor is exposed.

The agency theory identifies the risks of franchising as including “information asymmetry” and “moral hazard”.

Information asymmetry means that it is impossible for both parties to observe all of the relevant information they need for the decision making process and so the franchisee is able to behave opportunistically in a manner that the franchisor would deem inappropriate\(^{170}\). Moral hazard is the influence of the environment on the franchisee’s willingness to work effectively\(^{171}\). “Free Riding”, where the franchisee does not behave in accordance with the rules of the franchise, is therefore a risk\(^{172}\).

Certainly the degree of risk involved for the franchisor can be substantial. It is disclosing all of its business know-how to an independent party that is also permitted to use the Franchisor’s brand. In doing so it is opening the brand to potential abuse by another and creating an extremely effective future competitor which after the expiry of the franchise agreement and any post termination restrictive covenants will be able to freely compete with the franchisor and its other franchisees in a manner that no other competitor can.

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\(^{172}\) Op cit Lafontaine
Recent research in the US\(^{173}\) suggests that “due to the public good nature of the franchise trademark, franchisees have an incentive to shirk by providing a sub-optimal level service since they do not bear the full cost of any resulting deterioration of the trademark’s value”\(^{174}\).

Research into franchise disputes in the UK\(^{175}\) underlines the risk of “Free Riding” by some franchisees who seek to compete with their franchisor during the term of the franchise agreement and fail to meet their other contractual obligations by underperforming. These failings risk damaging the franchisor’s brand.

UK, German, French and Spanish franchisors\(^{176}\) were asked how significant various risks resulting from their entering into the franchise relationship were to them. Their responses seem to add further support to the belief that information asymmetry and moral hazard are the main risks to franchisors. These areas of very significant risk were identified as competition from franchisees during the term of the franchise agreement,\(^{177}\) competition from franchisees after the term of the franchise agreement,\(^{178}\) underpayment of monies due from franchisees,\(^{179}\) franchisees not complying with the system\(^{180}\) and damage to the franchisor’s intellectual property\(^{181}\). Areas of less significant risk were identified as protection of know-how from unauthorised use by franchisees or their agents outside of the franchise system in France and Spain\(^{182}\) and in the UK underperformance by franchisees during the term of the franchise agreement which has a significant impact on the brand.\(^{183}\)

A survey of franchise lawyers from around the world\(^{184}\) adds further support to the view that information asymmetry and moral risk are the main risks. The responses suggest that the most important obligations of franchisees are to follow the system and not to compete during the term of the franchise. Post-termination non competes are considered to be of moderate importance.

It is important to bare in mind that the franchise relationship is not merely a bilateral one. It is a multilateral relationship. This potentially changes the dynamics of the relationship and creates a new and substantial risk for franchisors. As the franchise network increases, so the

\(^{173}\) Klick, Kobayashi and Ribstein, George Mason Law & Economics Research Paper No. 07-03.

\(^{174}\) Ibid - pp. 31-32.

\(^{175}\) Appendix 7

\(^{176}\) Appendix 3.

\(^{177}\) Appendix 3 - 80% of UK Franchisors, 72% of German Franchisors, 80% of French Franchisors, 4% of Spanish franchisors (72% thought that it was “insignificant”)

\(^{178}\) 96% UK, 56% German, 88% French, 40% Spanish (56% thought it was a “significant risk”)

\(^{179}\) 36% UK (60% thought that it was a significant risk), 88% German, 96% French, 100% Spanish

\(^{180}\) 12% UK (80% thought that it was a “significant risk”), 84% German, 48% French, 72% Spanish

\(^{181}\) 92% UK, 92% German, 88% French, 64% Spanish

\(^{182}\) 80% French, 68% Spanish

\(^{183}\) 72% UK

\(^{184}\) Appendix 4
balance of power in the franchisor/franchisee relationship can start to tip away from the franchisor. The changes are subtle and at first not always easy to identify, but the fact that the franchisees can come to account for the majority if not all of the franchisor’s income inevitably means that the franchisees have the potential to influence the actions of the franchisor. This leads to a fundamentally complex relationship and can mean that the franchisor comes to rely on the good working relationship it establishes with the majority of its more successful franchisees.

A case in point was Domino’s Pizza UK. In 1995 it had in the order of 35 franchised outlets in the UK of which approximately thirty percent (30%) were owned by one franchisee. When the franchisee was thwarted in its bid to purchase the failed UK master franchise, it took a belligerent stance against the new master franchisee making the running of the master franchise far more difficult than it should have been until his eventual exit in 2000.

Franchisors are exposed to a number of risks that are inherent in franchising.

2.4.2 Inherent Risks in Franchising to which the Franchisee is Exposed

Some of the risk to which franchisees are exposed tends to vary depending upon their size and sophistication. Less sophisticated and experienced franchisees, particularly small and mid sized unit franchisees, can sometimes invest substantial amounts of money into a new business based almost entirely upon the representations made to it by the franchisor. Not all such potential franchisees are experienced enough to carry out appropriate levels of pre-contractual due diligence on their own initiative, and there is no doubt that unscrupulous individuals sometimes seek to use franchising as a way of taking unfair advantage of inexperienced potential franchisees, so depriving them of the basic benefits that they were hoping to enjoy from becoming a franchisee. The most important of these benefits include an established brand name, access to a business format that will increase their chances of success, and ongoing assistance and support including effective marketing/advertising, ongoing development of the business format and the benefits of bulk purchasing discounts.

Other areas of risk impact on all franchisees regardless of their size and sophistication. The failure of the franchisor to deliver the promised level of support, know-how or brand recognition can lead to system wide failure of franchisees. The case of 24 Self Video is a case in point. The franchisor made some £4 million profit whilst 15 of its 30 franchisees went out of business due to a lack of real business format and support from the franchisor and the tying in of overpriced poorly selected products. The case of MGB Printing & Design

185 Mr Ali Khan
186 Hansard HC Vol 450 Col 1493 (24 October 2006).
Ltd v KallKwik UK Ltd\textsuperscript{187} details another such failure by a franchisor to deliver the promised level of support and advice.

The collapse of the Pierre Victoire Franchise\textsuperscript{188} and the Rymans and Anthena franchises\textsuperscript{189}, which all left orphaned franchisees with no franchisor to maintain the brand or develop the know-how, shows the vulnerability of the franchisees to the franchisor’s commercial failure, so underlining the need for franchisees to conduct full pre-contractual due diligence.

Franchisees are also susceptible to what the Klick, Kobayashi and Ribstein research\textsuperscript{190} identifies as a tendency for franchisors to “seek to expropriate the franchisee’s investments in market discovery and development in markets that turn out to be particularly profitable”. That is territorial encroachment. The contractual asymmetry inherent in the franchise relationship also adds to the risks. Analysis of franchise disputes in the UK\textsuperscript{191} underlines the need for pre-contractual due diligence and suggests that there is a high level of mismatch between what some franchisees feel they bought into as a franchisee and what they are delivered.

The delivery of inadequate support and territorial encroachment by the franchisor also seem to be common causes of dispute between franchisees and their franchisor, so exposing franchisees to a high level of risk and supporting Klick and Kobayashi’s findings.

As Emerson comments\textsuperscript{192} “The focus for many disputes is the aggrieved franchisee’s expectations, whether those expectations are based in contract terms or more general concepts of fairness. At its core, the merits of a franchisee’s argument may rest on the legitimacy – the reasonableness – of its expectations”\textsuperscript{193}.

Franchisees are exposed to a number of risks that are inherent in franchising.

2.4.3 Sub-conclusion

Franchisors are exposed to threats arising from informational asymmetry and moral risk whilst franchisees are subject to encroachment, inadequate business formats and inadequate support.

2.5 Deconstructing the Architecture of Franchising

This is critical analysis towards the first objective of this thesis and seeks to establish that franchising is a specific, distinct and uniform commercial activity within the EU.

\begin{itemize}
  \item \textsuperscript{187} QBD – 31 March 2010 – [2010] EWHC 624 (QB)
  \item \textsuperscript{188} Scotland on Sunday 23 May 2010
  \item \textsuperscript{189} Franchise World Feb/March 1994
  \item \textsuperscript{190} Op cit Klick, Kobayashi and Ribstein
  \item \textsuperscript{191} Appendix 7
  \item \textsuperscript{193} Ibid.
\end{itemize}
It is suggested that the architecture of franchising comprises several distinct features (economic interest, independence, the business format, the brand, control by the franchisor and ongoing support of the franchisee by the franchisor) and can therefore be differentiated from both commercial agency and distribution. The architecture needs to withstand a number of tensile stresses that result from the long term nature of the franchise relationship.

It is suggested that the fact that franchising is used in a wide variety of commercial sectors and that although the balance of economic power between franchisor and franchisee can vary substantially from franchise to franchise, it does not materially impact upon the fundamental features of the architecture of the franchise relationship.

2.5.1 An Economic Perspective of the Architecture of Franchising

This is critical analysis towards the first objective of the thesis and seeks to identify the specific, distinct and uniform economic elements of franchising.

Franchising is a long established commercial strategy that has evolved over the years and is represented by some 9,971 different systems in the EU194.

Some economic based explanations of franchising, such as that offered by Housden195, add little to our understanding of it as they are so general that they include other third party contractual relationships, such as commercial agency and distributorship. Rather than define franchising they identify the basic characteristics of a third party commercial arrangement.

Franchising can be seen as “a contractual bond of interest in which an organisation, the franchisor, which has developed a pattern or formula for the manufacture and/or sale of a product or service, extends to other firms, the franchisees, the right to carry on the business, subject to a number of restrictions and controls. In almost all cases of significance, the franchisee operates using the franchisor’s name as a trade name.”196 This suggests that the elemental parts of franchising are a format, a brand, restrictions and control.

Thompson takes a different approach and focuses primarily upon the independence of the parties and their respective assets, suggesting that franchising is “an organisational form which combines the decentralised ownership of physical assets with centralised brand name ownership and provision of operational know-how197.”

194 See Section 2.2.2 above.
195 “A right to do or use something which is granted by one party (the franchisor) to another party (the franchisee) for a consideration.” Housden, Franchising and Other Business Relationships in Hotel and Catering Services (1986, Heinemann)
Rubin also focuses on decentralisation describing franchising as a system that “partitions decisions between two legally independent but economically linked entities … and allocates to each the appropriate level of residual claims. The franchisee alone makes decisions regarding local operating policies such as location, pricing, hours of service and hiring. And the franchisee bears the residual claims from these decisions – the net profit of the unit after expenses”\(^{198}\). This decentralisation point is well made and is consistently present in all franchising relationships but its failure to consider other elements is disappointing.

Gerstenhaber’s view of franchising echoes part of Thompson’s analysis and focuses instead upon the key role of the business format as “a system leasing arrangement under which the franchisee acquires from the franchisor the licence to duplicate the franchisor’s existing and successful system of providing a product/service to the end user” \(^{199}\). However, it does not refer to the use of a brand or autonomy of the parties. Nevertheless, it captures much of the commercial essence of the franchising relationship – the replication of the franchisor’s business “blue print” by the franchisee and reflects those elements that are important to those in business who utilise the franchise model. In doing so it identifies another fundamental element of the franchise relationship.

The Franchising Council of Australia (FCA) definition of franchising\(^{200}\) fails to identify the business format as a fundamental element and focuses instead on the use of the brand and the independence of the parties. The importance of the brand is echoed in many other analyses including that of both the International Franchise Association\(^{201}\) and the European Franchise Federation. Like Rubin, the IFA focuses upon the independence of the parties, but also indentifies the brand and the formal as being of elemental importance. However, it also suggests a further element – the ongoing support of the franchisor\(^{202}\). The European Franchise Federation (“the EFF”), also focuses on the brand, the business format, the

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\(^{199}\) Moshe Gerstenhaber, the Managing Director of the Kall Kwik printing chain in the UK between the years 1975 and 1998 Directory of Franchising 1989 (Franchise World).

\(^{200}\) “a business relationship in which the franchisor (the owner of the business providing the product or service) assigns to independent people (the franchisees) the right to market and distribute the franchisor’s goods or service, and to use the business name for a fixed period of time” http://www.franchise.org.au/lib/pdf/aboutfranchising/WhatIsFranchisingBrochure.pdf accessed 21 August 2009.

\(^{201}\) Which is in fact the franchise association of the USA (the ‘IFA’)

\(^{202}\) “a contractual relationship between the franchisor and franchisee in which the franchisor offers or is obliged to maintain a continuing interest in the business of the franchisee in such areas as know-how and training; wherein the franchise operates under a common trade made, format and/or procedure owned or controlled by the franchisor and in which the franchisee has or will make a substantial capital investment in his business from his own resources.”
independence of the parties and ongoing support by the Franchisor, but also adds control by the Franchisor.  

Blair and La Fontaine bring all of those elements together in their explanation of franchising but also expressly state an element which is implied in all of the other definitions – economic interest. They suggest that “the franchisor maintains ownership over the trade name and marks and … develops a complete “recipe” to run each outlet. It then licences the right to operate under the central trade name and business format in a given market for a certain period of time to individuals or small firms in exchange for various fees. The ownership stake of the franchisee in current and future profit leads him to put significant effort into the outlet. At the same time, the ongoing fees he pays to the franchisor ensure that the latter has incentives to maintain the value of the brand by, amongst other things, screening and monitoring the franchisees and keep abreast of market trends.” It amounts to a synthesis of the various elements identified by other sources into a balanced compound that identifies the brand, the business format, independence, ongoing support to the franchisee by the franchisor, the economic interests of both parties and the control and enforcement of the brand standards by the franchisor.

203 “a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the Franchisor and its individual Franchisees, whereby the Franchisor grants its individual Franchisee the right, and imposes the obligation, to conduct a business in accordance with the Franchisor's concept. The right entitles and compels the individual Franchisee, in exchange for a direct or indirect financial consideration, to use the Franchisor's trade name, and/ or trademark and/or service mark, know-how, business and technical methods, procedural system, and other industrial and/or intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between parties for this purpose”. “A particular form of associated commerce, in other words a business partnership, between a franchisor and his independent partners - the franchisees. Together they form the franchise network. Of the many forms of business partnerships, franchising is the most sophisticated both in the business concept construct as in the scope of the franchisor-franchisee relation. A franchisor seeks to duplicate, as many times as possible, a tested and successful business or system with a network of independent partners, the franchisees. A franchisee is legally and financially separate and independent of the franchisor and of the other franchisees in the network.” “the franchise business is generally built around a brand name which may be a trademark, a service mark and/or trade name. During the term of a franchise contract, the franchisor gradually transfers to his franchisee all the know-how and assistance necessary to efficiently and profitably run the franchisee's independent outlet. The packaging of these elements - the brand name, the transfer of know-how and constant assistance and support - summarises the distinctive elements of franchising with regard to other forms of associated businesses.”

2.5.2 A Legal Perspective of the Architecture of Franchising

This is critical analysis towards the first objective of the thesis and seeks to establishes that the fundamental legal architecture of franchising throughout the EU is specific, distinct and uniform.

Whereas an economic analysis of franchising focuses upon how the parties organise their economic interests, a legal analysis is more concerned with the rights and obligations they allocate to each other in the relationship. There is a continuum of control and independence which is interpreted in different ways in different jurisdictions to define what amounts to franchising. However, this different approach to analysing franchising ultimately leads to the identification of the same key elements.

2.5.2.1 Independence, the Brand and Economic Interest

Some legal definitions are extremely wide and barely distinguish franchising from other third party relationships such as distributorship and commercial agency. For example, the UK’s Financial Services Act205 describes franchising as “arrangements under which a person earns profits or income by exploiting a right conferred by the arrangements to use a trade name or design or other intellectual property or the goodwill attached to it...”. It identifies only the independence, brand and economic interest as elemental parts of franchising.

The “Community of Interest” approach used in the US in states such as Wisconsin206 and New Jersey207 identifies the same three elements. It defines a “franchise” as an agreement between two or more persons in which (1) the franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor’s trade name or marks, (2) the franchisor and franchisee share a community of interest in the marketing of the goods or services, and (3) the franchisee pays a franchise fee.

“Community of interest” generally means a continuing financial interest between the parties in the operation of the franchisee’s business or the resale of the franchisor’s products. The Wisconsin statute explicitly defines a community of interest as a “continuing financial interest between the grantor and the grantee in either the operation of the dealership business or the marketing of such goods or services.”208 However, the 1987 Ziegler decision by the Wisconsin Supreme Court209 lists 10 factors that should be considered in determining whether

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205 Financial Services Act 1986 Section 75, the Act was repealed by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001.
206 Wisconsin Fair Dealership Law.
207 New Jersey Franchise Practices Act.
208 Wisconsin Statute Chapter 135.02(1).
209 Ziegler Co. v Rexnord Inc. [1987] 139 Wis.2d 593 N.W.2d 873
a community of interest exists\textsuperscript{210}. Although the primary factor in this equation is interdependence (which generally arises when the franchisee invests heavily in the franchise business such that its economic health hinges on the continuation of that business), other elements include the franchisor’s control of the franchisee.

The now defunct Block Exemption Regulation for Franchise Agreements, (which was adopted by the European Commission on 30 November 1988\textsuperscript{211} and exempted franchise agreements which came within its bounds from Article 81 of the Treaty of Rome) focused only on the vertical restraints in the franchise agreements. It therefore identified know-how (the format) and the brand as the key elements defining a franchise as “a package of industrial or intellectual property rights relating to trademarks, tradenames, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or provision of services to end users”.

\textsuperscript{210} These factors include: (1) the duration of the parties’ relationship; (2) the extent and nature of the parties’ obligations; (3) the percentage of time or revenue devoted to the grantor’s products or services; (4) the percentage of the grantee’s gross proceeds or profits derived from the grantor’s products or services; (5) the extent and nature of the grantee’s territory; (6) the use of the grantor’s trademarks or logos; (7) the grantee’s financial investment in the inventory, facilities, and goodwill of the alleged dealership; (8) the personnel devoted to the alleged dealership; (9) the amount of money and time spent on advertising and promotions for the supplier’s products and services; and (10) the extent of supplemental services provided by the grantee to purchasers of the grantor’s products or services.

\textsuperscript{211} Commission Regulation (EEC) 4087/88 on the application of article 85(3) of the Treaty to categories of franchise agreements.
2.5.2.2 Business Format, Control and Assistance

The importance of the brand, the business format and economic independence are also identified in the other approach to defining franchising commonly found in the US. The so-called “Marketing Plan” or “Prescribed System” approach. This is more successful than the Community of Interest approach in distinguishing franchising from other third party relationships. Its influence is evident in all of the other 26 countries\textsuperscript{212} that have a franchise law which defines franchising and the work of numerous legal commentators\textsuperscript{213}.

The Marketing Plan Approach deals with not only the business format, the brand and economic interest but also the issues of “control and assistance”. It therefore distinguishes franchising from other third party relationships.

The State of California’s franchise legislation was the USA’s first franchise law when it was introduced in 1970.\textsuperscript{214} It adopts the Marketing Plan Approach, defining a franchise as a contract or agreement, either express or implied, whether oral or written, between two or more persons by which:

\begin{quote}
1. a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor;

2. the operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logo type, advertising or other commercial symbol designating the franchisor or its affiliate; and

3. the franchisee is required to pay, directly or indirectly, a franchisee fee.”
\end{quote}

It involves a symbiotic relationship between two legally independently owned businesses based upon the use of a brand and a business format with which it is closely associated. Each has its own differing rights and obligations. Franchisees can only succeed when the system as a whole succeeds. Franchisors therefore have to provide a system, a brand and support.

\textsuperscript{212} There are 28 other countries with franchise laws but two of them – France and Belgium do not seek to define franchising.

\textsuperscript{213} Op cit Mendelsohn (p. 2) adopts a marketing plan approach and suggests that franchising consists of four elements and must exhibit eight different features: The four basic elements are the ownership by the franchisor of a trademark, an idea, a secret process, a patent or a specialised piece of equipment and the goodwill and know-how associated with it; the grant of a licence by the franchisor to the franchisee permitting to exploit these elements; the imposition of controls relating to the operation of the franchisees and the payment of a fee to the franchisor by the franchisee. The basic features Mendelsohn believes must be present are a written contract; a successful business format which is identified with a brand name which may be a trademark, service mark and/or trade name; training; on-going support; use of the franchisors’ brand by the Franchisor; a substantial capital investment by the franchisee into its own independent business.

\textsuperscript{214} Cal. Corp. Code Section 31005(a)(1).
The Franchisor’s success depends upon operating a successful network of franchisees. Franchisees must therefore diligently follow the franchise system. However, what is implicit in this is that whilst franchisor and franchisee have a common interest in the brand being successful what they own and therefore care about is different. The franchisee is focused on maximising the profits of its outlets. The franchisor is focused on the profits of the overall chain. Those two objectives, whilst broadly similar are not the same, and they do not always imply the same desired behaviour. Control by the franchisor is a key element in the relationship. This dichotomy is at the heart of franchising. It is what the franchise agreement attempts to reconcile in a mutually satisfactory manner. It is what a regulatory regime must seek to deal with.

The Federal Trade Commission Franchise Rule’s definition takes a similar approach as do other US states.

Section 4(1) of the Australian Franchise Code also focuses upon the brand, the business format, control, assistance and the economic interests of the parties.

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215 FTC Rule Section 436.1(h) – See Appendix 10.

It defines a franchise agreement as an agreement:

“(b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and

(c) under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:

(i) owned, used or licensed by the franchisor or an associate of the franchisor; or

(ii) specified by the franchisor or an associate of the franchisor; and

(d) under which, before starting any business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:

(i) an initial capital investment fee; or

(ii) a payment for goods or services; or

(iii) a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or

(iv) a training fee or training school fee; but excluding

(v) payments for goods or services at or below their wholesale price; or

(vi) repayment by the franchisee of a loan from the franchisor; or

(vii) payment for the wholesale price of goods taken on consignment; or

(viii) payment of market value for purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.”

The definition then goes on the state that a transfer, renewal or extension of a franchise agreement and motor vehicle dealerships (The Trade Practices (Industry Codes-Franchising) Regulations (1998)) are included within the definition. A list of other relationships, such as employer/employee, landlord and tenant and co-operatives are excluded from the definition (Trade Practices (Industry Codes-Franchising) Regulations Section 4(3)). Certain limited types of franchise agreements are also exempted from the Code (Trade Practices (Industry Codes-Franchising) Regulations Section 5 - The two main types of exempted franchise agreement are where the franchisor is resident outside Australia and only grants one franchise or master franchise to be operated in Australia. The other main exemption is “fractional franchises” where the franchise agreement is for goods or services substantially the same as those previously supplied by the franchisee and the sales under the franchise are likely to provide no more than 20% of the franchisee’s gross turnover).
In the EU Member States franchise laws\textsuperscript{217}, there is a marked lack of homogeneity in the definition of franchising. Although France\textsuperscript{218} and Belgium\textsuperscript{219} have franchise laws, both have declined to define franchising.

Italy’s definition of franchising focuses on the brand and other intellectual property rights, commercial assistance and the economic interests of the parties. Although it does not expressly deal with a business format or control\textsuperscript{220}, these are implied by the reference to intellectual property rights, which includes know-how.

Spanish law\textsuperscript{221} focuses only upon the business format and fails to identify the brand, control/support or the economic interest of the parties.

The International Institute for the Unification of Private Law\textsuperscript{222} has drafted a definition which follows the Marketing Plan approach referring to a business format (prescribed system), the brand, assistance and control, independence and the economic interests of the parties. Interestingly, despite providing a fairly well rounded definition of franchising it has not been adopted by any of the legislators which have sought to define franchising.

2.5.2.3 Other Perspectives

In Germany, some legal commentators take a somewhat different approach to examining the architecture of franchising. They focus upon how the different elements of the franchise agreement might determine how they should be dealt with by German law. Instead of identifying independence, the brand, economic interest, the business format, control and assistance as key elements in the legal architecture of franchising, they suggest that it can be viewed in a number of different ways. It can be seen as a licence of intellectual property to the franchisee, the provision of business services by the franchisee to the franchisor, the provision of support by the franchisor to the franchisee, the sale of goods to the franchisee or even the leasing of real estate to the franchisee by the franchisor in some cases. Franchise agreements are therefore compared to these other agreement types. Namely service agreements, licences, stakeholder agreements and “mixed” agreements.

Some consider that the franchisee’s duty to promote the franchisor’s goods and services are the predominant elements of franchise agreements. They therefore classify them strictly as

\textsuperscript{217} It also informs members of the legislature in member states when discussing franchising. Malcolm Wicks (Minister of Energy), Hansard HC vol 450 col 1493 (24 October 2006)
\textsuperscript{218} Law No. 89-1008 31 December 1989, French Commercial Code Article L.300-3
\textsuperscript{219} “Law relative to pre-contractual information in the framework of agreements of commercial partnership” adopted on 19 December 2005, modified on 27 December 2005
\textsuperscript{221} Article 62 of Act 7/1996. An activity which “is carried out by virtue of an agreement or contract by which a company, known as the franchisor, grants to another, known as a franchisee, the rights to exploit its own system of commercialisation of products or services”.
\textsuperscript{222} UNIDROIT, Model Franchise Disclosure Law, Article 2 – See Appendix 9.
business management contracts similar to agency agreements. Although it is true that in most franchises, the franchisee’s duty to promote the goods and/or services of the franchisor will be one of the main obligations under the franchise agreement the simple classification as a business management contract underestimates the importance of the other obligations which are central to the franchise agreement such as the licence of the intellectual property rights.

Others see franchise agreements as simple licence agreements (Rechtspacht), as the transfer of know-how and licensing of the trade mark and business format are key elements of the franchise relationship. However, this view fails to take into account the other key elements of franchising – particularly the support provided by the franchisor and the franchisee’s obligation to perform under the brand. Franchisees, as opposed to licensees, are not mere beneficiaries, but have extensive duties under the franchise agreements in particular regarding promoting the goods and/or services of the franchisor under the trade name and the trade marks of the franchisor.

Other commentators compare franchise agreements with shareholders’ agreements. There are two main flaws with this classification. Firstly, most franchise systems are characterised by a strict hierarchy and control by the franchisor. The franchisor directs, through guidelines, the operations manual and so on how the franchise business should be operated. Shareholders on the other hand even if they have different rights under the shareholders’ agreement, tend to (co-) operate on the same level. It is also questionable if the intention to make a profit is sufficient to conclude that a franchisor and a franchisee share a common purpose, as both parties try to achieve this by very different means and have conflicting interests. The simple aim to make a profit is a common feature in all commercial contracts.

The preferred view is that franchise agreements are mixed contracts that contain a mixture of elements found in other forms of agreements (Mischvertrag or Typenkombinationsvertrag). There are five basic different types of agreement felt it to be relevant;

(i) business management contracts (Geschäftsbesorgungsvertrag); the main feature of which is the obligation of the agent or manager to pursue a

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223 Emmerich, JuS 95, 761, 763.
224 Skaupy, NJW 1992, 1785, 1789
225 Vergl. etwa Flohr, Franchisievertrag, 3. Auflage 2006, S. 73 Nr. 5; S. 118 Nr. 1
226 Martinek in Martinek/Semler, §4 Rn. 44
227 Giesler, in Giesler/Nachschütt, Franchiserecht, 2. Auflage 2007, Chapter 5, Rn. 82
228 Ibid, Rn. 84
229 BGH, Judgment dated 03.10.1984 – VIII ZR 118/83, NJW 1985, 1894, 1895
230 BGH NJW 1985, 1894, 1895; OLG Hamm, Urteil vom 13.03.2000 = NZG 2000 1169;
commercial activity for the financial benefit and in the financial interest of the principal. The franchisee’s duty to promote the franchisor’s goods and services under the franchisor’s trade name and trademark, and the franchisor’s obligations to support and assist the franchisee in the operation of its business, such as are seen as obligations which are characteristic of business management contracts;

(ii) service agreements; services as are provided under the franchise agreement without them being directly for the financial benefit or the financial interest of the other party, such as conducting training sessions for the franchisees, or to develop new goods and/or services or to continue to further develop the franchise concept;

(iii) lease agreements; when the franchisor also acts as landlord of the franchisee and makes the premises available to the franchisee by way of lease or sub-lease or leases equipment to the franchisee;

(iv) licence agreements; in respect of the use of the trademark, the know-how and the franchise concept; and

(v) depending on the nature of the franchise in question also contracts for the sale of goods if the franchisee agreement contains an obligation on the franchisee to purchase goods and/or equipment from the franchisor.

How many and to what extent these different agreement types are reflected in the franchise agreement will depend on the underlying franchise concept and the requirements of the parties. Although the German approach has some similarities with the other approaches discussed in that it identifies the brand and assistance by the franchisor as key elements. It suggests an implied reluctance to recognise franchising as a specific, distinct and uniform business model and fails to identify the importance of the business format, independence, economic interest or control of the franchisee by the franchisor. It is suggested that such an approach is incomplete. It fails to identify key elements of the franchise relationship and is perhaps too constrained by its desire to place franchising into the German legal system’s existing taxonomy of third party relationships.

232 This is also the reason why the agency compensation upon termination is applied by analogy to franchise agreements.
2.5.3 Architectural Features that Distinguish Franchising from Distribution and Commercial Agency

This is critical analysis to establishing the first objective of the thesis and seeks to establish that the specific, distinct and uniform fundamental elements of franchising distinguish it from both distribution and commercial agency.

Some academics seem oblivious to the fundamental difference between franchising on the one hand and commercial agency and distributorship on the other 233. They certainly have a number of characteristics in common. They are third party relationships that involve a “principal” and an “agent”. They all come within Housden’s 234 ill informed definition of franchising as “a right to do or use something which is granted by one party to another for a consideration”, but from there onwards fundamental differences between these three channels to market emerge. Franchising consists of a brand, control and assistance by the franchisor, a business format, independence and economic interest. The use of a brand, independence, some level of control and possibly even assistance and economic interest can sometimes be found in both commercial agency and distribution. A business format, can not.

Commercial agency and franchising both “generally bring together a strong party (the principal) and a weaker party (the agent/franchisee). Both parties are consistently, before, during and after the collaboration, in this unequal position with each other” 235. This perception of an imbalance of economic bargaining strength between the parties is what seems to persuade academics 236 and some Courts 237 that franchising and commercial agency are the same thing. However, although there can be some overlap in certain circumstances, the two are quite distinct.

A commercial agency is defined as “a self employed intermediary who has continuing authority to negotiate the sale or purchase of goods on behalf of another person (“the Principal”) or to negotiate and conclude the sale or purchase of goods on behalf of and in the name of the Principal” 238.

The key elements are independence and the power to negotiate sale and purchases for, on behalf of or in the name of the Principal.

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233 The Amsterdam Team – ibid
235 The Belgian House of Representatives, 28 Jan 2004 – draft parliamentary bill relating to Franchise Agreements (lodged by Mme t. Pieters – Doc 510747/0001
236 E.G. the Amsterdam Team
237 BGH Judgment of 12 Nov. 1986 I ZR 209/84 (“Aquella”)
Franchisees are independent and certainly have the right to negotiate sales and purchases under the brand. However, that is fundamentally different from negotiating for or on behalf of the Principal. Franchisees are inevitably obliged under the terms of a franchise agreement to give notice to the public that it is an independently owned and operated business operating under licence from the franchisor. Further, franchisees generally sell goods or services on their own behalf under the brand, not on behalf of the franchisor. Franchisees generally own the goods they sell. It is of course possible for franchisees to sell goods or services to be provided by the franchisor (e.g. a travel agency franchise, such as TUI or Thomas Cook). However, there are some other fundamental differences between a franchise and a commercial agency. The franchise is run in accordance with a business format. A commercial agency is not. Further, although a Principal will give some low level assistance and assert a low level of control over the agent, a franchisor will deliver a higher level of assistance and assert a substantially greater level of control over the use of the brand and the business format.

Commercial agency is concerned with the legal process by which the title of goods or services are passed to purchasers by the agent. Franchising is more concerned with the manner in which they are sold – that is the business format. It is theoretically possible that a franchise involves a commercial agreement by which the way in which the title to goods is passed from one party to the other and then to the consumer amounts to commercial agency. But despite this theoretical co-existence, the two are fundamentally different.

Distribution is also different to franchising. It is where “one party agrees with the other to supply certain goods for resale within the whole or a defined area of the common market.” Distribution involves nothing more than the wholesale of goods by the manufacturer to an independent party which sells those goods in such manner at its sole discretion it deems appropriate. Selective distribution arrangements impose qualitative requirements upon the environment in which the goods are sold.

The differences between straight distribution arrangements and franchising are stark. Selective distribution involves no use of the brand, no control or assistance and no business format.

Selective distribution is far more like franchising. It involves the use of the brand, and a certain level of control. However, it rarely involves assistance from the principal and, most fundamentally, there is no business format. Business format is the franchisor’s know-how of how to run the business, its “blue print” for success.

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239 This is certainly the case in the sample franchise agreements
240 Reg 1983/83.26 O.J.Eur Com. (No L173)
The perception that the Principal and the Franchisor both have a much stronger bargaining position that the distributor and franchisee again persuades some commentators and courts that distribution and franchising are the same thing. Again this perception does not accord with reality. For example, the toy shop Hamley’s franchisee in India, “Reliance”, is many times larger than Hamleys. Likewise Fortnum & Masons and its distributor in Japan, Mitsukoshi.

Selective distribution can at times look like franchising at a superficial level, but the assistance provided by the franchisor and its provision of a business format are the key difference.

Franchising is a flexible commercial tool used by a wide variety of companies in a large range of sectors. Although some academics, legislators and courts struggle to differentiate it from distribution and commercial agency, franchising is a fundamentally different species of third party commercial relationship.

Franchising is a specific, distinct and uniform type of commercial activity which is fundamentally different to commercial agency and distribution because only franchising comprises the fundamental elements of independence, economic interest, a business format, a brand, control and assistance.

2.5.4 The Tensile Stresses that the Architecture of Franchise Agreements needs to withstand

This is critical analysis towards the first objective of the thesis and establishes that the specific, distinct and uniform nature of franchising is, in part due to the fact that the relationship between a franchisor and its franchisees is of a fluid and dynamic nature and changes with the passage of time, thereby challenging the franchise agreement.

The architecture of the franchise agreement has to withstand the tensile stresses that result from these on-going changes. The franchise relationship changes firstly as the foundations of the franchisor/franchisee dynamics harden through commercial interaction between the two and secondly as the structural elements of the relationship expand and contract in response to environmental changes.

Some compare the relationship to that between a parent and child. During the initial period the franchisee is relatively “helpless”, as the young infant is heavily reliant on the parent, so is the franchisee reliant upon the franchisor. As the franchisee gains more experience and

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confidence it adopts an attitude similar to that of the adolescent child. It rebels, it no longer feels that the franchisor gets everything right. It pushes the boundaries of the relationship to test it to the full. Disputes and arguments are common often forcing both parties to re-evaluate the relationship in a forthright and sometimes final manner. However, as the franchisee further matures into adulthood it begins to see the value of the relationship with the franchisor and establishes a mature and mutually beneficial rapport with it – one that is substantially different from that it enjoyed in its “infancy” and “adolescence”

The only way that the franchise agreement can accommodate these changes and at the same time seek to balance the interests of itself and all the franchisees is to allow the franchisor to unilaterally make changes. However, that leaves the relationship open to potential abuse.

An analysis of franchise disputes in the UK tends to support this hypothesis and suggests that most franchise disputes occur after the first two years of the franchise when the relationship has moved into its juvenile stage. The disputes considered were due to the franchisee allegedly seeking to compete with the franchisor during the term of the franchise agreement, alleged failure by the franchisor to provide the appropriate level of support to the franchisee as provided for in the franchise agreement, alleged under performance or other breach of the franchise agreement by the franchisee and alleged misrepresentation by the franchisor during the recruitment process. However the research cannot establish how justified these allegations were and very few franchise disputes end up in the courts with a public judgment. It is possible that there is an element of franchisees wanting to use the franchisor as a scapegoat, and blame it for their own shortcomings or as a justification for their own breaches.”

The franchise relationship’s ongoing nature differentiates it from “one-off” transactions such as the sale of goods, which are “discrete transactions …. of short duration, involving limited personal interactions and with precise party measurements of easily measured objects of exchange”. Franchise relationships are fundamentally different. They are relational and are characterised by “long duration, personal involvement by the parties and the exchange, at

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243 Appendix 7. Note: these are the grounds of dispute raised by the parties, not those proved.
244 Appendix 7. 90% of the sample.
245 70% of the sample.
246 60% of the sample.
247 40% of the sample.
248 85% of the sample.
249 During the period 2004-2008, Field Fisher Waterhouse consistently rated by Chambers Legal Directory during that period as the leading franchise legal practice in the UK, only handled four franchise disputes that ended in a judgment by the courts or an arbitrator ChipsAway 2; LighterLife 1, Dream Doors 1. All other disputes were settled before judgment was given.
250 Op cit Gudel, p. 763.
least in party, of things difficult to monetize or otherwise measure”.\textsuperscript{251} As a result “obligations are not frozen in an initial bargain. They evolve over time and circumstances change. The object of contracting is to establish and define a co-operative relationship, not merely to allocate risk”\textsuperscript{252}. This means that “parties are obliged to behave in a way that promotes the relationship, and ….. is consistent with the needs and expectations of both parties”\textsuperscript{253}. This change introduces tensile stresses into the franchisor/franchisee relationship. However, franchise agreements do not evolve or change over the years as the franchise system develops. They are static documents fixed for a term of years. They require mutual performance over a number of years and therefore do not always define the parties’ full obligations. They need a degree of flexibility to accommodate these tensile stresses. Because of their longevity and the multilateral nature of franchising they inevitably vest the Franchisor with an amount of discretion as to how the rights and obligations of both parties will be performed.

How the franchisor exercises its discretion will inevitably impact upon the franchisees’ operation of its business. “In making discretionary decisions, franchisors can extract value from the franchisees in many ways, such as granting additional franchises in close proximity, raising the price of goods sold to franchisees, increasing rent on the franchisees locations, increasing inventory and growth requirements, as well as increasing advertising funds. Conflicts invariably arise when the franchisee perceives the franchisor’s exercise of discretion to be unfair”.\textsuperscript{254}

2.5.5 The Impact of Sectoral Contextualisation upon the Architecture of Franchising

This is critical analysis towards the first objective of the thesis and endeavours to establish that despite the differing nature of the sectors in which franchising is used, it is a specific, distinct and uniform type of commercial activity and as a result sectoral differences do not impact upon its architecture.

Despite the tendency of trade associations and commentators to speak of the “Franchise Industry” and the “Franchise Sector”, it is not a business sector in its own right. Rather, it is a strategic tool that is adopted by businesses in a large variety of different business sectors as part of their market channel strategies.

The 2010 edition of the Franchise Directory\textsuperscript{255}, the leading directory of the UK franchise sector, provides a panorama of the types of businesses that have franchised themselves in the

\textsuperscript{251} Ibid.
\textsuperscript{252} Op cit Leichtling, p. 671.
\textsuperscript{253} Leichtling quoting Parritt at 717.
\textsuperscript{254} Whitner, Brito, Spandorf, paper at ABA Franchising Forum Oct. 2007.
\textsuperscript{255} British Franchise Directory and Guide 2010, 26\textsuperscript{th} edition.
UK. It lists 12 different categories of franchises in the United Kingdom\textsuperscript{256}. Ten of the categories cover services, two cover goods and one covers food. The reason that this totals 13 rather than 12 is that one category (Catering and Hotels) covers both service and food. The IFA’s PWC 2010 Franchise Economic Outlook Report\textsuperscript{257} suggests a similar spread of franchising in the USA.

There is a wide range of commentary on the use of franchising in various sectors. It is “very successful in the food distribution market and the manufacturing and DIY and also the car maintenance, travel agency, hotels and hair dressing business sectors” according to one bill placed before the Belgian Parliament\textsuperscript{258}, whilst Blair and La Fontaine\textsuperscript{259} observe that in the US franchising “dominates retailing” in the US and has a strong representation in a broad range of sectors, particularly the restaurant sector.

Adams and Prichard Jones\textsuperscript{260} suggest that it is important to consider the different types of franchising that exist and identify the basic elements of each type. They believe that there are essentially two basic types of business format franchising\textsuperscript{261}, namely goods and service franchises. They suggest that, from an economic point of view, goods franchises can be divided into three sub categories\textsuperscript{262} and that all service franchises have one thing in common with each other – there is only one market level. This analysis seems to omit one common form of franchising. The type of franchise which consumers in the EU are probably most familiar with – food franchises. Whether they are family restaurants, take aways or home delivery businesses, all food franchises are a hybrid between goods franchises and service franchises and cannot properly be classified as either. However, regardless of the omission of the restaurant sector in their analysis, the main issue is that they do not conclude that the architecture of franchises in each of these sectors vary from each other in any fundamental manner and their subsequent analysis of the franchise agreement makes no suggestion that this is the case.

Analysis of a sample of 25 franchise agreements from the UK, Germany, France, the USA and Australia was undertaken to examine whether or not sectoral contextualisation of


\textsuperscript{257} Op cit PWC. It lists the Automotive, Commercial and Residential Services, Quick Service Restaurants, Table/Full Service Restaurants, Retail Food, Lodging, Real Estate, Retail Products and Services and Personal Services.

\textsuperscript{258} The Belgian House of Representatives, 28 Jan 2004 – Development [Doc 510747/001]

\textsuperscript{259} Op cit Blair and La Fontaine. F, p.8

\textsuperscript{260} Op cit Adams and Jones, p. 23.

\textsuperscript{261} Ibid
franchising does have any impact upon its fundamental elements. The sample comprises franchises in 5 sectors. The food/restaurant sector, the retail sector, the hotel/leisure sector, the services sector and car rental sector as detailed in the following table:

**Categorisation of Sample by Sectors**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Australia</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Car Rental</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Retail</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Others Services</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Food/Restaurant</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5</strong></td>
<td><strong>5</strong></td>
<td><strong>5</strong></td>
<td><strong>5</strong></td>
<td><strong>5</strong></td>
</tr>
</tbody>
</table>

The sample agreements all identify independence, economic interest, the brand, the business format, control of the franchisee by the franchisor and the provision of assistance by the franchisor to the franchisee, as features of the franchises’ architecture regardless of the sector in which they operate.

Sectoral contextualisation therefore does not impact the fundamental features of the architecture of franchising.

2.5.6 The Impact of Economic Contextualisation upon the Architecture of Franchising

This is critical analysis towards the first objective and seeks to establish that although value of the investment required from the Franchisee inevitably defines the type of franchisee attracted to each franchise system, franchising remains a specific, distinct and uniform type of commercial activity and as a result the scale of economic investment required does not change the fundamental features of its architecture.

The investment required to buy into a franchise immediately disqualifies those franchisees who cannot access sufficient capital. This in turn has a substantial impact upon the nature of the relationship between the franchisor and its franchisees particularly in terms of the ability of the franchisee to negotiate the commercial terms of the franchise. For example, whilst a

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263 Appendix 8  
264 Martinek, ibid
franchisee of a hotel concept such as Ramada\textsuperscript{265} will be investing several millions of pounds in bricks and mortar and fit out costs for each hotel, and may pay the franchisor to operate the hotels through a management agreement, a franchisee for a contract cleaning business such as Jani-King\textsuperscript{266} needs to find only a few hundred pounds and is able to pay that by way of instalments over the life of the franchise agreement.

From a commercial point of view, the difference between such a sophisticated hotel “investment” franchisee and a contract cleaning “job” franchisee could not be bigger. One is typically sophisticated, experienced in the ways of business, and wealthy looking for substantial returns on its capital investment. The other is doing little more than buying himself a job of manual labour that will secure him a modest level of ongoing income for the life of the franchise. Between these two extremes there is a broad spectrum of franchisees varying from the seasoned businessman who is buying a franchise to add to his portfolio, to the former teacher or bank manager who has decided to enter the commercial world in their middle years. These differences inevitably impact upon the franchisor/franchisee relationship and US franchise law exempts large and/or sophisticated franchisees from the requirement for pre-contractual disclosure,\textsuperscript{267} but do not impact upon the technical legal components of the contractual relationship\textsuperscript{268}.

Some commentators have focused upon this disparity in the balance of economic power between franchisors and different types of franchisee to categorise franchising. The categorisation of franchise systems according to the balance of power and alignment of interests between the parties was first developed by Martinek in the 1980s and has since been further modified\textsuperscript{269}. This approach categorises franchise agreements into two basic types; subordination and partnership franchising. It then suggests a further subdivision in respect of partnership franchising.

The analysis suggests that so called “Subordination Franchising” exists where there is a hierarchical relationship between franchisor and franchisee and that the cooperation between the parties is limited to the distribution of the goods and/or services on a vertical level. As such it resembles other distribution arrangements and is “the further development and refinement of the classic authorised dealer model”\textsuperscript{270}. A franchised outlet is distinguished from an authorised dealership due to its look and feel which is identical to those of the corporate outlets of the franchisor. The cooperation between the parties is limited to the

\textsuperscript{265} See Appendix 8
\textsuperscript{266} ibid
\textsuperscript{267} See Chapters 4 and 5 below.
\textsuperscript{268} See section 3.4 below
\textsuperscript{269} Martinek. ibid ss 18 Rn 18ff
\textsuperscript{270} Ibid § 4 Rn. 52
franchisor making available to the subordinate franchisee the necessary know-how and providing the services set out in the franchise agreement. The franchisee itself becomes an instrument of the franchisor in its distribution system.

The counter-point to Subordination Franchising is so-called “Partnership Franchising”, which according to Martinek can be divided further into three sub-categories – “Co-ordination Franchising”, “Coalition Franchising” and “Confederation Franchising”. In “Partnership Franchising” there is more of an economic balance between the franchisor and its franchisees. “Co-ordination Franchising” is characterised as a uniform exchange agreement between the franchisor and its franchisees who are considered equal partners. The franchisees are not mere instruments of the franchisor who carry out their commercial activity mainly for the benefit and in the interest of the franchisor. They act in their own interests using the franchise model. Opposing interests between the franchisor and franchisees are co-ordinated and a common marketing strategy for the products and/or services is developed. The franchisee uses the franchise concept for its own benefit without being subjected to the directions of the franchisor. Big ticket franchises such as hotel franchise systems are co-ordination franchises, according to Martinek.

“Coalition Franchising”, according to Martinek, is characterised by a balance of power and both parties not only sharing a common interest (making a profit by exploiting the franchise concept), but also a common purpose in that both the franchisor and franchisee take on the mutual obligation to optimise the distribution of the goods and/or services of the franchised outlets on the basis of a system specific marketing concept. As this mutual duty of optimisation is considered as the overarching purpose of the franchise agreement, they are seen as transcending mere obligations of a common purpose and the franchisor and franchisee are deemed to form a very primitive form of company.

“Confederation Franchising” goes one step further than coalition franchising. The balance of power is marked and the common purpose is extended from a bilateral relationship between franchisor and franchisee to a multi lateral relationship between the franchisor and all franchisees in the network. The suggestion is that some sort of unwritten umbrella agreement

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271 Ibid § 18 Rn. 18 ff.
272 For that reason, Martinek considers the business management element in these type of franchise relationships to be predominant with additional service agreement elements and, depending on the type of franchise sales contract, lease agreement, licence agreement and know-how transfer elements. This means that subordination franchise agreements are mixed contracts with business management agreement features as their core element. (Ibid § 4 Rn. 60)
273 Ibid § 4 Rn. 63
274 Ibid § 4 Rn. 64
275 Ibid § 4 Rn. 69
276 Ibid § 4 Rn. 68
amongst all participants is concluded\textsuperscript{277}. The overarching purpose of this hypothesised umbrella agreement covers everyone in the network and comprises of the increase in the goodwill of the products and/or services and competitiveness of the franchise system, the exploitation of group purchasing opportunities and the breakdown of the market into different segments for each participant. This manifests itself in the “optimisation of the intercompany cooperation in all areas which are relevant for the distribution (of the goods and/or services) for the benefit of all”\textsuperscript{278}. The group interests in confederation franchising systems form the core of the franchise that all participants undertake to develop.

Whilst it is clearly correct that (largely as a result of the size of the investment the franchisee makes) there are variances in the degree of hierarchy in franchise systems, these do not impact upon the key architectural features of franchising already identified, namely the duty of the franchisor to support the franchisee, its ability/right to control the franchisee, the brand, the business format, independence and economic interest.

Using Martinek’s analysis, the 25 franchises considered in this thesis\textsuperscript{279} based upon the commercial reality of the relationship between franchisor and franchisee could be categorised as follows:

\textsuperscript{277} Ibid § 4 Rn. 72  
\textsuperscript{278} Ibid § 4 Rn. 73  
\textsuperscript{279} Appendix 8
<table>
<thead>
<tr>
<th>Subordinated Franchises</th>
<th>Partnership Franchises</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Choice Hotels</td>
</tr>
<tr>
<td></td>
<td>BB’s Coffee &amp; Muffins</td>
</tr>
<tr>
<td></td>
<td>Bartercard</td>
</tr>
<tr>
<td></td>
<td>Cash Converters</td>
</tr>
<tr>
<td></td>
<td>Expense Reduction Analyst</td>
</tr>
<tr>
<td>USA</td>
<td>Intercontinental Hotels</td>
</tr>
<tr>
<td></td>
<td>National Car Rental</td>
</tr>
<tr>
<td></td>
<td>Dominos Pizza</td>
</tr>
<tr>
<td></td>
<td>Snap on Tools</td>
</tr>
<tr>
<td>UK</td>
<td>Jani King</td>
</tr>
<tr>
<td></td>
<td>Costa Coffee</td>
</tr>
<tr>
<td></td>
<td>Hertz</td>
</tr>
<tr>
<td></td>
<td>Ramada</td>
</tr>
<tr>
<td></td>
<td>Kall Kwik</td>
</tr>
<tr>
<td>German</td>
<td>Eisman</td>
</tr>
<tr>
<td></td>
<td>Applebees</td>
</tr>
<tr>
<td></td>
<td>Starwood Hotels</td>
</tr>
<tr>
<td></td>
<td>Hertz</td>
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<tr>
<td></td>
<td>Polo Ralph Lauren</td>
</tr>
<tr>
<td>France</td>
<td>Arteria</td>
</tr>
<tr>
<td></td>
<td>Ibis</td>
</tr>
<tr>
<td></td>
<td>Yves Rocher</td>
</tr>
<tr>
<td></td>
<td>Pronuptia</td>
</tr>
<tr>
<td></td>
<td>La Bôte a Pizza</td>
</tr>
</tbody>
</table>

Based upon the commercial reality of the relationship, the distinction between subordinated and partnership franchises reflects the investment required. Low investment franchises are subordinated franchises. All others are partnership franchises.
The identification of confederation franchises based upon the commercial reality of the relationship is relatively straightforward and reflects a high investment. Identifying coordination and coalition franchises is far more problematic and is impossible to do with the sample agreements considered, or indeed, on the information available, on the commercial reality of the relationship.

The conclusion which is drawn from this is that Martinek’s categorisation of subordinated and partnership franchises can be justified based upon the commercial reality of the relationship. It reflects low investment franchises on the one hand and medium, substantial and high investment franchises on the other. The categorisation of high investment franchises as confederation franchises is sustainable based upon the commercial reality of the

<table>
<thead>
<tr>
<th></th>
<th>Co-ordination Franchising</th>
<th>Coalition Franchising</th>
<th>Unclear whether coordination or confederation franchise</th>
<th>Confederation Franchising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>-</td>
<td>-</td>
<td>Cash Converter</td>
<td>Choice Hotels</td>
</tr>
<tr>
<td>USA</td>
<td>-</td>
<td>-</td>
<td>Dominos Pizza Intercontinental Hotels National Car Rental</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>-</td>
<td>-</td>
<td>KallKwik Costa Coffee Hertz Ramada</td>
<td></td>
</tr>
<tr>
<td>German</td>
<td>-</td>
<td>-</td>
<td>Applebees Polo Ralph Lauren Starwood Hotels Hertz</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>-</td>
<td>-</td>
<td>Yves Rocher Pronuptia La Bôte a Pizza Ibis</td>
<td></td>
</tr>
</tbody>
</table>
relationship. However the categorisation of other partnership franchises as co-ordination and coalition franchises is not borne out by the commercial reality of the relationship entitled by the sample agreements considered.

More importantly though, regardless of how the agreements can be categorised using Martinek’s approach, such categorisation was not reflected in the actual agreements themselves. The distinction between subordinated and partnership franchises is to some small extent reflected in the agreements considered. The Jani-King and Coverall agreements were distinctly more controlling than the other agreements in the sample. However, the distinction between Co-ordinated, Coalition and Confederation franchises was not reflected in the sample agreements considered at all.

All of the agreements considered, regardless how Martinek would categorise them, have the same basic legal architectural features.

Martinek’s analysis therefore seems somewhat contrived and is certainly not supported by an analysis of the sample franchise agreements. None of the agreements in the sample give any hint of the mutuality that is characteristic of Coalition Franchising let alone the over-arching purpose imposed on the franchisor and all of its franchisees which is supposed to be found in Confederation Franchising. The differences suggested between Subordination Franchises and Co-ordination Franchises may in some circumstances be similar to the “de facto” commercial relationship between economically stronger franchisees and their franchisors on the one hand and economically weaker franchisees and their franchisors on the other but they do not impact upon the basic architectural features of franchising; independence, economic interest, business format, brand, control and assistance.

2.5.7 Sub-Conclusion

The most complete and succinct economic and legal views seem to agree that the architecture of franchising exhibits six key features, namely; independence of parties; use of a brand; use of a business format; control of the franchisee by the franchisor; assistance supplied to the franchisee by the franchisor and economic interest. It is distinct from agency and distribution, the main difference being the business format and the ongoing support. The long term nature of the franchise relationship means that the architecture of franchise agreements need to withstand a number of tensile stresses. This results in franchisors having an unusually high level of discretion, which can in turn lead to abuse.

It is therefore submitted that the economic and sectoral contextualisation of franchising does not impact upon the basic architectural features of the franchise relationship; independence, economic interest, business format, brand, control and assistance.
2.6 Conclusion

This chapter has established that although franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU and which stimulates economic activity by offering economic advantage to all those involved, improving distribution and giving business increased access to other member states, it is not fulfilling its potential to contribute to the realisation of the single market.

Business format franchising is the latest incarnation of a long established business structure. Its importance is acknowledged by a wide range of institutions and it has emerged as an important vehicle for entrepreneurship that appeals to large corporations and small businesses alike. The 9,971 or so franchise networks operating in the EU and the 405,000 or so outlets make a substantial contribution to the GDP of a number of member states, with a roughly estimated total turnover of €215 billion (US$300 billion). It has great potential to stimulate economic activity within the EU by improving the distribution of goods and/or services within and between member states. However, it is over concentrated in a small number of EU member states and a comparison with the size of franchising in the USA and Australia suggests that its potential to contribute to the single market and promote trade between member states is far from being fulfilled at present. An estimated 83.5% of its turnover being concentrated in only 25% of the member states.

The economic drivers that lead franchisors and franchisees to become involved in franchising and the consequential inherent risk differ.

Improved access to both appropriately qualified managerial resource and capital (the Agency, Resource Scarcity and Transaction Cost theories) and other economic drivers such as bulk purchasing, economies of scale and enhanced product development explain why businesses use franchising as part of their commercial strategy. A number of economic incentives resulting in an increased chance of success (such as access to a proven format, a nationally recognised brand, ongoing support, economies of scale and so on) supported by various situational, personality and economic correlatives explain the attraction of franchising to franchisees.

There are a number of different risks inherent in franchising for franchisors and franchisees. Franchisors are exposed to risks arising from information asymmetry and
moral hazard (such as underpayment, in term competition, abuse of the franchisor’s brand and non compliance with the business format). Whilst franchisees are exposed to the risk of misrepresentation, encroachment, poor quality business formats and inadequate support.

Franchising is a symbiotic relationship between two legally independent businesses that is used in a wide range of sectors and on a broad spectrum of scale and value which can be differentiated from commercial agency and distribution. The architecture of franchising comprises six basic features; Independence of the parties involved, economic interest, a business format, a brand, control of the franchisee by the franchisor and the provision of assistance to the franchisee by the franchisor. It is distinct from agency and distribution, the main difference being the business format and the ongoing support. These features are not impacted by either economic or sectoral contextualisation\textsuperscript{287}. The legal architecture is uniform regardless of the legal system in which the franchise operates\textsuperscript{288}.

Despite the differing nature of the sectors in which franchising is used these differences do not impact upon the architecture of franchising. Likewise although the value of investment required from franchisees inevitably defines the type of franchisee attracted to each franchise system, the resulting differences in economic bargaining power does not change the fundamental architectural features of franchising\textsuperscript{289}.

This architecture is subjected to tensile stresses as a result of the long term and ever changing nature of the franchise relationship. In order to withstand these stresses the franchise agreements give the franchisor a degree of flexibility that can result in abuse of the franchisee\textsuperscript{290}.

\textsuperscript{286} See 2.4 above  
\textsuperscript{287} See 2.5.1 above  
\textsuperscript{288} See 2.5.5 and 2.5.6 above  
\textsuperscript{289} ibid  
\textsuperscript{290} See 2.5.4 above
Chapter 3 Does the Contractual and Regulatory Environment Support and Promote Franchising?

In the previous chapter, the first objective of the thesis has been achieved. It has been established that although franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU and which stimulates economic activity by offering economic advantages to all those involved, improving distribution and giving business increased access to other member states, it is relatively underdeveloped in the EU and is not fulfilling its potential to contribute to the realisation of the single market.

The economic drivers that draw franchisors to franchising are its ability to enable them to access higher quality resource for its business (Agency theory), access capital and greater management resource (Resource Scarcity theory) and decrease overheads, economies of scale and so on to enable them to compete more effectively (Transaction Cost theory). The economic drivers which attract franchisees to franchising are access to a known brand, franchisor support and assistance, use of a proven format, economies of scale and independence. There are also personality and economic correlates that have an impact. The consequential risks assumed by franchisors are moral hazard and information asymmetry. The consequential risks assumed by franchisees are inaccurate pre-contractual representations by the franchisor, encroachment, a poor business format and provision of inadequate support.

This chapter seeks to achieve the second objective of the thesis.

It seeks to establish whether the regulatory environment in the EU is in any way responsible for this under achievement of franchising in the single market. It will consider whether or not franchising needs to be regulated and the difficulties experienced by those member states that have sought to do so. It will do this by considering the differing approaches of EU member states to constructing franchising’s contractual environment and its impact on the risks to which franchisors and franchisees are exposed. It considers the impact of the self regulatory system in the EU and then considers the lack of homogeneity between the legal eco-systems that comprise the regulatory environment within the EU and the failure of those legal eco-systems to re-enforce the economic drivers that attract franchisors and franchisees to franchising or to reduce the inherent consequential risk.

It is submitted that franchising does need regulating and that the economic determinants and the interparty dynamics of the franchisor/franchisee relationship lead to a contractual environment that transcends sectoral divergence and the differing legal traditions of EU member states. This contractual environment tends to support and re-enforce the economic drivers that encourage franchisors to become involved in franchising and reduces their consequential inherent risk to a reasonable level. However, although it tends to re-enforce
some of the economic drivers that encourage franchisees to become involved in franchising it
does not re-enforce them all and it fails to reduce all the consequential inherent risks for
franchisees to an adequate level.

It is also submitted that the regulatory environment in the EU within which franchising
operates (which comprises a series of legal eco-systems), does not adequately protect and
reinforce the economic attractions that drive franchisors and franchisees to become involved
in franchising. Nor does it adequately reduce the consequential risks. It is therefore to some
extent responsible for the under achievement of franchising in the EU.

3.1 The Difficulties Experienced in Seeking to Regulate Franchising in the EU

This is critical analysis towards the second objective. It seeks to identify the nature of the
current regulatory environment in the EU and the reasons for it.

Those intimately involved in franchising in the EU exhibit differing approaches to the
regulation of franchising. Franchise trade associations in some member states\textsuperscript{291} have fought
long and hard to have franchise specific laws enacted in their jurisdictions. At the same time,
in other member states, such trade associations have expended a great deal of time, energy
and money to ensure that franchise laws are not enacted in their jurisdiction\textsuperscript{292}. This is despite
all such trade associations being members of the European Franchise Federation and therefore
supposedly sharing a common view of how franchising should be regulated\textsuperscript{293}.

The regulation of franchising on a purely national level in certain EU member states has
created barriers which restrict the ability of franchisors to freely expand from one member
state to another\textsuperscript{294}.

There is a wide divergence of opinion and even conflict as to the form and approach that
those laws take.

A degree of political cynicism towards franchising is noticeable in the EU. It seems that
franchising is “big enough” for its regulation to make an impact in the public consciousness
but not important enough to matter to the government concerned if that regulation is not as
positive or as appropriate as it might be. It has been treated as a political plaything. A
palliative to potentially troublesome politicians who, although outside of the political
mainstream, have the potential to create irritating diversions for the main players\textsuperscript{295}. It took

\textsuperscript{291} E.g. the Italian Franchising Association.
\textsuperscript{292} E.g. the British Franchise Association.
\textsuperscript{293} European Franchise Federation website http://www.eff-franchise.com/ accessed 14 August 2009
\textsuperscript{294} Italy, Spain, France, Lithuania, Estonia, Sweden, Belgium and Romania
\textsuperscript{295} Belgium, France, and Italy
seven years and eight bills in Italy\textsuperscript{296}, twenty four years and five bills in Belgium\textsuperscript{297} and nineteen years and twelve bills in Sweden\textsuperscript{298} to produce a franchise law.

\textsuperscript{296} In Italy, there was a seven year battle involving eight separate bills proposing a franchise law. The President, a gaggle of the Italian parliaments’ numerous political parties (particularly the Communist and the Left Democratic parties) the Italian Franchise Association, the FIF Confeserienti (the National Association of Traders), the Commission for Constitutional Affairs and the Italian Justice Commission were all actively involved in the process. (A) Resolution of July 24th 2000: (B) Bill of law no. 19 of 30\textsuperscript{th} May, 2001 from Senators: MACONI, GROSSO, PASQUINI and PIATTI; (C) Bill of law no. 25 of 30\textsuperscript{th} May 2001 from Senator: ASCIUTTI ;(D) Bill of law no. 103 of 6\textsuperscript{th} June 2001 from Senators: MARINO, MUZIO and PAGLIARULO; (E) Bill of law no. 842 of 14\textsuperscript{th} November 2001 from Senator: COSTA; (F) Bill of law no. 95 of 30\textsuperscript{th} May 2001 from Deputies: GAMBINI and others;(G) Bill of law no. 1523 of 24\textsuperscript{th} August 2001 from Deputies: MAZZOCCHI and others; (H) Bill of law no. 4702 of 13\textsuperscript{th} February 2004 from Deputies: PERROTTA.

\textsuperscript{297} On 4\textsuperscript{th} February 1982 (Wetsvoorstel tot regeling van de franchise overeenkomst, zitting 1981-1982, 4 February 1982, Parl. Doc. 90, no.1) a proposal was made which focused on regulating the franchise relationship rather than pre-contractual disclosure and was rather cumbersome. It proposed that franchising be regulated by a Public Commission, which would approve franchisor’s standard agreements. All modifications agreed with the franchisee had to be approved by the Commission. The Commission would have had the ability to require franchisors to prove to it that they had the necessary financial and technical means to guarantee the normal performance of the agreement. One of the 2003 bills proposed establishment of a Commission of Franchise Arbitrators (the Belgian House Of Representatives, 30 Oct 2003, Clause 16) to deal with any disputes between franchisors and franchisees was perhaps the most unusual and eccentric provision. The Commission would have consisted equally of representatives from organisations protecting the interests of franchisees and of representatives from organisations protecting the interests of the franchisors. On 8 October 2003 Anne Barzin (Reform Movement member of the Belgian House of Representatives), Serge Van Overtveldt and Philippe Collard proposed a draft Parliamentary Bill “Concerning pre-contract information in relation to contracts by which one person grants to another the right to carry on commercial activities” (the Belgian House of Representatives, 28 Jan 2004 – Summary Doc 51 0747/001 Second sitting of 51\textsuperscript{st} Parliament). The proponents took the view that franchisors usually offer franchises on a “take it or leave it basis” and that there is a clear imbalance between the rights and obligations of the franchisor compared with those of the franchisees (The Belgian House Of Representatives, 30 Oct 2003, Extraordinary Session 2003, Introduction to Draft parliament Bill – Summary). They therefore proposed that franchisees need to be specifically regulated, particularly in relation to pre-contractual disclosure, transfer of the agreement, the nullity of certain clauses, the franchisor’s right of pre-emption, the duration of the contract and the manner in which the contract is terminated. They also proposed a dispute resolution procedure. On 28 January 2004 Mme Trees Pieters (Christian Democrat Party member of the Belgian House of Representatives) proposed a draft Parliamentary Bill relating to franchise agreements (The Belgian House of Representatives, 28 Jan 2004 – Summary Doc 51 0747/001 Second sitting of 51\textsuperscript{st} Parliament), which praised franchising as a form of distribution of goods in wide and successful use, but saw it as a relationship between a stronger party, the franchisor and a substantially weaker one, the franchisee. She therefore proposed to bring in “a number of clear and flexible provisions to correct the imbalance in the contractual relationship, and to introduce minimum trading protection for the franchisee without adversely affecting the development of this system of distribution” which include pre-contractual disclosure and the imposition of mandatory terms in the franchise agreement (The Belgian House of Representatives, 28 Jan 2004 – Summary Doc 51 0747/001 Second sitting of 51\textsuperscript{st} Parliament). On 17 March 2004 Alain Mathot (Socialist Party member of the Belgian House of Representatives), Jean-Marc Delizée
Even when governments do become involved in the regulation of franchising a degree of
cynicism is evident. For example when the “Rainbow coalition” in Belgium introduced a
draft bill into Parliament in 2001 it was proposed, at least in part, because the vast majority of
franchisors present in Belgium are not Belgian and so any protection afforded to franchisees
was seen as having little political risk and being a potentially populist move.

3.2 The Need to Regulate Franchising in the EU - Abuse, Sharp Practice and
Failure

This is critical analysis towards the second objective of the thesis and seeks to show that it is
necessary to regulate franchising in the EU.

The growth of franchising seems to have brought with it a degree of sharp practice, abuse and
commercial failure that has lead the authorities in some member states to conclude that
specific regulation was required.

and Sophie Pécriaux (all three members of Socialist Party Member of the Belgian House of
Representatives) proposed a draft Parliamentary Bill “Regulating Franchise Agreements with a View to
Improving Commercial Practices in this Sector” (The Belgian House of Representatives, 17 March 2004
Doc 51 0924/001 Second sitting of 51st Parliament). The sponsors of the bill declared that franchisors offer
their franchises on a “take it or leave it” basis and that there is a clear imbalance between the rights and
obligations of the respective parties. They therefore proposed that franchise agreements should be regulated
as regards pre-contractual disclosure, the void effect of certain provisions, the franchisor’s right of pre-
emption, the period of the franchise agreement and the manner in which it can be terminated (The Belgian

A Swedish franchise law was first mooted in a public report in 1987. Statens offentliga utredningar
(SOU) 1987:17 “Franchising”. However it was another 19 years before it was adopted by the Swedish
parliament. It was largely the result of the dogged determination of a particular MP who during that period
was able to ensure that no less than 12 bills proposing a franchise law were presented to the parliament and
several public reports made. The mandate of the 1987 public report was to survey the extent of franchising
in Sweden, and describe and analyse the advantages and drawbacks of franchising. Against this background
the report considered the need for and possible content of a specific law on franchising. The areas of law
focused on in the resulting report, were labour law, contract law, competition law, intellectual property and
consumer law. The report proposed a definition of franchising and took the view that franchise agreements
are often characterized by being one-sided, and consequently include clauses which might be considered to
be unfair. However the overall conclusion of the report was that franchise agreements should be subject to
general law of contract rather than franchise specific regulations. Nevertheless, the report did suggest a
mandatory notice period of one year upon termination of the agreement by the franchisor, save in the case
where the grounds for termination were misrepresentation by the franchisee. The report suggested that in
order to protect consumers franchisees and franchisors should be obliged to notify the public that their
business was part of a franchise and that employees of franchisees should have the right to negotiate
directly with the employer’s organisation to which the franchisor was connected. Following the
Government’s decision to dismiss the 1987 Report, a series of private member’s Bills were proposed by Mr
Stig Gustafson, which called for a new government study on the need for legislation to protect the weak
franchisees, were raised in Parliament between 1992 and 2003 (Lagutskottets (LU): 1992/93:LU2,
1998/99:LU7, 2000/01:LU17, 2001/02:LU12, 2002/03:LU4 and 2003/04:LU7). However, these private
member’s Bills were all rejected by Parliament.

A coalition of the Liberals, Socialists and Greens

Pascal Hollander, “Possible Legislative Developments: Is Belgium Doomed to Become a Hell for
There are many examples of abuse, sharp practice and failure in franchising in EU member states. In the UK, in 2007 there was an uproar in the press\textsuperscript{301} about the Self Video 24 franchise. Fifteen of the thirty franchisees were forced to cease trading due to their poor financial performance caused by lack of any support from the Franchisor, whilst the franchisor itself made an alleged £2 million profit\textsuperscript{302}. Labour MP Brian Donohoe raised the matter in Commons stating that it was “a myth” that investing in a franchise was safe\textsuperscript{303}. The collapse of the Pierre Victoire restaurant chain in 1998 was another example of a franchise chain going into receivership, leaving 104 franchisees in dire financial straits\textsuperscript{304}. Likewise the collapse of the Pentos Group Plc – franchisor of the Athena and Rymans retail brands\textsuperscript{305}.

In Germany there has also been a number of franchise failures. For example, Foto Quelle, a mail order business with more than 1,000 franchises failed due to poor management; the master franchise of Hooters in Berlin, Brandenburg, North Rhine Westfalia and Hesse (Wings of Germany) was declared bankrupt in 2006. In 2007 Kindervilla (children’s nurseries) was declared bankrupt, resulting in criminal proceedings in 2009 due to 20 franchisees having lost around €150,000 each; and Zwo24, a dry cleaning business failed in 2004 due to over ambitious expansion. The restaurant Wienerwald failed three different times. In 1982 with 1,600 restaurants due to over aggressive expansion; in 2003 due to adverse market conditions and in 2007 due to insufficient capitalisation. It is currently being relaunched for a fourth time\textsuperscript{306}.

In France, Law n° 89-1008 of December 31, 1989 was adopted due to the proliferation of abuse, sharp practice and commercial failure in franchising. Franchisors such as the Letter Station (which embezzled funds from some sixty franchisees in 1985), took advantage of franchising’s growing popularity, whilst several legitimate franchise such as VO 9, Allo-Video, Dermo Vital, Climat de France, Plein Pot, La Taste, Relais Bleus, La Sweaterie and Sporteus\textsuperscript{307} failed. These incidents seriously damaged the public image of franchising and led the authorities to consider regulating franchise agreements.

A similar record of abuse\textsuperscript{308} led to the adoption of the Spanish franchise law\textsuperscript{309}. It was a

\textsuperscript{301} The Mirror – Penman and Sommerlad “Fleeced by 24 Self Video Franchise” September 13 2007
\textsuperscript{302} ibid
\textsuperscript{303} Hansard HC Vol 450 Col 1493 (24 October 2006)
\textsuperscript{304} Scotland on Sunday 23 May 2010
\textsuperscript{305} Franchise World Feb/March 1994
\textsuperscript{306} Marzheuser-Wood, B, 2009 “Franchising in Germany”, EfN Conference (London)
\textsuperscript{308} A number of so-called “empty franchises” (fraudulent schemes to extract money from unsuspecting individuals) SAP Valencia of 21 May 1993 (AC\textbackslash 1993\textbackslash 1024).
record of abuse that also led to the regulation of franchising in Italy. Although there was no particular big scandal or case of abuse which made the headlines. Many small players on the market were granting “franchises” without having any significant formula, brand, trademark, know-how or business format for the franchisee and without providing the potential franchisee with the information necessary to take an informed decision about the advantages of joining the franchisor’s network.\(^{310}\)

The much publicised dispute over the Singer Sewing Machines company’s termination of its franchisees led to the suggestion that franchising be specifically regulated being raised in the Swedish Parliament for the first time in its 1982/83 session.\(^{311}\)

Franchising is therefore subject to abuse, sharp practice and failure and so needs to be regulated.

3.3 Analysis of the Contractual Environment

3.3.1 The Differing Approaches of EU Member States to constructing the Contractual Environment

This is critical analysis towards the second objective and suggests that the differing approaches of EU member states has no substantial impact on the basic elements of franchising’s contractual environment.

It is suggested that the fundamental economic and relational elements of franchising mean that despite the different approach that civil and common law jurisdictions take to the drafting of commercial contracts, franchise agreements exhibit a common contractual architecture that transcends these differences and creates a uniform contractual environment for franchising in the EU.

3.3.1.1 An Analysis of Franchise Specific Laws in the EU

This is critical analysis towards the second objective of this thesis.

The heterogeneous nature of the regulatory environment is contributed to by the franchise specific laws of eight EU member states. These will not all be considered in detail in this study. However, it is important to explain and contrast their content to establish the lack of any common approach amongst them.

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\(^{310}\) Interview with Prof. Aldo Frignani, Professor, University of Turin (March 2009).

\(^{311}\) An attempt to obtain compensation for them under Sweden’s protectionist employment laws failed. However, the lawyer who represented the franchisees, Mr Stig Gustafsson soon after entered the Swedish parliament as an MP, and spurred on by his failure to obtain compensation for the franchisees, dedicated himself to introducing a franchise regulation that would deliver the protection that he had failed to obtain for them under the employment law. After 21 years of campaigning by Mr Gustafsson, the Swedish parliament adopted a franchise specific law (Statens offentliga utredningar (SOU) 1987:17 “Franchising”).
Although France provided initial momentum to the move towards franchise specific laws in the EU, its approach has not been copied wholesale by any of the other member states. This may well be because although the French law predates the other EU member state franchise regulations by some years, many of those member states began considering the need for such a law several years before the Loi Doubin was enacted\(^ {312} \). Each member state has taken a markedly different approach. Six of the member state franchise focused laws are concerned with precontractual disclosure. Two member states require the franchise agreement and the other relevant documents to be registered. One of the member states (Belgium) follows the French example and does not mention the word franchising. The two laws that do not require precontractual disclosure are more concerned with trying to define a franchise and the rights and obligations it gives rise to. These eight laws are outlined in the table below.

A draft franchise law was also considered in Greece in 2006 and 2007 but was dropped in 2008 because of a lack of governmental interest.

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\(^{312}\) The first Franchise Law Bill introduced into the Belgian Parliament dates back to 1982 and that in Sweden to 1987.
<table>
<thead>
<tr>
<th>EU Member State</th>
<th>Title of Law</th>
<th>Precontractual Disclosure</th>
<th>Specification of Contractual Terms</th>
<th>Registration of Documentation on a Public Register</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>Law No 89-1008 dated 31 December 1989 (the Loi Doubin). New Article 330 of Civil Code.</td>
<td>20 days before executing contract</td>
<td>n/a</td>
<td>n/a</td>
<td>It does not refer to franchising but to “any person who places a commercial name, a trade mark or sign at the disposal of another person in consideration for an undertaking of exclusivity or quasi-exclusivity for the exercise of his business”.</td>
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<tr>
<td>Spain</td>
<td>Article 62 of Act 7/1996 and Royal Decree 2485/1998</td>
<td>20 days before executing contract</td>
<td>n/a</td>
<td>Yes, at regional or central registries</td>
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<td>Italy</td>
<td>Law No 129 – 6 May 2004</td>
<td>30 days before</td>
<td>Details of the</td>
<td>n/a</td>
<td>A full copy of the</td>
</tr>
<tr>
<td>EU Member State</td>
<td>Title of Law</td>
<td>Precontractual Disclosure</td>
<td>Specification of Contractual Terms</td>
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<td>executing contract</td>
<td>following must be provided;</td>
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<td>franchise agreement replaces the need for a summary of the agreement’s terms.</td>
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<td>- Fees due</td>
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<td>- Investment requested</td>
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<td></td>
<td>- Territory</td>
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<td>- Details of know-how</td>
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<td>- Services to be provided by franchisor</td>
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<td>- Renewal</td>
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<td>- Termination</td>
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<td>- Transferability</td>
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<td>It imposes</td>
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<td>(1) Mandatory conciliation before</td>
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<td>EU Member State</td>
<td>Title of Law</td>
<td>Precontractual Disclosure</td>
<td>Specification of Contractual Terms</td>
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<tr>
<td>Sweden</td>
<td>The Disclosure Act 2006 (2006:484)</td>
<td>14 days before executing contract</td>
<td>legal proceedings</td>
<td></td>
<td>(2) The concept must be tested and the results disclosed to the franchisee</td>
</tr>
<tr>
<td>Belgium</td>
<td>Law Governing Pre-Contractual Information Within the Framework of Commercial Partnership Agreements – 19 December 2005, modified 27 December 2005 (Doc:51 1687/006)</td>
<td>One month before executing contract</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
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<tr>
<td>Romania</td>
<td>Ordinance 52/1997 as modified by Law No.</td>
<td>No time specified</td>
<td>Must specify</td>
<td>n/a</td>
<td>It does not refer to franchising but to “commercial partnership”</td>
</tr>
<tr>
<td>EU Member State</td>
<td>Title of Law</td>
<td>Precontractual Disclosure</td>
<td>Specification of Contractual Terms</td>
<td>Registration of Documentation on a Public Register</td>
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<td>Estonia</td>
<td>Law of Obligations Act 2002 Section 375-378</td>
<td>n/a</td>
<td>- duty of good faith</td>
<td>n/a</td>
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<td>- grant of rights to franchisee by franchisor</td>
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<td>Lithuania</td>
<td>Civil Code Article 6.766-6.779 (200)</td>
<td>n/a</td>
<td>- duty of good faith</td>
<td>Yes, but it can be contacted out of (although this results in the agreement being unenforceable against third parties)</td>
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<td></td>
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<td>- automatic transfer of franchise to franchisee’s heir in the event of death</td>
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<td>Specification of Contractual Terms</td>
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<td>- franchisor can be held liable for claims against franchisee regarding the quality of goods or services supplied</td>
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<td>- automatic right of renewal</td>
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In order to meaningfully consider whether the fundamental economic and relational elements of franchising mean that despite the different approach of civil and common law jurisdictions take to the drafting of commercial contracts, franchise agreements exhibit a common contractual architecture that transcends these differences and creates a uniform contractual environment for franchising, the architecture of a sample of 25 franchise agreements was analysed. In order to avoid any jurisdiction specific issues the sample comprises the agreements of 5 UK franchisors, 5 German franchisors, 5 French franchisors, 5 US franchisors and 5 Australian franchisors\(^{313}\). These are all agreements of franchisors established in the EU and doing or seeking to do business in more than one EU member state. In order to avoid any distortion due to focusing upon a particular sector franchises in the retail, commercial and personal services, food/restaurant, contract cleaning, renovation services, printing, car rental and hotel sectors were included. In order to avoid any distortion due to the type of franchisee involved or the level of capital investment required a broad selection was included ranging from low budget contract cleaning businesses (minimum investment of £500)\(^{314}\) to large hotel businesses requiring an investment of many millions of pounds\(^{315}\).

It is submitted that the sample will evidence a distinct difference between those franchise agreements drafted for use in civil jurisdictions and those drafted in common law jurisdictions, but that they will exhibit a common architecture and address common issues.

3.3.1.2 Contrasting the Civil and Common Law Approaches

This is critical analysis towards the second objective of this thesis.

The civil law agreements considered for this thesis were all shorter than their common law counterparts. The civil law agreements range between 15 and 30 single spaced A4 pages whereas the common law agreements range between 60 and 90 single spaced A4 pages.

Whilst all of the agreements considered address generally the same commercial issues, the common law agreements go into far more detail on technical legal issues.

It has been suggested that common law agreements are generally more verbose than civil law agreements not because common law agreements address more issues but because in common law countries the drafting style of contracts is heavily influenced by the drafting style of

\(^{313}\) See Appendix 8
\(^{314}\) Jani-King
\(^{315}\) Intercontinental
statutes and the tendency of the courts to interpret contracts and statutes in a literal manner. As a consequence, contracts are very detailed because the parties try to take into account all possible events that may occur in the future and lay down an adequate contractual discipline to deal with them. This seems to be borne out by the sample.

By contrast, it has been suggested that in civil jurisdictions the codes are usually “general and abstract” as they state general principles concerning relevant subjects which are designed to prevail over the will of the parties and then add specific rules which are to be applied in those cases where nothing has been stated by the parties. As a result, civil law franchise agreements are brief and concise and the parties rely on relevant statutory provisions. Again, this seems to be borne out by the sample.

Other explanations, in addition to the impact of substantive law, include a tradition of succinctness in legal drafting in civil jurisdictions, and the limitations imposed by civil procedure. Article 242 of the German Civil Code, which imposes a general duty of good faith on the parties to a contract, is cited as an example of why civil law agreements do not need to be as detailed as their common law counterparts.

The application by analogy of the rules applying to “type-contracts”, such as commercial agency to franchise agreements is another reason for the brevity of the civil law franchise agreements in the sample.

3.3.1.3 Differentiating Features of the Civil Law Approach

This is critical analysis towards the second objective of this thesis.

Unlike common law, civil law distinguishes between those contracts that are of a recognised type of agreement (“type-contracts” or “nominate” contracts) and those that are not. The reason for this difference is mainly a historical one and the type-contracts are those which were most common at the time the civil codes were drafted. The belief being that as and when any new types of contracts become more common the rules applying to type-contracts could be applied to them by analogy as and when appropriate. If this proved to be inadequate then specific laws could be adopted for them.

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317 Ibid
320 For example, the German Civil Code inter alia categories the following types of agreement, Business Management Agreements, Service Agreements, Lease Agreements and Licence Agreements.
321 Op cit Frignani, A. 1996
The crucial point for this thesis is that the European civil codes do not usually have franchise specific laws or type-contracts\textsuperscript{322}. Franchise agreements are atypical or inominate agreements (innomé in French)\textsuperscript{323}. General contract law and, where deemed appropriate, by analogy the law applicable to other “type-contracts” or “nominate contracts” are applied to them, for example commercial agency and consumer law\textsuperscript{324}.

Civil law comprises mandatory and non-mandatory rules. The function of the “non-mandatory rules” is to replace the silence of the parties on specific issues but they can be opted out of by the parties. They are essentially template or precedent terms that are deemed generally appropriate to a specific type of contract. This means that the parties need only deal with the specific issues arising in a particular contract.

Mandatory rules cannot be avoided by the parties and include general concepts or principles such as public policy and good faith. The incorporation into a contract of terms that conflict with mandatory rules will be void as may be the entire agreement. Void clauses may be replaced by corresponding mandatory rules.

Civil codes usually list terms which are considered to be essential elements of type-contracts, the lack of which invalidates the agreement. They also usually list other terms which are felt to be a natural consequence of a certain type of contract, but which can be opted out of.

Civil codes distinguish between contracts for exchange (such as sale of goods) and contracts for co-operation (or adhesion\textsuperscript{325}) (such as franchising). Contracts of exchange are usually type-contracts, whereas generally contracts for co-operation are not, as is the case with franchise agreements. As a result contracts for exchange tend to be shorter than contracts for co-operation. Franchise agreements, being contracts for co-operation which are not type-contracts are therefore generally longer than other civil agreements\textsuperscript{326}.

Civil courts are generally more comfortable interpreting legal rules than the will of the parties and so prefer to apply mandatory and non-mandatory rules by analogy and general concepts such as good faith\textsuperscript{327} to franchising agreements.

\textsuperscript{322} The exceptions are Lithuania, Estonia and Romania, all of which specifically refer to franchise agreements in their civil code and list mandatory, non mandatory and essential terms for them.


\textsuperscript{324} In Spanish law there are four key decision of the Supreme Court (Tribunal Supremo) about franchising STS 27 September 1996, RJ 1996/6646; 4 March 1997, RJ 1997/1642, 30 April 1998, RJ 1998/3456 and 21 October 1005, Id Cendoj 28079110012005100801

They recognise franchise agreements as an inominate atypical agreement, the norms of which are framed by analogy and characterise franchising in the same manner as to ECJ’s judgment in Pronuptia.


\textsuperscript{326} Op cit Frignani, A 1996

\textsuperscript{327} Op cit Fignani, A 1996
3.3.1.4 **Common Key Features**

This is critical analysis towards the second objective of this thesis.

An analysis of the sample agreements leads one to conclude that franchise agreements, be they civil or common law agreements, and regardless of the economic and sectoral contextualisation exhibit certain common key features.

Olson, Weinberg and Spencer\(^{328}\) suggest that

“although there is no “cookie cutter” approach to drafting a franchise agreement …. there are key provisions commonly found in franchise agreements, regardless of industry or business …. (although) …. every industry, business and relationship has unique considerations and each consideration may affect and alter those provisions”.

They identify key terms to include the grant, the financial terms (including targets and product ties), the term and renewal, the franchisors obligations, the franchisees obligations, confidentiality, restrictive covenants/non competition, transfer of the business, termination.

The Encyclopaedia of Forms and Precedents\(^ {329} \) identifies the same key common terms in franchise agreements.

Analysis of the sample agreements suggests that these key terms are indeed found in all franchise agreements as they are in all those comprising the sample. Some agreements in the sample present targets and product ties separately from other financial terms. Others combine confidentiality with restrictive covenants and provisions about the manual. However these are a matter of form rather than substantive content.

One can therefore conclude that regardless of whether agreements are drafted in the civil or common law idiom and despite economic and sectoral contextualisation franchise agreements comprise certain key terms.

3.3.1.5 **Sub-Conclusion**

Despite clear and substantial differences between the civil and common law approaches to drafting commercial contracts, franchise agreements exhibit a uniform architecture.


3.3.2 Analysis of the Contractual Environment as regards the Economic Drivers

This is critical analysis to the second objective. It seeks to show that the contractual environment of franchising has a differing impact on the economic drivers that attract franchisees to franchising and those that attract franchisors.

It is suggested that the contractual environment created by the architecture of franchise agreements generally protects the economic drivers that attract franchisors to franchising. It also protects many (but not all) of the economic drivers that attract franchisees to franchising.

Considering each of the key features of the architecture of a franchise agreement in turn within the context of those agreements comprising the sample, one is able to extrapolate upon the adequacy of the contractual environment in supporting and re-enforcing the economic drivers in the franchisor/franchisee relationship.

3.3.2.1 The Grant

The franchisee is granted the right to use the franchisor’s business format (know-how) and trade marks. These are two of the key elements of a franchise. The integrity of this intellectual property is fundamental to the relationship. If the franchisor does not have the right to licence the franchisee to use it, if it infringes the rights of others or is insufficient or otherwise unfit for the intended purpose, the franchisee will be deprived of the main benefit of the transaction. However, only two (2) of the agreements in the sample warranted their ownership of the trade mark, and none warranted the validity of them or their ownership of or the effectiveness of the know-how.

The rights granted are often, but not always, restricted to either a specific area or a stated location\textsuperscript{330}. They can either be exclusive or non exclusive\textsuperscript{331}. The territory is usually a geographical area that allows a planned approach to exploitation of the franchise.

“Encroachment” on the franchisee’s business by franchisors has been identified as a substantial problem\textsuperscript{332}. However, it is not always fully prohibited by the agreement. The franchisor’s placement of a new company-owned or franchised unit too close to an existing one has emerged

“to be one of the most vexing, emotional and yet least understood franchising problems in mature markets such as the US”\textsuperscript{333}.

\begin{itemize}
  \item \textsuperscript{330} 18 of the 25 agreements
  \item \textsuperscript{331} 13 of the 25 agreements were exclusive
  \item \textsuperscript{332} Purvin, R, 1994, “The Franchise Fraud”, The American Association of Franchisees and Dealers, 129
\end{itemize}
The grant of geographical exclusivity to franchisees is aimed at preventing this. In the sample, just over half of the franchisors grant geographical exclusivity of some kind. The others have no geographical protection at all – probably for good commercial reasons such as the prevalence of national, non-geocentric, accounts in the customer base. Encroachment is usually considered to exist

“If a franchisor develops, or grants to a franchisee the right to develop, a new outlet or location which sells essentially the same goods or services under the same trademark, service mark, trade name, logotype or other commercial symbol as an existing franchisee and the new outlet or location is in unreasonable proximity to the existing franchisee’s outlet or location and has an adverse effect on the gross sales of the existing franchisee’s outlet or location, the existing adversely affected franchisee has a cause of action for monetary damages…”334.

Deliberate cannibalisation of a franchisee’s business by the franchisor is clearly inappropriate. However encroachment is sometimes the unintended consequence of the franchisor embracing new technologies in an endeavour to maintain and increase the business’ competiveness for the ultimate benefit of not only itself but also its franchise network. For example, the advent of the worldwide web has meant that encroachment can be by way of a multi-channel approach to the market. The impact on the franchisee’s business of this electronic intra brand competition is regulated by only 60% of the agreements in the sample335, so raising a potential concern over the violation of the franchisees’ business interests through “non-traditional” encroachment. Encroachment is an issue which many of the agreements in the sample fail to deal with in an appropriate manner.

3.3.2.2 Term and renewal

All of the agreements in the sample were granted for a period of between five and ten years. A conditional right of renewal is often included336. The franchisee must be confident that it will be able to amortise its investment in the franchise and make a reasonable return within the initial term. It was not possible to judge whether or not the terms granted by the franchise agreements in the sample allowed this. Research in the US suggests that the vast majority of franchisees do seek and are allowed by the franchisor to exercise the right of renewal337.

3.3.2.3 Targets

334 Iowa Code 2001 Supplement, Section 537A.10
335 15 of the 25 agreements.
336 21 of the 25 agreements
337 Op cit Blair and La Fontaine F 2005, p.263
In order to try and ensure the optimum exploitation of the rights granted to the franchisee, minimum performance levels are sometimes agreed\textsuperscript{338}. Others simply place an obligation on the franchisee to use best or reasonable endeavours to grow the business\textsuperscript{339}.

The consequences of failure to meet the targets vary. Termination of the agreement is the most common option, although there is almost always an opportunity to remedy the breach in some way\textsuperscript{340}. This can be “catching up” and meeting the following year’s target and/or paying liquidated damages to compensate the franchisor for its resulting loss of income. It follows from this that the targets should be reasonable, but none of those agreements with targets gave any rationale for them, so it was not possible to judge whether or not they are reasonable.

3.3.2.4 The Franchisor’s Obligations

The franchisor is obliged to provide training and ongoing support to the franchisee and to keep it fully appraised of developments in the business format\textsuperscript{341}. This training in the business format and the ongoing support are key elements of a franchise. There is sometimes also an obligation to supply goods or services to the franchisee\textsuperscript{342}. However, the franchisor’s obligations are generally minimal and the agreements usually do not go into detail\textsuperscript{343}. Several refer to the manual which is stated to contain details of the franchisor’s obligations\textsuperscript{344}. Frequency of visits to the franchisee is sometimes stated\textsuperscript{345}. None of the agreements impose an obligation for the franchisor to provide a minimal, objective qualitative level of support to the franchisee. The number of days that training will be given for is often stated\textsuperscript{346}. The vague nature of the franchisor’s obligations and the lack of any qualitative rather than quantitative metric means that franchisees have no real contractual right to challenge the franchisor if it fails to deliver a reasonable level of support. This lack of any objective measurable standard of performance in any of the agreements, means that providing that the franchisor delivers some support the franchisee will not be able to challenge its adequacy or relevance. The ever changing nature of all businesses, particularly due to the impact of new technologies, means that the franchisor must be able to develop and adapt the business format and, as a consequence, the type of support it provides to the franchisee. That is perhaps why the agreements do not detail the support to be provided. However, the total lack of any

\textsuperscript{338} 9 of the 25 agreements
\textsuperscript{339} 10 of the 25 agreements
\textsuperscript{340} 7 of the 11 sample agreements with targets
\textsuperscript{341} All of the agreements in the sample imposed these obligations
\textsuperscript{342} 12 of the 25 sample agreements
\textsuperscript{343} Only 5 of the 25 agreements go into any great level of detail about the franchisor’s obligations
\textsuperscript{344} 8 of the 25 sample agreements
\textsuperscript{345} 6 of the 25 sample agreements
\textsuperscript{346} 15 of the 25 sample agreements
A qualitative measure in the agreements does expose the franchisee to the risk that the franchisor provides it with inadequate support.

An example of the problems that this lack of appropriate support by the franchisor can create are illustrated by the case of MGB Printing and Design Ltd v KallKwik UK Ltd. In this case the franchisee was obliged in the franchise agreement to provide the franchisee “from time to time with advice, know-how and guidance.” The court ruled that there was a duty of care which meant that the franchisor was obliged to exercise reasonable skill and care in providing such know-how and advice, which the franchisor had breached. This failure to deliver an appropriate level of skill and care was evident throughout the franchise causing a further 92 franchisees in the franchisor’s Kall Kwik and Prontaprint businesses to threaten proceedings on the same grounds as their fellow franchisee, Mr Bibby.

The long term nature of the franchise agreement and the need to accommodate the resulting tensile stresses within the franchise relationship are discussed in Chapter 2. They result in the franchisor having a good deal of flexibility although this is markedly less so in the German sample. This is due to the impact of the German law of good faith. This flexibility can be misused by franchisors and as a result the contractual environment does not adequately reduce the risks to franchisees or support the economic drivers that attract them to franchising.

3.3.2.5 The Franchisee’s Obligations

By contrast to those of the franchisor, the obligations of the franchisee are generally voluminous and include use of the know-how and the brand, following the franchisor’s system and meeting brand standards. This control is a fundamental element of the franchise. In order to ensure this as far as possible, the franchise agreement goes into detail on issues such as use of the trade marks, staff training and operational procedures. Common law agreements go into more detail than those from civil jurisdictions.

The strength of franchise systems typically does not lie in the absolute quality of the products or services offered. Instead it resides largely in the capacity of the franchised chain to offer a uniform product at a reasonably uniform price. Quality and service variation have external effects that damage other franchisees as well as the franchisor and this creates tension between the franchisor and individual franchisees. The individual franchisee’s incentives are not aligned with those of the franchisor and other franchisees.

“The profit-maximising behaviour of an individual can have adverse external effects on the franchisor and other franchisees”.349

These provisions of the franchise agreement are designed to remove or at least mitigate the fundamental incentive issue because franchisees care more about the profits of their own outlet while the franchisor cares more about the profits of the system as a whole. The provisions also provide for the franchisor’s right to monitor the performance of the franchise through regular inspections, audits and so on.

The manual, which is expressly incorporated in the agreement, also imposes innumerable operational obligations on the franchisee and details the franchisor’s know-how. The copyright in both the original and translated manual is stated to vest in the franchisor350.

3.3.2.6 Confidentiality

A franchisor must disclose a considerable amount of confidential information (the business format) to each of its franchisees. The franchise agreements prevent the franchisee from disclosing the confidential information or using it to compete with the franchisor351. These restrictions endure for the duration of the franchise and thereafter. A number of EU member states also impose a duty of confidentiality upon both parties to the franchise agreement352, so further re-enforcing this point.

3.3.2.7 Non-competition

Franchise agreements forbid franchisees to compete with the franchisor during the term of the agreement353 and for a limited period with a limited geographical area thereafter354. The post-termination restrictions are limited by law in all EU member states. This clause is essential to protect the integrity of the franchisor’s business.

3.3.2.8 Transfer of the Franchisee’s Business

Franchise agreements usually allow the franchisee to sell its business to a third party that has been previously approved by the franchisor, subject to the franchisor’s pre-emptive right to purchase the franchisees’ business on the same terms as the bona fide third party offer

350 19 of the 25 sample agreements
351 These terms are in all 25 sample agreements
352 E.g. Article 18 of the German Unfair Competition Act and BGB Sections 675(1), 611 and 241(2)
353 All of the agreements in the sample
354 22 of the agreements in the sample. The two exceptions in the sample were hotel franchises, where the franchisee still retains the hotel at the end of the franchise and needs to be able to operate it under another brand.
(provided this right is exercised within a reasonable time)\textsuperscript{355}. This is necessary to enable franchisees to realise a “capital profit” on their investment whilst at the same time enabling the franchisor to ensure the quality of its franchisees. The pre-emptive right is necessary to enable the franchisor to retain control (which is an essential element of a franchise).

\textit{3.3.2.9 Product or Service Tie}

There is often a product or service tie which obliges the franchisee to purchase specific brands and/or purchase goods or products from the franchisor or approved suppliers\textsuperscript{356}. The justification for such a tie is that it helps to ensure product consistency across the network. It can relate to goods that are sold on without modification (e.g. ice cream in a Baskins-Robbins franchise) or ingredients that are used to make the final product (e.g. the dough in a Domino’s Pizza). Such a provision could, of course, be abused to deliver additional inflated income streams to the franchisor. Likewise the products or services supplied could be of a poor standard and so be problematic. However only a small number of the agreements in the sample provided for redress in such circumstances\textsuperscript{357}. It is possible that some franchisors supply such goods or services under its standard terms and conditions which do provide for such redress, but the sample did not enable this to be considered.

\textit{3.3.2.10 Goodwill}

Goodwill survives a defunct business\textsuperscript{358} and under the terms of common law franchise agreements it is stated to accrue to the franchisor\textsuperscript{359} not the franchisee. However, this is not the case in the civil law agreements, which are silent on the issue. This is presumably because most civil law jurisdictions, follow the German lead and take the view that goodwill accrues to the franchisee by way of analogy to the position as regards commercial agents.

\textit{3.3.2.11 Termination}

The franchise agreements give the Franchisor the express right to terminate the franchise agreement for breach. A distinction is often made between a remediable and irremediable breach, with the right for the franchisee to remedy remediable breaches. The franchisee is not given any express right to terminate the agreement (although this does not impact upon its right to do so under the law of contract). The civil law agreements tend to have less draconian rights of termination.

\textsuperscript{355} 23 out of the 25 sample agreements
\textsuperscript{356} 12 out of the 25 sample agreements
\textsuperscript{357} 8 of the 12 agreements that had a ??
\textsuperscript{358} In \textit{Ad-Lib Club Ltd v Granville} [1971] 2 All ER 300, [1972] RPC 673 goodwill sufficient to found an action of passing off was held to survive a well known nightclub by some years.
\textsuperscript{359} Usually there will be an express team requiring the franchisee to hold the goodwill as bare trustee for the franchisor, but, even in the absence of such a term, it would appear that the goodwill accrues to the franchisor: see \textit{J H Coles Pty Ltd v Need} [1934] AC 82, PC.
3.3.2.12 Sub-conclusion

The uniform architecture of franchise agreements comprises provisions detailing the grant made by the franchisor to the franchisee, the term and renewal, targets, the obligations of both parties, confidentiality, non competition, transfer, product and services ties, good will and termination.

The asymmetry between the obligations of the franchisor and those of the franchisee is necessary because of the multi-lateral nature of franchising and because of the dynamic and changing nature of business. The Franchisor must be able to protect the integrity of the brand not only for its own benefit but also for that of its franchisees. If a franchisee prejudices the brand it damages not only the business of the franchisor, but also the business of the other franchisees. The franchisor must therefore be able to take immediate and effective action against any franchisee that is not following the franchise system. In order to make this possible the franchisee’s obligations must be clearly detailed in the agreement. Franchisees should act in the best interests of the franchise as a whole – meaning the franchisees as a group – rather than their individual best interests.

The contractual environment in the EU supports the economic drivers that encourage franchisors to become involved in franchising. It does not adequately support all of the economic drivers that encourage franchisees to become involved in franchising. It provides for a brand, a format and support but it does not impose a qualitative measure for the format or assistance provided.

3.3.3 Analysis of the Contractual Environment as regards Risk

This is critical analysis towards the second objective of the thesis. It suggests that the contractual environment created by the architecture of franchise agreements generally reduces the inherent risks for franchisors but is less successful in reducing them for franchisees.

3.3.3.1 Risks to the Franchisor

The franchisor is exposed to information asymmetry and moral hazard potentially resulting in “free riding”. It is suggested that these are reduced to an appropriate level by the contractual environment. The franchisor is also subjected to abuse of its intellectual property and non payment of fees. These are generally dealt with in a satisfactory manner by the contractual environment.

In order to reduce the impact of “free riding” and information asymmetry the franchise agreements in the sample impose an obligation on the franchisee to comply with the system

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360 See section 3.4
361 See section 2.4 above
and grant the franchisor the right to audit their business for compliance. Non-compliance can lead to termination by the franchisor. This is clearly a strong incentive for franchisees to follow the system. Any fetter on the right to terminate is problematic in that it reduces the effectiveness of the incentive.\(^\text{362}\)

A prohibition on in-term competition by the franchisee reduces that particular risk for the franchisor. However, although a prohibition on using the franchisor’s trade secrets after the term of the agreement helps to prevent competition from former franchisees a permanent prohibition on competing without using the franchisor’s trade secrets is restricted to a short period only. This is due to a general prohibition on long term restrictive covenants in EU member states. Indeed in some member states post term restrictive covenants are only permissible if the franchisee is paid compensation.\(^\text{363}\)

The franchise agreement generally gives robust protection to the franchisor’s intellectual property. However, the franchisor’s ownership of goodwill which is clearly stated in common law franchise agreements is contrary to the law in some member states such as Germany, Austria and Greece and so is not included in the German agreements in the sample.\(^\text{364}\)

The agreement incentivises the franchisees to pay monies due to the franchisor by way of the imposition of interest on late payments and a right to terminate the agreement in the event of non payment.

When franchisors were asked which obligations were important in protecting their business from franchise abuse there was general agreement that they were non competition by franchisees during the agreement;\(^\text{365}\) non competition for a reasonable period after termination;\(^\text{366}\) no challenge of the franchisor’s intellectual property by franchisee’s;\(^\text{367}\) franchisees being obliged to follow the system;\(^\text{368}\) and payment of monies due to the franchisor.\(^\text{369}\)

The majority of franchise lawyers surveyed\(^\text{370}\) felt that following the franchisor’s system, not challenging the franchisor’s intellectual property rights\(^\text{371}\) and not competing with the

\(^{362}\) Several member states do impose fetters on the franchisor’s right to terminate e.g. Germany

\(^{363}\) See section 3.5.4 below

\(^{364}\) Germany – see section 3.8

\(^{365}\) UK – 80% of sample; Germany – 72% of sample; France – 80% of sample but only 47% in Spain where 68% thought it to be insignificant.

\(^{366}\) UK – 96%; Germany – 56%; France – 92%; Spain – 40% - in Spain 52% thought that it was “significant” rather than “very significant”.

\(^{367}\) UK – 96%; Germany 84%; France – 80%; Spain – 100%.

\(^{368}\) Germany – 84%; France – 52%; Spain – 76% only 12% of those in the UK thought it was “very significant” although 84% thought it was “significant”.

\(^{369}\) UK – 48%; Germany 24%; France 60% and Spain none.

\(^{370}\) Appendix 4.

\(^{371}\) 56% of the sample
franchising during the term of the franchise agreement\textsuperscript{373} were the most important restrictions that should be placed on the franchisor\textsuperscript{374}.

This is similar to the results of other research. For example, according to Pratt\textsuperscript{375}, of the 129 franchisors that he questioned, the majority felt that being involved in a competing business, passing on confidential information, non payment of fees under declaration of turnover and encouraging other franchisees to take action against the franchisor, were the issues on which they were willing to litigate.

So, the agreements in the sample, (unsurprisingly, as they are all drafted by the franchisor), suggest that the contractual environment does reduce the risk of being involved in franchising for the franchisor to an appropriate level, providing member state law does not fetter the contractual rights in any way.

\textbf{3.3.3.2 Risks to the Franchisees}

Franchisees are exposed to inappropriate pre-contractual representations, brand failure, inadequate business formats, encroachment and poor quality support. It is suggested that these are not reduced to an adequate level by the contractual environment.

None of the franchise agreements in the sample gave contractually binding effect to pre-contractual representations made to the franchise. Franchisees are therefore obliged to rely on non-contractual remedies if they have entered into the franchise agreement on the basis of incorrect information. Indeed many of the agreements in the sample\textsuperscript{376} expressly excluded liability for at least some of the pre-contractual representations made by the franchisor to the franchisee. These are mostly common law agreements\textsuperscript{377}. This inability to rely on representations made to the franchisee during the sales process does nothing to reduce the risks imposed on them.

\textsuperscript{372} 20\% of the sample
\textsuperscript{373} 16\% of the sample
\textsuperscript{374} 48\% of the sample felt that not competing with the franchisor during the term was the second most important obligation, 24\% that it was following the franchisor’s system and 20\% that it was not challenging the franchisor’s intellectual property. 56\% of the sample felt that not competing with the franchisor for a reasonable period after the end of the agreement was the third most important obligation, 28\% felt that it was non competition with the franchisor during the term and 20\% that it was not challenging the franchisor’s intellectual property. 36\% felt that not challenging the franchisor’s intellectual property was the fourth most important obligation, 20\% that it was following the franchisor’s system, 16\% that it was not competing after the term and 8\% not competing during the term. 12\% felt that non competition for a reasonable period after the term was the fifth most important obligation and 4\% not challenging the franchisor’s intellectual property rights.
\textsuperscript{375} Pratt, Franchise World Dec/Jan 2007, p. 9.
\textsuperscript{376} 15
\textsuperscript{377} 12 of the 15 agreements are from common law jurisdictions
All of the agreements clearly state the extent of the rights granted to the franchisee as regards duration, and territory. However, only some\textsuperscript{378} of them (regardless of whether the grant is exclusive), restrict the franchisor from using multi-channel strategies to exploit the market in competition with the franchisee. Encroachment is not adequately dealt with in many agreements. In the fast changing era of multi-channel marketing and electronic commerce, it is perhaps reasonable that the franchisor does not restrict its long term ability to exploit the market in ways that it is not yet familiar with. Indeed such a restriction could have an extremely damaging impact on its business and that of the franchise network as a whole. However, there is clearly an opportunity here for unethical or opportunistic franchisors to take advantage of the franchisee. This encroachment issue is not dealt with adequately in the franchise agreement.

The obligation of the franchisor to provide support to the franchisee during the term of the agreement is stated in all agreements in the sample, however, none of them give any detail about the extent or quality of that support. The support provided to the franchisees by the franchisor is a fundamental part of the communal relationship between the parties. That is why the obligation to support the franchisee is imposed on the franchisor. However, none of the agreements in the sample impose a set standard for the support or go into detail about what the support entails. This is because franchise agreements are long term agreements and (as detailed in Chapter 2 above) during that term market, economic and technological changes can mean that the franchisor will need to further develop and adapt its concept, making the level and type of support that needs to be delivered to its franchisees change\textsuperscript{379}. However, no such obligation was found in any agreement in the sample. This means that franchisees can find it very difficult to hold the franchisor to a set standard of support. If the franchisor fails to provide the franchisee with use of the brand, access to the know-how, or any support all the agreements in the sample permit the franchisee to terminate the agreement. However, none of the agreements give that right to the franchisee if the franchisor greatly reduces the level of support it delivers to the franchisee, even if that reduced level of support is clearly inadequate. Unethical and opportunistic franchisors could take advantage of the lack of any qualitative provision in the agreement and decrease the support given merely to increase its own margins.

The franchisor generally has broad discretion to take decisions that have an impact upon the franchise at its sole discretion in the common law agreements and the French agreements.

\textsuperscript{378} See section 2.5.4
Only the German agreements caveat the franchisor’s discretion with an obligation of reasonableness. This exposes franchisees to the risk of exploitation by the franchisor.

The franchisee’s ability to sell on its rights, subject to the franchisor’s pre-emption rights found in many agreements in the sample merely balances the rights of both franchisor and franchisee.

The tying of franchisees to purchase certain goods and/or services from the franchisor or approved third parties present unethical or opportunistic franchisors the opportunity of selling over priced and substandard products to a captive market.

“Buying into a franchise system with an unproven product, an unknown trademark and/or an untested operating system may constitute the only ‘catastrophe’ necessary to cause (franchisees) to lose (their) entire live savings … Investing in a franchise enterprise that provides little support but takes much in the way of royalties, fees and other charges can ensure failure rather than success.”

The franchise agreements in the sample suggest that the contractual environment does not adequately reduce the risks of franchising for franchisees, largely due to the long term nature of the relationship and the dynamic and changing nature of the markets in which the franchised business operates.

3.3.3.3 Sub-conclusion

The contractual environment in the EU reduces the consequential risk inherent for the franchisor to a reasonable level although it is still exposed to “free riding” by franchisees. However, it does not do so for the franchisee, which is exposed to inappropriate precontractual representations, brand failure, inadequate business formats, encroachment and poor quality support.

3.4 Analysis of the Self Regulatory Environment

This is critical analysis to the second objective of the thesis and suggests that the self-regulatory environment in the EU does not adequately support the economic drivers or reduce the consequential risks inherent in the franchisor/franchisee relationship.

There can be no doubt that

“a healthy franchising sector requires adequate and appropriate infrastructure”

and that

\[380\] Op cit Purvin, R 1994, p.4
“central to this infrastructure is the legal environment in which franchising operates
an environment providing for the orderly development of franchising for the benefit
of franchisors, franchisees and the wider community”\textsuperscript{382} \textsuperscript{383}.

The big question is how such an environment can be best achieved within the EU.

Self regulation as a way of regulating commerce has been subject to severe criticism from
lawyers and other social scientists\textsuperscript{384}. As Alistair Darling, then the UK government minister
with responsibility for the financial services, stated one of

“the problem(s) with self-regulation is the public’s perception that trade interest
dominates which is extremely damaging”\textsuperscript{385}.

Certainly the Australian experiment with the self regulation of franchising between 1993 and
1996 does not inspire confidence in it and supports the view that

“it can prevent abuses by “dishonest franchisors” only to a very limited extent and (its
main) purpose is to prevent the interference of the regulator in the sector”\textsuperscript{386} \textsuperscript{387}.

However others argue that when there is market failure, private law remedies are inadequate
or too costly and self regulation is a better/cheaper option, self regulation can be in the public
interest\textsuperscript{388}. As a result, in the past bills designed to regulate franchising in both Belgium and
Sweden have been defeated\textsuperscript{389}. The abuse, sharp practice and commercial failure in

\textsuperscript{382} Ibid.
\textsuperscript{383} See Appendix 3. The vast majority of franchisors surveyed believe that complete transparency in the
recruitment process avoids most of the problems that franchisors face with their franchisors.
\textsuperscript{385} Steward. E, The Four Horsemen of the Apocalypse- The Financial Services Authority and its Statutory
Objectives, BLR Vol. 22 Number 11 pp. 258-261.
\textsuperscript{386} The Belgian House of Representatives, 17 March 2004 Doc 51 0924/001 Second sitting of 51st
Parliament - Draft Parliamentary Bill regulating franchise agreements with a view to improving commercial
practices in this sector (lodged by MM Alain Mathot and Jean-Marc Delizée and Mme Sophie Pécriaux).
\textsuperscript{387} Despite being declared by the Australian government on its launch as the most progressive
industry/government franchising initiative undertaken in the world the Australian self regulatory code
proved to be a failure and “Within a year of its commencement concerns were being raised about its
effectiveness” (Schacht, Creating a better business environment: a package for Australian small business,
21 December 1995, p 3) and after only 14 months the Australian government initiated an independent
investigation into it. The Gardini Report was released to the public in March 1995. It estimated that
approximately 40\% to 50\% of franchisors had not registered under the Code and concluded that it was
unlikely that more than 70\% of franchisors ever would. It also concluded that a significant number of those
franchisors that did not register failed to provide adequate pre-contractual disclosure, to offer a cooling off
period or observe the standards of conduct contained in the code. The Code was also found to not have been
successful at dealing with serious franchise disputes (The Gardini Report to Senator the Hon. Chris Schacht
on the effectiveness of the self-regulatory framework, March 1995). The report concluded that “a system of
mandatory self-regulation or co-regulation” was necessary and recommended “......specific franchising
legislation providing for compulsory registration of franchisors and compliance with codes of practice
...The legislation should provide for adequate disclosure documentation, the establishment of appropriate
independent code administration bodies, and dispute resolution procedures...”
University Press
\textsuperscript{389} See section 4.5

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franchising can certainly be ascribed to a degree of failure in the market. Private legal remedies are without doubt beyond the reach of smaller franchisees on the basis of cost. Self regulation does offer a cheaper and more focused alternative. In addition it can be argued that self regulation gives access to a greater degree of expertise and technical knowledge\textsuperscript{390} and so can provide a more targeted and commercially appropriate result.

3.4.1 The Determinants of the Self Regulatory Environment

The self regulation of franchising in the EU is implemented through the European Franchise Federation and its 16 member state franchise associations. The European Franchise Federation’s Code of Ethics has been adopted by all of its member associations (with a number of small differences). It provides a useful benchmark for prospective franchisees when seeking to evaluate a particular franchisor’s behaviour. It also helps franchisors to understand best practice and so increases the chance that franchisors will conduct themselves in an ethical and fair manner. In that sense the Code is extremely important.

The Code of Ethics requires franchisors who are members of the national franchise associations to follow best practice. They must disclose to their potential franchisees, information concerning the franchise concept, the people with decision-making power in the system’s head office, the Franchise offer, outlook on profitability (if available), the Franchise contract (including all standardised attachments), information on membership of professional association and information on other distribution channels of the franchise products or services\textsuperscript{391}.

3.4.2 The Self Regulatory Environment’s Relationship with the Legal Regulatory Environment

The British Franchise Association\textsuperscript{392} claims credit for establishing the current “favourable regulatory climate for franchising”\textsuperscript{393}, asserting that the European Commission is satisfied with the EFF and its member association’s self regulatory arrangements based on the EFF’s Code of Ethics – although it acknowledges that this needs to be “actively managed”. It believes that


\textsuperscript{391} a) Branches, wholesale trade, specialist trade, mail order, internet sales etc

\textsuperscript{392} The British Franchise Association (“BFA”) asserts that it is “the largest and most successful franchise association in Europe”\textsuperscript{392}. With 350 franchisor members, 115 affiliate (non franchisor) members and reserves of over £1 million\textsuperscript{392}, it is the biggest franchise association in the EU. It is therefore an appropriate and very accessible case study both of the issues facing franchise associations in the EU and the current and potential effectiveness of the self regulation of franchising by national franchise associations in the EU.

\textsuperscript{393} One Vision, 2008 – Strategic Option for the Association’s Future, p. 29.
“Regulation is not just about ivory towers and idiots making up rules”\textsuperscript{394},
and that over the past 10 years it has
“successfully prevented several misguided attempts to regulate franchising which
would have seriously damaged franchising throughout the common market”\textsuperscript{395}.
That is an exaggerated claim, but there certainly is a substantial body of opinion that firmly
believes that
“only the versatility of a self-regulatory regime will enable franchising to grow in a
manner that strongly encourages ethical practice. Laws can only seek to offer redress
to those wronged. Ethical practice however prevents them being wronged in the first
place”\textsuperscript{396}.
Market forces are deemed to be the best means of ensuring that franchising’s needs are met. It
is believed that the shackles of legal regulation will inevitably retard the commercial
development and success of franchising because of its inevitably cumbersome and
commercially divisive nature.
An appropriate self-regulatory regime is thought to be able to prevent rather than cure
problems by promoting ethical franchising, with caveat emptor still applying throughout. The
problem here is that the difference between ethical and non-ethical franchising
“is not always apparent until too late and then often at great expense to the
franchisee”\textsuperscript{397}.

3.4.3 The Key Elements of the Self Regulatory Environment

An analysis of the self-regulatory regime of the franchising sector in the EU suggests that it
focuses upon pre-contractual disclosure, the resolution of disputes between franchisors and
their franchisees, the enforcement of best practice and education. The BFA, as Europe’s
largest and most influential franchise association, offers a useful case study. It believes that it
can “self regulate” franchising by promoting best practice and endeavouring to deal with
disputes between franchisors and their franchisees.

3.4.3.1 Disclosure

Appropriate disclosure requirements could reduce some of the risks of pre-contractual
misrepresentation and inadequacy of the business format and support. However, the BFA is
against set form regulation disclosure on the grounds of adequacy, cost and complexity.

\textsuperscript{394} Franchise World, Feb/Mar 2007, p. 16-18.
\textsuperscript{395} Sir Bernard Ingham, BFA Annual Convention, 2005
\textsuperscript{396} Brian Smart, Director General of the BFA speaking at the BFA Annual Conference 2005.
It believes that

“a franchisor’s obligation to disclose to a potential franchisee should not be limited by a list of items in a statute. It should be determined by the facts of a particular set of circumstances”398.

The BFA has therefore not followed the lead of the French and Italian associations and recognised that there is a legitimate role for statutory regulation of disclosure. It believes that disclosure laws only limit a franchisor’s duty to disclose to what in some circumstances may be an inappropriately low level claiming that in France the Loi Doubin

“operates to the benefit of franchisors who can “prove” through the disclosure document that they told an aggrieved franchisee what they were statutorily obliged to tell them”399.

As a result the BFA has failed to impose even a low level of mandatory standard form pre-contractual disclosure on its membership. It also comments that franchisors face substantial financial and administrative burdens due to legislation400. However, the Director General of the BFA insists that his organisation has never set itself against disclosure, only disclosure that is too complex to be effective.401

The benefits of precontractual disclosure are clear even to the BFA’s membership402. However, despite these being “dangerous times for franchising”403, it is not on the BFA’s agenda. As a result many of the risks to which franchisees are exposed are not adequately reduced.

3.4.3.2 Enforcement of Best Practice

Best practice could, in theory, create a self regulatory environment that supports the economic drivers and reduces the consequential risks inherent in franchising. However, without rigorous enforcement of them the credibility of the BFA as an efficient agent of self regulation is limited. The BFA’s record to date does not inspire confidence404.

398 Brian Smart in interview with the author 18 September 2008.
399 One Vision, 2008 – Strategic Option for the Association’s Future, p. 29.
400 Quoting the initial cost to franchisors in the USA of complying with the disclosure law as more than $25,000 with an annual updating cost of $5,000.
401 Brian Smart in interview with the author 18 September 2008.
402 At the 1996 BFA Annual Convention the majority of attendees voted decisively in favour of the BFA adopting a mandatory set form disclosure document for its members.
403 Brian Smart, The British Franchise Association’s Director-General – Franchise World, Feb/Mar 2007, pp. 16-18.
404 In 2007 it expelled 3 members for breach of its Code of Ethics – more than in the previous ten years put together (Brian Smart, Director-General of the British Franchise Association speaking at the BFA’s Annual General Meeting on 6 December 2007 at the Hyatt Regency Hotel, Birmingham). In 2008 it expelled one member (Duckett, Franchise World, Feb/Mar 2008, p. 8). However, these four franchises are apparently still trading and the BFA will not name them or the grounds for their expulsion, presumably for fear of legal
3.4.3.3 Dispute Resolution

If it is to be able to support the economic drivers and reduce the consequential inherent risk, an effective and obviously impartial dispute resolution procedure is essential for a self regulatory regime. The BFA’s current “franchisee-friendly, three-tiered dispute handling procedures, offering a choice of conciliation, mediation and arbitration” is the jewel in its self regulatory crown.

However, its success is somewhat limited. The vast majority of UK franchisees surveyed stated that they did not trust the impartiality of the BFA’s dispute resolution procedure and stated a preference for litigation over BFA arbitration. In any event, it is limited to disputes in which the Code of Ethics is alleged to have been breached.

However, most franchisees were willing to use the conciliation and mediation procedure. Franchisors that have used the procedures have mixed views and experiences. When interviewed, one stated

“I am always willing to use the conciliation and mediation services offered by the BFA as they are not binding and only increase the chance of avoiding serious conflict with a franchisee.”

The BFA’s dispute resolution procedure is a mixed success. The conciliation and mediation services are seen as having a role in dispute resolution, although the arbitration has in effect been abandoned and in any event is restricted in the type of dispute it can consider.

3.4.3.4 Education

Educating franchisors and potential franchisees should enable the regulatory environment to better support the economic drivers and reduce the consequential inherent risk in franchising.

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405 Franchise World Dec/Jan 2003, p. 11.
406 The arbitration system has only been used six times and fell into disuse after one of the arbitrators (Gordon Harris, a partner in the law firm Wragge & Co.) was successfully sued for negligence by a franchisor, Piretk, in respect of a case that he arbitrated on under the BFA scheme.
407 Appendix 5 - 87% of the franchisees surveyed did not trust its impartiality and 7% did not know.
408 Ibid 89 of the 160 franchisees surveyed would rather use litigation to settle disputes with their franchisor and 40 did not know.
409 Ibid 101 of the 160 franchisees surveyed were willing to use the conciliation and mediation procedures, 43 did not know and only 16 were not willing to use them. The mediation and conciliation procedure is used around 10 times a year (Brian Smart in interview with the author 18 September 2008). This is acknowledged by the BFA to be in large part to the insistence of the English courts that the parties try to settle disputes before litigating them (The Woolfe Reforms –26th April 1999, new Civil Procedure Rules for England & Wales).
410 Steve Mills, CEO of MRI Limited. Interview with author April 2005.
In order to do so, educational programmes must ensure that potential franchisees fully understand what they will be buying into and the need to take and follow appropriate advice.

The BFA’s educational initiatives include its website\(^{411}\), a host of hard copy publications, several series of ongoing seminars and a presence at the franchise exhibitions in London, Birmingham, Manchester and Glasgow. It also co-sponsors with the National Westminster Bank Plc, an annual survey of the franchise industry in the UK. The importance of this role is underlined by “One Vision 2008” but the limited impact of its “Proud to Franchise” initiative in the same year underlines the difficulties involved.

Educating franchisors to act for the greater good of franchising is always going to be a difficult and never ending task. The BFA is seeking to meet his challenge and broaden its funding base through its “One Vision” Strategy,\(^{412}\) but its failure to gather momentum suggests that this will do little to reduce the risks inherent in franchising or support its economic drivers.

3.4.4 Failings in the Self Regulatory Environment

Whatever the self regulatory environment might aspire to its prospects of success are compromised by a number of fundamental difficulties. The problems that self regulation encounters are conflict of interest, finance, enforcement of their decisions, competition from other self-regulatory bodies and an inability to have any impact on non-members. The BFA again offers a useful case study.

3.4.4.1 Conflict of Interest

Franchise associations primarily exist to protect and promote the interests of their members\(^{413}\). Promoting franchising itself is very much a secondary role for them. There is a clear conflict of interest.

This is well illustrated by the BFA. For the first 24 years of its existence, there was not even a suggestion that franchisees should be involved in the BFA\(^{414}\). It saw itself as a trade body or

\(^{411}\) www.bfa.org
\(^{412}\) One Vision, 2008 – Strategic Option for the Association’s Future.
\(^{413}\) E.g. see the German Franchise Association (DFV)’s home page www.dfv-franchise.com which addresses itself entirely to franchisors and their interests rather than franchising as a whole and states that its main duties include supporting franchise systems in establishing themselves in the German market.
\(^{414}\) The BFA members are all franchisors. To become a member, a franchisor has to be accredited. In 2008, 59 new members were admitted (compared to 55 in 2007), 10 applications were rejected (compared to 31 in 2007) and 1 member was “managed out” or terminated (compared to 3 in 2007). BFA affiliates comprise professionals involved in franchising such as lawyers and bankers. They also have to be “accredited”. The inter-relationship of all these parties and franchisees was explained by the current Director General, Brian Smart, at the BFA’s 2008 Conference (at the Savill Court Hotel, Ingleton Green, Windsor on 3-4 July 2008) as being “a matrix of mutual contribution and benefit underpinned by money, standards and business”.

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pressure group, the sole function of which was to further the interests of its members. This has seriously undermined its stance on self regulation\textsuperscript{415}.

The Director-General has expressed his confidence that

“there is a great deal to gain from the combined force of franchisees and franchisors for the protection and promotion of franchising”\textsuperscript{416}.

However, effective self-regulation of franchising is far from straightforward.

“In order to secure in the UK, Europe and the rest of the world, a legislative and regulatory environment for ethical franchising which encourages its profitable quest”\textsuperscript{417},

the BFA must be

“and be recognised as, the authoritative voice of business format franchising in the UK, representing its ethical franchise community, in particular its franchisors, franchisees and professional advisors”\textsuperscript{418}.

The BFA faces several difficult challenges in achieving this. The first is encouraging a number of franchisees to invest time in the BFA for the greater good of franchising in a truly representative way, rather than merely to promote their own parochial interests. The second is

\textsuperscript{415} It was the experienced eye of Sir Bernard Ingham which, in 2002, saw this lack of franchisee involvement as a serious flaw that undermined the BFA’s claim to represent the interests of franchising rather than franchisors. He championed the creation of a Franchisee Forum. This Franchisee Forum has taken two different forms during its short life. In its first form it was based upon individual membership and the second upon delegate members from franchise networks. The Forum was launched in a blaze of publicity in October 2002 when it “held its first historic solo meeting” (Franchise World Dec/Jan 2003, p. 11). It is currently made up of 11 franchisees from the systems of the franchisors who serve on the BFA policy board (by contrast the French Franchise Federation admitted franchisees to its main board, causing some franchisors to resign from the organisation). Shortly after the Forum’s initial meeting, The BFA’s Director General stated that “We will in the future look to franchisees for input and support when it comes to the protection of good franchising in the face of any clumsy attempts at legislation” (Franchise World Dec/Jan 2003, p. 11). These good intentions suggested a real intent for the BFA to move from being a franchisor pressure group to an association that more genuinely represents the interests of all of those involved in franchising. The Franchise Forum’s first task was to assist in considering whether franchise brokers can have a legitimate and ethical role to play in the sale of franchises. The BFA’s decision to consult over such an important matter was hailed as “a significant step in (the BFA’s) endeavour to embrace franchisees and thus become truly representative of the franchise sector as a whole, rather than only that of the most powerful partner in the franchise relationship.”

\textsuperscript{416} However, despite these good intentions, the initial impetus was lost and seven years on there is no evidence to suggest that the Franchisee Forum has had any substantial impact upon the BFA. Indeed, the BFA President has confessed that “We have still not found the mechanism by which we can tap the energies of franchisees and are thrashing around trying to understand how to involve them” (at the BFA 2008 Conference). The association’s initiative did not capture the hearts and minds of its franchisor members. The cynical view of the majority of its members was perhaps well illustrated by one member of the BFA Board, who, speaking on a no-name basis, expressed the view that the Franchisee Forum “is only a bit of window dressing to give the impression that the BFA represents franchising rather than franchisors” (BFA Annual Conference 2008, interview with the author).

\textsuperscript{417} One Vision, 2008 – Strategic Option for the Association’s Future, p. 5.

\textsuperscript{418} ibid.
the simple economic fact of life that the BFA relies on funding from franchisors for its survival. If it does anything which a significant number of its franchisor members disagree with, it risks losing their funding and potentially ceasing to exist. The BFA cannot justify a claim that it is the voice of franchising until franchisees are a fully integrated part of it with something approaching the same amount of influence as franchisors. This would be a tremendous change, which it is doubtful that many franchisors will have an appetite for it. Of all the EU national franchise associations only France actively involves franchisees in any meaningful way. No other national franchise association in the EU purports to involve franchisees.

3.4.4.2 Enforcement of Decisions

The BFA’s existence and position of influence over franchisors is fragile and is not in any way guaranteed. As the Director General of the BFA once said, its role is “rather like treading on egg shells”.

As a consequence it rarely exercises its right to expel members due to their failure to comply with its Code of Ethics.

3.4.4.3 Finance

In order to give self regulation any chance of success the franchise association must be properly financed. Finance is a big issue for the BFA. Without an appropriate level of funding it is powerless to do anything. Its sole source of income is its membership. Members pay a single fee regardless of their size. Whilst this prevents those with “deep pockets” from dominating the association it limits the overall income to what the smallest member can

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419 The Franchise associations that are members of the EFF are those in Sweden, Finland, Denmark, Bulgaria, Spain, Italy, Slovenia, Romania, Portugal, Poland, The Netherlands, Ireland, Germany, France, The Czech Republic, Belgium, Austria, Hungary and the UK. Many were founded in the 1970s (the BFA, the Spanish Franchise Association, the German Franchise Association, the French Franchise Federation). Others are far more recent (e.g. the Romanian Franchise Association was established in 2006).
420 Since early 2008 it has appointed 2 franchisees to its Board of Directors. All of its member networks (as it refers to franchise systems) are invited to nominate franchisee candidates and the franchisors then elect 2 of the short list to the board. This initiative was controversial and led to at least one franchisor resigning from the FFF (Brian Smart in interview with author on 18 September 2008).
422 See pp [50] 9.4.1 above
423 In the 2008 Annual Report it showed turnover to be down 5% on 2007 to £1.25 million, with administrative costs of £885,280 (down 8% in 2007) and a profit of £141,344 (up 18.9% on 2007). Reserves were £1.02 million.
424 Unlike the French Franchise Federation which generates far higher membership fees by changing members based upon the size of their networks.
Without strong finances the ability of the BFA is limited in what it can do to educate and regulate its members.

3.4.4.4 Impact on Non Members

The EFF estimates that there are 9,971 franchise brands in Europe\(^ {426}\). Although the European Franchise Federation and its 16 member state franchise associations seek to self regulate franchising in the EU, they represent less than 1,577 franchised brands\(^ {427}\), which is less than 16% of the franchises in the EU\(^ {428}\). The remaining 8,300 or so franchised brands\(^ {429}\) have nothing to do with the EFF or its member state national franchise associations.

This inability to regulate non-BFA members undermines the credibility of the BFA’s Director General, Brian Smart’s view that

> "we have got a robust (self) regulatory framework (sic!), that can defend your way of doing business in the public domain."\(^ {430}\)

The Australian experience clearly shows that a voluntary regime lacking any means of compelling compliance, will always be preaching to the converted. The unarguable paradox is that those franchisors who most need to be regulated are the ones who are least likely to comply with a voluntary code. The BFA believes that by establishing itself as the authority on what is “good” and what is “bad” franchising, it can place “bad” franchisors at a substantial commercial disadvantage by directing potential franchisees only to “good” franchisors. It may well be that its influence could become such that it does make franchise recruitment more difficult for franchisors that do not meet its standards. However, between there and schemes that are clearly criminal, there remains a grey area in which non BFA member franchisors, free of the restrictions imposed by the BFA, might take advantage of naïve or inexperienced potential franchisees. The BFA believes that most such abusive schemes are either large but short lived or very small and so have minimal impact\(^ {431}\), although it lacks any empirical evidence to justify this belief. That may or may not be so, but it is cold comfort to the franchisees who suffer and does little to inspire confidence in self-regulation.

3.4.4.5 Competition Between Self Regulatory Bodies

\(^{425}\) In order to facilitate a more representative approach the BFA is considering restructuring itself and has suggested four alternatives to its members, each of which will have an impact on its finances, although two years on , no change has been agreed by its members. \textit{One Vision, 2008} – \textit{ibid}.


\(^{427}\) It has a membership of 19 national franchise associations in all. The Spanish Association is not a member as it is not a “not for profit” organisation. 7 EU member states do not have a franchise association. The Swiss, Croatian and Turkish associations are members of the EFF but are obviously not EU associations. The EFF therefore represents 16 national associations in the EU.

\(^{428}\) The aggregate membership is approximately 1,577. See Appendix 12.

\(^{429}\) Section 2.2. There is great uncertainty about the number of franchises in the EU.

\(^{430}\) Franchise World, Feb/Mar 2007, pp. 16-18.

\(^{431}\) Brian Smart, Director General of the BFA in interview with the author 18 September 2008.
Another problem with self regulation of franchising in the EU is that there is no limit to the number (or control of the integrity) of associations that purport to regulate the sector. The national franchise associations in the EU vary in size, resource and professionalism. Some, such as the BFA, owe their origins to franchisors coming together to protect and promote their best interests and have become increasingly sophisticated and well resourced over the years. Others, such as the Bulgarian Franchise Association are still in their very early days. A number, like the Danish and Greek Franchise Associations were started by professional advisers seeking to use the association to promote their services to franchisors.

The Spanish Franchise Association, although long established and comparatively well resourced is actively involved in running exhibitions and trade missions and so is deemed not to be a “not for profit” organisation and is therefore not allowed to join the EFF.

In Germany, the Franchise Association was decimated when many of its members deserted it to join the Co-Operatives Association, which boasts large influential members such as TUI.

The European Franchise Federation is a somewhat uneven mix in terms of size, influence, resources and outlook and cannot claim to fully represent either franchising or franchisors even in all those member states in which franchising is most prevalent. This has resulted in occasional anarchy amongst the various franchise associations.432

This lack of order amongst the organisations that would self regulate franchising does not stop there. Periodically other, self appointed, would be self regulatory organisations pop up, such as the European Franchise Committee.433

3.4.5 Sub-conclusion

The self regulatory environment does not effectively support or re-enforce the drivers that attract either franchisors or franchisees to franchising. Neither does it reduce the consequential inherent risks for either party.

The self regulatory environment in the EU is marked by a complete lack of homogeneity, the lack of a clear or consistent approach to enforcement, a significant conflict of interest

432 For example, in 2006 the BFA “managed to secure the resignation of the full board of the EFF” and appoint a replacement board and Chairman so that it was fit to “take us forward into the renegotiation of the EC block exemption regulation next year” (Franchise World, Feb/Mar 2008, p. 29). In 2007, the EFF and the World Franchise Council, had a bitter dispute because the WFC wanted to grant direct membership to franchisors and so compete with national franchise associations in the EU.

433 This UK based “Pretender” declares that its primary mission is “to promote fair franchising, franchise broker and dealer practices, to promote trade and exemplary trade practices and to provide members with programs, training courses, workshops, services and products which enhance their ability to conduct their individual businesses and careers with competence and integrity”. It goes on to state that it advocates beneficial legislation and legal doctrines” and promotes ethical franchising. It also boasts a “franchising Bill of Rights”. It invites membership from other organisations but gives no details of who its members are. www.efcommittee.eu, this site no longer exists, so further suggesting the transient nature of the organisation.
between the interests of franchisors and franchising as a whole and an inability to have any influence whatsoever on nearly 80% of franchise chains in the EU, as they are not members of the national franchise associations.

3.5 **Analysis of the Legal Regulatory Environment**

This is critical analysis to the second objective of the thesis. It suggests that although individual member state law can create a national regulatory environment that to some degree supports the economic drivers and reduces the consequential risk inherent in the franchisor/franchisee relationship, the heterogeneous nature of the legal regulatory environment in the EU makes it difficult for it to do so adequately on an EU wide basis.

The disparity between franchising in the EU and franchising in both the USA and Australia is marked. A mixture of economic, cultural and historical factors probably account for much of this relative underdevelopment of franchising in the EU and its over concentration in the five largest economies. However, it is also, in part, be due to the failure of the regulatory environment in the EU to support franchising and its expansion across member state boundaries.

Most academic commentators agree that franchising has emerged as an important vehicle for entrepreneurship\(^4\) which, whilst endorsed as a way for large firms to become nimble and more responsive to customers\(^5\), retains its appeal as the preferred method for small businesses to grow\(^6\).

The heterogeneity found in the legal eco-systems constituting the regulatory environment substantially impacts upon franchising within the EU. It is detrimental to both the protection available to franchisors and franchisees vis-à-vis each other and to the security of commercial transactions. This heterogeneity amounts to a technical barrier to trade. It means that the regulatory environment in the EU does not support and re-enforce the economic drivers that attract franchisors and franchisees to franchising. It substantially inhibits the conclusion and operation of franchise agreements where franchisor and franchisee are established in different member states.

In order to encourage business to use franchising for interstate trade, the trade in goods and services between member states should be carried on under conditions which are similar to those of a single market and this necessitates the approximation of the legal systems of the

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member states to the extent required for the proper functioning of franchising in the common market.

An analysis of the legal regulatory environment of franchising in all 29 countries that have franchise specific laws\(^{437}\), suggests that it comprises four different legal “eco-systems”. Anti-trust\(^{438}\), foreign trade/investment\(^{439}\); the franchisor/franchisee relationship\(^{440}\) and hybrids\(^{441}\).

The EU legal regulatory environment of franchising comprises several legal “eco-systems”. Those created by franchise specific laws\(^{442}\) which focus on the franchisor/franchisee relationship and those created by eight distinct other types of EU member state law, each of which is interpreted according to the legal traditions of the relevant jurisdiction. These are good faith; misrepresentation; anti trust; consumer protection; employment; commercial agency; restrictive covenants; and breach of contract. Their impact on franchising is considered below in three parts. First the pre-contractual relationship, then the contractual relationship and finally the termination of the relationship.

3.5.1 The Pre-Contractual Relationship – Franchise Specific Disclosure Laws

\(^{437}\) Australia, Barbados, Belarus, Belgium, Brazil, Canada, China, Estonia, France, Georgia, Italy, Indonesia, Japan, Kazakhstan, Lithuania, Malaysia, Mexico, Moldova, Romania, Russia, South Korea, South Africa, Spain, Sweden, Taiwan, Ukraine, USA, Venezuela, Vietnam

\(^{438}\) Anti-trust regulations are aimed at preventing restraint of trade and generally focus upon classical competition law issues such as tying, full line forcing, retail price maintenance, exclusivity and so on. These are found in Japan (Japan Fair Trade Commission Guidelines, April 2002 – These provide for disclosure and offer guidance on vertical restraints) and Venezuela (The Venezuelan Pro-Competition Agency’s Guidelines for the Evaluation of Franchise Agreements, January 7, 2000 – These are based upon the previous EU Franchise Block Exemption from 4087/88). The EU has this type of regulation in the form of Article 81 of the Treaty of Rome and the Vertical Restraints Block Exemption.

\(^{439}\) Foreign trade/investment regulations are typical of developing markets with either a protectionist economic policy or distinct political aims, such as the distribution of wealth. These are found in China, Indonesia, Kazakhstan, Korea, Malaysia, Moldova, Russia, Ukraine, Belarus, Barbados and Vietnam. Typically they seek to regulate the entry into their domestic market of foreign business systems that escape the restraints placed upon direct foreign investment. Clearly the EU would not want to adopt this type of law as it is contrary to its general approach to free trade.

\(^{440}\) Pure franchise regulations focus upon areas of potential abuse in franchising, namely pre-contractual disclosure and the in-term relationship between the franchisor and its franchisees. These are generally symptomatic of more developed markets and are found in the USA, Australia, Canada, Brazil, Taiwan, Georgia and Mexico. They have much in common with the franchise laws of France, Spain, Italy, Belgium and Sweden. The laws of the USA and Australia are of particular relevance. Some of these pure franchise regulations have their roots in consumer protection law (E.g. the California Franchise Investment Law (1970) (Cal. Corp. Code Sections 31000 to 31516).

\(^{441}\) Some countries have adopted laws which are hybrid in form in that they are best placed in one category but also show characteristics of another. Two examples are Malaysia and China, both have foreign trade/investment franchise laws with a strong element of pure franchise regulation in them. Croatia defines franchise agreements but does not regulate them (Croatian Regulation on block exemption granted to certain categories of vertical agreements, Article 3(6)). The South African Consumer Protection Act 2009, which will come into force in 2010, is a hybrid between anti-trust regulations (it prevents or limits full-line forcing) and pure franchise regulations (focusing on pre-contractual disclosure) (Eugen Honey, partner, Bowman Gilfillan Attorneys, 17 February 2009).

\(^{442}\) In eight EU member states; France, Spain, Italy, Belgium, Sweden, Romania, Estonia and Lithuania
This is critical analysis to the second objective of the thesis and suggests that the franchise specific pre-contractual regulatory environment in the EU fails to both adequately re-enforce the economic drivers that attract franchisors and franchisees to franchising and to reduce the inherent consequential risk to an appropriate level.

3.5.1.1 The Architecture of the Franchise Specific Laws

It is suggested that the regulatory environment in the EU offers a lack of homogeneous pre-contractual protection for franchisees against inadequate pre-contractual disclosure on an EU wide basis and so does not adequately support the economic drivers that attract franchisees to franchising or reduce the consequential risks they assume. The drivers that attract franchisors to franchising are supported, although the risks they assume are not reduced.

An analysis of the French disclosure laws and those in Spain, Italy, Belgium, Sweden and Romania shows that franchisors are obliged to make disclosure to potential franchisees about information in eight distinct areas, a set number of days before the franchise agreement is entered into. There is no real norm in these six EU member states or in any of the other 21 non EU jurisdictions that impose a disclosure obligation on the franchisor, but certain common themes do exist.

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444 Article 62 of Act 7/1996.
445 Law of 6 May 2994, No. 129.
449 Spain: A disclosure document must be issued to the potential franchisee “at least twenty days prior to signature of the franchise agreement or pre-agreement, or payment by the future franchisee to the franchisor of any consideration”.

Italy: The Italian franchise law requires that at least 30 days before the date of execution of the franchise contract, the franchisor must deliver to the franchisee a copy of the contract

France: 20 days before signature of the agreement
Belgium: Disclosure must be made at least one month before closing
Sweden: The Swedish Disclosure Act 2006 requires the franchisor to disclose to potential franchisees in writing, within a reasonable period of time before closing, such information on the nature of the agreement and such other information which, according to the circumstances, may be required. A reasonable period of time is considered to be at least 14 days.

Romania: The Romanian law is the least burdensome of all the EU member state disclosure laws and fails to state a time at which disclosure must be made.

450 The time at which disclosure must be given tends to range between 10 and 30 days before signing although this does vary in some jurisdictions. In Brazil the offering circular must be delivered to a prospective franchisee at least 10 days prior to the execution of a franchise agreement. Malaysia and Taiwan opt for the same period, whilst Korea requires only 5 days and other countries require longer. The Canadian states all require 14 days, Vietnam 15 days, China 20 days (South Africa is proposing the same time) and Mexico a rather excessive 30 days. Japan and Indonesia lay down no minimum period of time.
The Eight Elements of the Franchise Specific Pre-contractual Regulatory Environment in the EU

<table>
<thead>
<tr>
<th>Constituent elements of the Pre-Contractual disclosure Requirements of Franchise Specific Laws in the EU</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate Information</strong></td>
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<tr>
<td>---</td>
</tr>
<tr>
<td>France 452</td>
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<tr>
<td>Spain</td>
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<tr>
<td>Italy</td>
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</tbody>
</table>

451 This includes a list of the networks’ outlets, the ‘chain’ of franchisees, the name and address of each franchisee in the network
452 Only applies if there is exclusivity or quasi-exclusivity
453 It requires details of the franchisor company and its directors, banking references, the main stages in the development of the company and the network; the professional experience of the managers and the financial details for the previous two years.
454 The French law also requires details of any potential competitors linked to the franchisor in the area
455 Spain is the only member state with a franchise specific law that does not require a copy of the franchise agreement to accompany the disclosure document
456 The Spanish Royal Decree requires disclosure of a “general description of the sector of activity of the franchise” (Royal Decree 2485/1998 Article 3) which is interpreted by local practitioners as an obligation to define “the market conditions of the franchise network” (American Bar Association (ABA Book) 2002, workshop 9, p.139).
457 The Italian law requires that all relevant corporate information relating to the franchisor that is not detailed in the franchise agreement including, when requested by the franchisee, the franchisor’s balance sheets for the three previous financial years.
458 The Belgium law goes further and requires details of all intellectual property. Article 4 para 1 1° of the Law Governing Pre-contractual Information Within the Framework of Commercial Partnership Agreements. See Appendix 10.
459 The Italian law imposes a duty of ‘loyalty, fairness and good faith’ in relation to earning claims
460 In Italy a copy of the franchise agreement must accompany the disclosure document
<table>
<thead>
<tr>
<th></th>
<th>Corporate Information</th>
<th>Trade Marks</th>
<th>Characteristics of the Business Format</th>
<th>Details of the Franchise network</th>
<th>Earning Claims</th>
<th>Dispute History</th>
<th>Summary of Contractual Terms</th>
<th>Market Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>✓</td>
<td>✓</td>
<td>x</td>
<td>✓</td>
<td>x</td>
<td>x</td>
<td>✓</td>
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<td>Sweden</td>
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<td>Romania</td>
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<td>Estonia</td>
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<td>Lithuania</td>
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**Key**

✓ - required

✗ - not required

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461 The Belgian law requires forecasts as to the current state of both the local and national market. This applies to all franchisors seeking to do business in Belgium, even if they are based elsewhere and the agreement is not subject to Belgian law. The disclosure must include information on “the market in which the activities are carried out”, as well as on “the market share of the sector” “from both a general and a local point of view”. It also requires disclosure of details of the amortisation of the franchisees’ investment. This is a heavy burden to impose on the Franchisor.

462 The Swedish law requires details of all tied goods and services
### Consequences of failure to comply with franchise specific pre-contractual disclosure requirement in EU

<table>
<thead>
<tr>
<th>Consequences of failure to comply</th>
<th>Right of action</th>
<th>Burden of proof</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>France</strong></td>
<td></td>
<td></td>
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<tr>
<td>• Invalidity</td>
<td>Franchisee can file suit for declaration of invalidity and damages within 5 years</td>
<td>Defective consent must be established</td>
</tr>
<tr>
<td>• Financial penalty</td>
<td></td>
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<tr>
<td>• Damages</td>
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<tr>
<td><strong>Spain</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Invalidity</td>
<td>Franchisee can file suit for declaration of invalidity and damages</td>
<td>Defective consent must be established</td>
</tr>
<tr>
<td>• Financial penalty</td>
<td></td>
<td></td>
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<tr>
<td>• Damages</td>
<td></td>
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<tr>
<td><strong>Italy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Invalidity</td>
<td>Franchisee can file suit for declaration of voidness and damages</td>
<td>Deliberate non-disclosure and defective consent.</td>
</tr>
<tr>
<td>• Damages</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Belgium</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Invalidity</td>
<td>Franchisee can file suit for declaration of voidness within 2 years. Can sue for damages</td>
<td>Strict liability</td>
</tr>
<tr>
<td><strong>Sweden</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Specific performance</td>
<td>Franchisee can apply to Swedish market court for order of specific performance</td>
<td>Strict liability</td>
</tr>
</tbody>
</table>

- *Invalidity* refers to the invalidity of the franchise agreement due to non-disclosure.
- *Financial penalty* refers to financial penalties imposed by the courts.
- *Damages* refer to compensation for damages incurred.
- *Deliberate non-disclosure* and *defective consent* are key elements in establishing the right of action.
<table>
<thead>
<tr>
<th>Consequences of failure to comply</th>
<th>Right of action</th>
<th>Burden of proof</th>
</tr>
</thead>
<tbody>
<tr>
<td>Damages</td>
<td>Franchisee can sue for damages</td>
<td>Defective consent</td>
</tr>
</tbody>
</table>

Note: Breach of franchise laws outside the EU generally lead to rescission and/or the imposition of fines. In the Canadian provinces of Alberta, Ontario, Prince Edward Island and New Brunswick a failure to give the required disclosure results in the prospective franchisee can rescind the franchise agreement by giving notice to the franchisor the earlier of either 60 days after receiving the disclosure document or no later than 2 years after the franchise is granted (Alberta Franchises Act Section 13, The Arthur Wishart Act (Franchise Disclosure) 6(1) and (2); The Prince Edward Island Franchises Act Chapter 36 Bill 43 Section 6(1); The New Brunswick Franchises Act s 6(1)). If there is a misrepresentation in the disclosure document as a result of which the franchisee suffers a loss the franchisee has a right of action in damages against the franchisor and/or every person who signed the disclosure document (Alberta Franchises Act Section 13, The Arthur Wishart Act (Franchise Disclosure) 6(1) and (2); The Prince Edward Island Franchises Act Chapter 36 Bill 43 Section 6(1); The New Brunswick Franchises Act s 6(1)). A franchisee is deemed to have relied upon any information detailed in the disclosure document (Alberta Franchises Act Section 13, The Arthur Wishart Act (Franchise Disclosure) 6(1) and (2); The Prince Edward Island Franchises Act Chapter 36 Bill 43 Section 6(1); The New Brunswick Franchises Act s 6(1)).
3.5.1.2 A Comparison of the Basic Elements

As can be seen in the above tables, there are eight basic elements that create the franchise specific pre-contractual regulatory environment in the EU, although their precise details and the consequences of non compliance vary between each of the member states. The French Loi Doubin, as the first EU franchise specific law is perhaps the most influential. The other five member state laws are generally similar, but notably unlike the French law, do not require exclusivity or quasi-exclusivity.

All of the disclosure laws have a general sweep-up provision. Under the French law the information disclosed must be “sincere” and permit the other party to “contract in full knowledge of the facts”. The combination of these two requirements places a heavy burden on the discloser, because false information can be “sincere” if the error was made in good faith, but would not permit a contract to be made “in full knowledge of the facts”.

The vague nature of the terms such as “sincere” introduces an element of uncertainty which can only be reduced by giving as much information as possible. The requirement to present information on “the general (and local) state of the market for the products or services which are the subject of the contract, and the prospects for development of this market” can be particularly problematic. It requires details of the market in which both the franchisee and its competitors are operating rather than simply the state of the franchisor’s business.

Although Article L.330-3 of the French Commercial Code is a domestic public policy law and therefore generally applies to all exclusive and quasi-exclusive agreements concerning a franchise that will be performed in France, a decision of the Paris Court of Appeals has held that the disclosure obligation under the Loi Doubin does not apply to international franchise agreements that are not governed by French law.

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463 In the case of an exclusive or quasi-exclusive agreement it requires disclosure, 21 days before signing, details of the franchisor company and its directors, bankers references, the main stages in the development of the company and the network; the professional experience of the managers and the financial details for the previous two years; details of its trade marks; a summary of the contractual terms of the agreement; details of the network and a market analysis.
464 Article 1(1).
465 Olivier Gast, Chapter on Law and Practice in the European Community in Abell, European Franchising, p. 611.
466 Paris Court of Appeals, 30 November, 2001. JCPE no. 3, 2002, p.29. Contrast the Swedish disclosure obligation which applies to foreign franchisors entering the Swedish market even if the agreement is not subject to Swedish law.
As regards enforcement of the law, the French courts of appeal have taken two different tracks as to the manner in which the disclosure law is to be applied\textsuperscript{467}. Some took the view that mere compliance by the franchisor with the legal requirement was enough to render the agreement null and void\textsuperscript{468} whilst other courts held that such non compliance can only lead to annulment of the contract if it gives rise to defective consent on the part of the franchisee\textsuperscript{469}. The Cours de Cassation opted for the second, subjective approach in 1997 and 1998,\textsuperscript{470} so Article 330-3 is to be interpreted according to the doctrine of defective consent, which provides that the courts should focus on the validity of consent rather than compliance with technical formalities\textsuperscript{471}. The burden of proof lies with the franchisee\textsuperscript{472}. A similar approach has been adopted in Spain, Italy and Romania. Non compliance with either the obligation of utmost good faith or to provide full information may lead to both criminal and civil sanctions in France. Article 2 of the implementing Decree imposes a penalty in Class 5 for failure to provide the required information (currently a fine of between €1,500 and €3,000 and/or between ten days’ and one month’s imprisonment). Article 2(2) prescribes the enhanced penalties in Class 5 for a second or subsequent offence (in this case a fine of between €6,000 and €12,000)\textsuperscript{473}. A claim for damages for failure to make pre-contractual disclosure cannot be based on contractual grounds. As a franchisor may only be liable in tort Article 1382 of the Code Civil applies which sets out that any claims from damages are time-barred after 5 years from the time that the claimant knew or should have known about the damage\textsuperscript{474}. There is little case law on the criminal sanctions for failure to comply with article L. 330-3. One suspects that the main reason is that the statute of limitations limits the period during


\textsuperscript{468} Based on Article 6 of the Civil Code which provides that parties cannot deviate from a mandatory rule. See, for example, CA Paris 7 April 1993, D. somm, p75, obs D. Ferrier.

\textsuperscript{469} A subjective approach based upon the franchisee’s “actual knowledge”. For example, see C.A Colmar 9 March 1990, D. 1990, somm, p 232 ff., obs J-J Burst.


\textsuperscript{471} Article 1109

\textsuperscript{472} Cass. Com. 7 July 2004 No. 02-15950.

\textsuperscript{473} Article R.25 of the Criminal Code.

\textsuperscript{474} The Spanish courts follow the French lead and focus on a subjective test based on the general doctrine of defective consent (Bueno Diaz, O. 2005 “Franchising in European Contract Law”. Sellier – European Law Publishers. pp86). Although the Spanish franchise law does not list the civil effects of the failure to make proper pre-contractual disclosure, it is possible that if a court considered the missing (or false) information to be fundamental (i.e. information that is essential for the franchisee to form its consent), the franchise agreement could be declared null and void (SAP Barcelona de 21 de septiembre de 2004 (AC/2004:1952)). If the missing information was not fundamental to the decision whether or not to enter into the franchise agreement, the agreement would not be declared null and void, but it would be still voidable. It therefore largely depends on the type of information that is missing in order to determine the impact on the validity of the contract.
which action can be taken to only one year. Providing information that is deliberately misleading will amount to fraud under Article 405 of the Criminal Code.

Unlike the other EU member states with franchise focused laws, Spain and Lithuania seek to reduce a mismatch of expectation between franchisor and franchisee (and so reduce the risk to franchisees), by requiring registration of appropriate documentation on public registers. This is fairly common in non EU jurisdictions such as China, Russia, Indonesia, Malaysia, Moldova and 14 of the States in the USA, but it is doubtful whether it is successful in reducing the risks to which franchisees are exposed.

3.5.1.3 Sub-Conclusion

The franchise specific pre-contractual regulatory environment in the EU seeks in six member states to reduce to risks to which franchisees are exposed by ensuring that they have sufficient information to allow them to take a view of the adequacy of the business format, the support delivered by the franchisor to its franchisees and the franchisor’s historical approach to encroachment. Its success in reducing those risks is dependent on the franchisee carefully considering the information it receives, particularly the feedback from existing franchisees.

475 Franchisors who sell franchises in China need to file MOFCOM together with, amongst other things, a sample franchise contract and the index of the Franchising Operation Manual. An application has to be made within 15 days after the execution of the franchise agreement (Article 8 of the Administration Regulations and Article 5 of Administration Rules on Commercial Franchise Filing—Decree of Ministry of Commerce 2007 (No 15)).

476 In Russia, franchise agreement must be registered with the tax authorities which maintain the register of Commercial Concessions in order to be valid against third parties (Russian Civil Code Part II Chapter 54 Articles 1028(2)).

477 Uniquely, in Indonesia, the franchise law provides that the franchisee rather than the franchisor must register the franchise agreement and disclosure statement at the Ministry of Trade within 30 days of the effective date of the franchise agreements (Regulation of the Minister of trade No 12/M-DAG/PER/3/2006 dated 29 March 2006, which revoked The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter III, Article 11.1). Failure to register resulted in the revocation of the franchisee's trade license (Regulation of the Minister of trade No 12/M-DAG/PER/3/2006 dated 29 March 2006, which revoked The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter VI Article 22). Franchise licenses between a foreign franchisor and a master franchisee are registered.

478 In Malaysia both the franchisor and the franchisee are required to become involved in the registration process. The franchise agreement, the letter of intent (which has replaced the disclosure document originally provided for), the operations manual, the training manual, a copy of the latest audited accounts and financial statements, and other documents must be registered with the Registrar of Franchises (The Franchise Act 1998 Part II Section 6(1)). The franchisee of a foreign franchisor must also register itself (The Franchise Act 1998 Part VIII Section 55). The problem here is that approval can take up to six months so delaying the franchisor’s ability to franchise considerably.

479 In Moldova the franchise agreement must be registered with the State Agency for the Protection of Industrial Property (Article 9(4) of the ) Moldovan Law on Franchising No. 1335 dated 1.1.1997 provides: “The franchise agreement is registered with the State Agency for the Protection of Industrial Property”) but do not as “The franchise agreement is considered to be valid from the day it is signed or form the day determined by the parties” (Article 9(3) ) Moldovan Law on Franchising). The validity of the franchise agreement does not depend on its registration with the Agency.

480 See section 4.6
and is comprised by the inevitable fact of life that the franchisor’s historical conduct may not be indicative of its future behaviour. The lack of homogeneity of approach to franchise specific laws between the different EU member states substantially dilutes its impact on cross border franchising. The lack of any uniform approach to pre-contractual disclosure further weakens the impact of franchise specific laws.

They do not seek to reduce the risks of informational asymmetry and moral risk to which the franchisor is exposed. Some regulatory regimes seek to redress this imbalance by imposing a duty of pre-contractual disclosure on the potential franchisee but that is not part of the pan EU pre-contractual regulatory environment.

The economic drivers which attract franchisors into franchising and those that attract franchisees to it are neither supported nor eroded in any particular way by the pre-contractual disclosure franchise specific regulatory environment in the EU.

3.5.2 The Pre-Contractual Relationship – Other Laws

This is critical analysis to the second objective of the thesis and suggests that the non-franchise specific pre-contractual regulatory environment in the EU fails to both adequately re-enforce the economic drivers that attract franchisors and franchisees to franchising and to reduce the inherent consequential risk to an appropriate level.

It suggests that in some member states other laws impact upon the pre-contractual regulatory environment in a manner that reduces some of the risks to franchisees that are inherent in their relationship with the franchisor. However, the lack of a homogenous approach throughout the EU substantially limits the impact of these on cross border franchising in the EU. These laws do not reduce the risks to which the franchisor is exposed. Neither do they support the economic drivers that encourage the franchisor or the franchisee to become involved in franchising.

Five key elements can be identified in the pre-contractual regulatory environment. Some are evident in all EU member states, whilst others exist in only a handful of them.

The most universal element is the obligation placed on franchisors not to mis-represent their franchise to potential franchisees. A related, but less common element, which is found in Germany and those member states over which it has historically had influence, is the

481 In Vietnam not only does the franchisor have to disclose information to the franchisee, but so does the franchisee to the franchisor. In order to assist a franchisor when deciding to grant commercial rights, Article 9 of the Commercial Law provides that, upon receiving a reasonable request from the franchisor the franchisee is under an obligation to supply the franchisor with information about itself. The earlier Chinese franchise law (the Measures for the Regulation of Commercial Franchises issued by the Ministry of Commerce of the People’s Republic of China, December 31, 2004, Chapter III Article 9) also provided for this but it was dropped (without any explanation) from the most recent Chinese statute.
obligation placed on the franchisor to disclose relevant information to the potential franchisee. The three other elements comprise an extra contractual obligation of confidentiality placed on franchisees and potential franchisees, obligations imposed on the franchisor to enter into an agreement with a potential franchisee if negotiations pass a certain point and a right for franchisees and a right, in certain circumstances, to withdraw from the contract within a specific time.

3.5.2.1 The First Element – A Duty Not to Misrepresent Facts

The concept of misrepresentation can be divided into two different categories. An obligation not to make false representations and a positive obligation to actively disclose certain facts.

The common law maxim of caveat emptor, buyer beware, applies in principle in both law and equity to all bargains struck under English and Scottish law. It applies to the purchase of specific things, upon which the buyer can and usually does exercise his own judgment. It applies also whenever the buyer voluntarily chooses what he buys and whenever, by usage or otherwise, it is a term of the contract express or implied that the buyer shall not rely on the skill or judgment of the seller.

However, if the potential franchisee relies on the judgement, knowledge and information (i.e. the representations) of the franchisor the maxim Caveat Emptor does not apply. If the franchisor’s representations are incorrect or misleading they can give the franchisee grounds for action against it. In some ways misrepresentation can be seen as the common law equivalent to a very limited form of pre-contractual duty of good faith. Indeed misrepresentation appears in various forms in certain civil jurisdictions as a part of the general pre-contractual duty of care or good faith.

Although in general terms, there is no positive legal obligation of franchisors under common law to disclose anything about the franchise to a potential franchisee, the commercial reality is that the franchisor makes the franchisee aware of the characteristics of the franchise system and discloses relevant information to potential franchisees so they are aware of what is involved in the running of the franchise. There is a general contractual principle that one must avoid making misrepresentations which induce a party to enter into a contract. In some circumstances silence can amount to a misrepresentation. If the franchisor breaches this

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482 Wallis v Russell [1902] 2 IR 585 at 615.
483 Jones v Just (1867-68) L.R. 3 Q.B. 197.
484 See Chapter 7 pp. 103-108 above.
principle the contract will be voidable and the franchisee can rescind the contract and in some circumstances, claim damages.

There are 3 differing types of misrepresentation in English and Scottish law. Fraudulent\textsuperscript{487}, negligent\textsuperscript{488} and innocent\textsuperscript{489} misrepresentations all give rise to slightly different consequences.

A misrepresentation is a false statement of past or existing fact given by a franchisor to a franchisee which induces the franchisee into a contract. It must be a statement of fact, past or present, and not merely a statement of opinion, an intention as these only show that the opinion or intention is held by the person expressing it\textsuperscript{490}. A mere statement of opinion which proves to have been unfounded will not be treated as a misrepresentation\textsuperscript{491}. However, a statement of opinion or intention that is not honestly held by the franchisor\textsuperscript{492}, or could not reasonably be held by it given his knowledge of the facts, may be regarded as a statement of fact and may constitute a misrepresentation\textsuperscript{493}. It is also the case that a statement of the intentions of a third party is a statement of fact and can constitute a misrepresentation as above\textsuperscript{494}.

The prohibition on mis-selling franchises in the United Kingdom is based on an implied representation that there are reasonable grounds for holding an opinion, even if that opinion is honestly held\textsuperscript{495}. Mere “advertising puff” does not amount to a representation of fact\textsuperscript{496}. The overall principle is that statements are not treated as representations where, having regard to all the circumstances, it is unreasonable for the franchisee to rely on the franchisor’s statements rather than his own judgement\textsuperscript{497}.

The distinction between fact and opinion has become much less important since 	extit{Esso Petroleum Ltd v Mardon}\textsuperscript{498}. Esso granted “solus agreements” to licensees. It offered a forecast of the probable sales of a petrol station, based on an estimated throughput of petrol, to a prospective franchisee. The estimate was produced before Esso was made aware that the local authority would not give permission for the pumps to front onto the main road and the

\textsuperscript{487} Derry v Peek (1889) 14 App Cas 337.
\textsuperscript{488} Hedley Byrne & Co Ltd v Heller & Partners Ltd [1963] 2 All ER 575; Misrepresentation Act 1967 (England).
\textsuperscript{489} Misrepresentation Act 1967 s.2(2).
\textsuperscript{490} Hummingbird Motors Ltd v Hobbs [1986] RTR 276.
\textsuperscript{491} Smith v Land and House Property Corp (1884) 28 ChD 7.
\textsuperscript{492} Strachan & Henshaw Ltd v Stein Industrie (UK) Ltd (No 2) (1997) 87 BLR 52.
\textsuperscript{493} Bradbury v Fitzmaurice (1885) 29 Ch D 459.
\textsuperscript{494} Citty on Contracts, 6-005; Economides v Commercial Union Assurance Co plc [1998] QB 587; Smith v Land and House Property Corp (1884) 28 ChD 7.
\textsuperscript{495} Smelter Corp of Ireland Ltd v O’Driscoll [1977] IR 305.
\textsuperscript{496} Brown v Raphael [1958] Ch 636.
\textsuperscript{497} Dimmock v Hallett (1866) 2 Ch App 21.
\textsuperscript{498} Harlingdon and Leinster Enterprises Ltd v Christopher Hull Fine Art Ltd [1991] 1 QB 564.
station was built backwards, Esso failed to adjust the estimate. The franchisee did all it could in attempting to reach the projected throughput but never managed to even reach half of the estimate provided by Esso. The difference was attributable to the positioning of the pumps at the station. The forecast was held to be a warranty which had been breached and a negligent misrepresentation by Esso as they “had special knowledge and skill…. [and] much more experience and expertise at their disposal….. to make a forecast” than the franchisee. Even the loss sustained under a second re-negotiated contract was held to be attributable to the original misrepresentation as it resulted from an attempt of the franchisee to mitigate its losses.

In certain circumstances representations may be implied and, if false, lead to an effective misrepresentation. This becomes an issue when, considering all the circumstances, it has been impliedly represented by the conduct of the franchisor that there exists some state of facts different from the truth. There is no legal duty on the franchisor to disclose material facts to the franchisee, however dishonest such non-disclosure may be. However, if a franchisor makes a statement which is literally true but is misleading because of other facts that have been omitted it can give rise to an action for misrepresentation by partial-disclosure. The same is true where there has been a change of circumstances that makes a previously made statement false, the initial statement is regarded as a continuing representation. In this situation, if the franchisor knows of the change in the facts, there will be a misrepresentation if it fails to disclose it to the potential franchisee. There is conflicting case law as to whether this duty to disclose applies to a change in the intention of the franchisor, but it appears likely that it does. In a situation where a statement was made innocently but falsely and later the franchisor discovers the true facts, failure to alert the franchisee changes the innocent misrepresentation to a fraudulent misrepresentation.

A franchisor will not be held liable for a misrepresentation unless it is material in the sense that it induces the franchisee into the contract. Therefore the franchisee must rely on the statement made to him. If it relies upon its own judgement or investigation the franchisor will not be liable. However, the franchisor will not escape liability merely by inviting the

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503 *With v O’Flanagan* [1936] Ch 575.
505 *Davies v London Provincial Marine Insurance Co* (1878) L.R. 8 Ch. D. 469.
506 *Attwood v Small* (1839) 6 C & F 523n.
franchisee to discover the truth if the invitation is rejected and the statement is still relied upon. It is not necessary for the representation to be the sole reason for the franchisee entering into the contract. If it is actively present in the mind of the franchisee when entering the contract then it is material in inducing him to enter the franchise agreement.

In some circumstances the franchisor may be deemed to be under a duty of care to comply with the pre-contractual representations it makes to potential franchisees.

In the UK any attempt by the franchisor to escape or limit its liability for misrepresentation must satisfy the requirements of reasonableness as set out in the Unfair Contract Terms Act 1977. In order to satisfy the reasonableness test, the franchisor must prove that the term is a “fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made”. Fraudulent misrepresentation cannot be excluded.

The use of entire agreement and non-reliance clauses to exclude liability for misrepresentation is not always successful and it is the evidence as a whole, including any such non-reliance clause, that will show will win the day. A non-reliance clause will not serve its purpose unless the franchisor can show that he entered the contract with the belief that the franchisee did not rely on the representations.

The English courts have recognised the efficacy of no reliance clauses in franchise agreements. For example, in the case of Fleet Mobile Tyres Ltd v Stone & Another the High Court Judge held that, whilst a no reliance clause does not guarantee complete protection, the franchisee's task of proving that he did, in fact, rely on a pre-contractual statement in the face of a clear statement in the agreement that he did not, is made very much more difficult. However, the recent case of Quest 4 Finance Limited v John Maxfield and Others shows that a misrepresentation claim will not always be defeated by a no reliance clause. Although the Quest case did not relate to a franchise agreement, the principles will apply to any commercial contract. In Quest, the court held that the Claimant could not rely on a no reliance clause to defend itself from a misrepresentation claim when the terms of the

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507 Redgrave v Hurd (1881) 20 Ch D 1.
508 Edginton v Fitzmaurice (1885) 29 Ch D 459.
510 S.11 (1).
511 Misrepresentation Act 1967 s.3.
512 Unfair Contract Terms Act s.11 (1).
514 ibid
515 Cremdean v Nash (1977) 244 EG 547.
contract entered into clearly contradicted information given in the Claimant's brochure and the Defendant showed that he had relied on the statements in the brochure.

In *MGB Printing & Design Ltd v KallKwik UK Ltd*\(^{519}\) it was established that the franchisor owed the franchisee a duty of care because of the proximate nature of the relationship and the foreseeability of damage. This duty of care extended to precontractual representations and the clauses excluding contractual liability for misrepresentation did not exclude tortuous liability.

A misrepresentation by the franchisor renders the franchise agreement voidable *ab initio* by the franchisee. Depending on the type of misrepresentation the franchisee may also claim damages. In fraudulent misrepresentation cases the franchisee may be able to recover all direct loss which can be shown to have resulted from the false statement. This is without regard for the usual requirements of remoteness that the loss be reasonably foreseeable or in reasonable contemplation of the parties\(^{520}\).

It is not only the common law jurisdictions of England, Scotland, Ireland and Cyprus that rely upon the concept of misrepresentation to regulate the pre-contractual relationship.

As franchise agreements are regarded as “atypical” agreements, German statutory law does not specifically provide for misrepresentation in franchising and so the general statutory provisions of the German Civil Code and the German Commercial Code apply. Intentional misrepresentation can trigger claims for contractual\(^{521}\) and other damages\(^{522}\), tort claims\(^{523}\), the right to rescission\(^{524}\) and criminal charges\(^{525}\).

Misrepresentation by the franchisor is regarded as a breach of the franchisor’s duty to take into account the rights, legal interests and other interests of the franchisee\(^{526}\) when negotiating a contract, resulting in the franchisor’s liability for damages if the misrepresentation resulted in defective consent and resulted in damage to the franchisee. This (contractual/pre-contractual) liability applies regardless of whether the misrepresentation has been negligent or fraudulent.

The quantum of the claim is determined by Art. 249 BGB: The franchisor must place the franchisee into the position that would have existed if the misrepresentation had not occurred.

\(^{519}\) Ibid
\(^{520}\) *Doyle v Olby (ironmongers) Ltd* [1969] 2 QB 158; *Smith New Court Securities Ltd v Citibank NA* [1997] AC 254; *Clef Aquitaine SARL v Laporte Materials (Barrow) Ltd* [2000] 3 All ER 493.
\(^{521}\) (Art. 280 sec. 1, 241 sec. 2, 311 sec. 2 BGB)
\(^{522}\) The Unfair Competition Act (UWG)
\(^{523}\) Art. 823 sec. 2 BGB
\(^{524}\) Art. 123 sec. 1, Art. 124 BGB
\(^{525}\) Art. 263 German Criminal Code – fraud)
\(^{526}\) Articles 241 sec. 2, 311 sec. 2 BGB
In some cases, this includes loss of profit (e.g. if the franchisee gave up employment in order to enter into the franchise contract)\(^527\). Contributory negligence of the franchisee is taken into consideration. Such contributory negligence can be assumed if the franchisee has specific business experience and fails to evaluate the information provided by the franchisor accordingly.

Alternatively, the franchisee can choose to rescind the contract which eventually may result in higher payments by the franchisor\(^528\).

The burden of proof that the information provided has been true and accurate, rests with the franchisor. This reversal of the burden of proof is due to the superior knowledge of the franchisor\(^529\).

A franchisee has a right to rescind the contract if the fraudulent misrepresentation caused the franchisee to enter into the franchise contract. Fraudulent intention can be assumed if the franchisor is aware that the information provided by him may be wrong and fails to inform the franchisor about the uncertainty, if the franchisor knows, or suspects, that the incorrect information is being relied upon by the franchisee when deciding whether or not to enter into the contract\(^530\). The right of rescission\(^531\) does not depend upon the franchisee suffering damages.

Rescission has to be claimed within one year commencing at the time the franchisee discovers the misrepresentation\(^532\).

Rescission renders the franchise agreement void. As a consequence, the franchisee can claim for reversal of the transaction according to the law of unjust enrichment\(^533\). The rescission has no effect on single sale contracts for goods which the franchisee made during the franchise period\(^534\).

The franchisor may also be liable for damages\(^535\). It may also be a criminal offence\(^536\) if the franchisor (i) intended to cause an error, (ii) intended to obtain for himself or a third party an unlawful material benefit, and (iii) caused damage to the franchisee’s property/assets. Fraud requires the franchisor to intend to obtain an unlawful material damage and a pecuniary

\(^{527}\) Giesler, Nauschütt, Franchiserecht, 2.ed. 2007, p.368 (Rn 54a).
\(^{528}\) Ibid.
\(^{529}\) Ibid.
\(^{530}\) Palandt, BGB, 69.ed. 2010, § 123 Rn 11.
\(^{531}\) Ibid
\(^{532}\) Art. 124 BGB
\(^{533}\) Art. 812 sec. 1 BGB
\(^{534}\) Giesler, Nauschütt, Franchiserecht, 2.ed. 2007, p.506 (Rn 251).
\(^{535}\) Articles 823 sec. 2 BGB
\(^{536}\) Article 263 sec. 1 of the German Criminal Code
detriment on the side of the franchisee. It is punished by a term of imprisonment of up to five years or a fine.

If the misrepresentation is regarded as “misleading advertising”, the franchisor may be liable for damages regardless of whether the misrepresentation is intended or negligent. Untrue/overstated information is regarded as being misleading if it addresses issues such as the essential characteristics of the goods or services; the reason for purchase; the nature, attributes or rights of the entrepreneur; any statement or symbol in relation to direct or indirect sponsorship; the need for a service, part, replacement or repair; compliance with a code of conduct; the rights of consumers.

Misrepresentation can be about facts or future prospects and the courts have found the following examples in respect of franchising. False statement of franchisor that there is a high number of successful franchisees; misinformation about the market success of the franchise system to date; false statement of franchisor that there are already customers existing in the specific trading area; wrong information about presumably needed capital resources, and providing exorbitant turnover statistics and describing them as a conservative estimate.

Many of the EU member states take the same general approach to misrepresentation.

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538 Articles 5, 3, 9 of the German Unfair Competition Act
539 Note that the franchisee is still bearing the risk of future prospects not proving true; C.f. Giesler, Nauschütt, Franchiserecht, 2.ed. 2007, p.358 (Rn 45).
542 OLG Hamburg, judgement from 17.04.1996 – 5 U 137/95 (not published).
546 In Malta an essential element of a valid contract is consent, and it is clear that a contract is not valid if the consent of one of the contracting parties is procured through the provision of incorrect information (Article 974 of the Maltese Civil Code). Latvia also relies upon it together with concepts of fraud and deceptive practices which give the franchisee the right to either claim cancellation of the franchise agreement (Article 1461 of the Latvian Civil Law) or sue for damages (Article 1779 of the Latvian Civil Law; the Latvian parliament intend to change their approach and adopt a franchise specific law that will require franchisors to give their potential franchisees prior disclosure of the nature of the franchise, evidence of the validity of the rights to be granted, details of the franchise networks and details of the terms of the franchise agreement, particularly the financial terms). In Estonia a right of action for misrepresentation is available to franchisees under the Civil Code Act Chapter 7 of the Law of Obligations Act, which provides that a person who entered into a transaction based on fraudulent misrepresentation may rescind the contract. If the contract is not yet concluded, then a claim against a fraudulent franchisor can be made under the Law of Obligations Act. This provides that persons who engage in pre-contractual negotiations, or other preparations for entering into a contract, shall take reasonable account of the other’s interests and rights (Section 14 subsection 1 of the Law of Obligations Act). The second sentence of the same subsection states that the information exchanged by the persons, in the course of preparation for entering into the contract, shall be accurate. If one of these rules is not followed by the franchisor, then the franchisee has the right to claim for damages (Section 14 (1) of the Law of Obligations Act. In Slovenia, the duty of good faith exists but only applies in the event that the franchisor has made a misrepresentation and provided misleading or inaccurate information to the potential franchisee. In which case, the franchisee can
Misrepresentation can help to reduce the risk that franchisees are induced to enter into a franchise on the back of false or inaccurate representations by the franchisor that it will be able to deliver those economic drivers that the franchisee is looking for from a franchise. In theory it can offer franchisors similar protection.

3.5.2.2 The Second Element – A Duty to Positively Disclose Relevant Facts

Whereas all EU member states prohibit misrepresentation in the sense that a party may not make false or misleading statements which may entice the other party to enter into a contract, only some civil jurisdictions go further and require a contractual party to make active pre-contractual disclosure.

In Germany, once contractual negotiations commence a pre-contractual relationship of trust is immediately established. This imposes on the parties a pre-contractual duty of care in providing pre-contractual disclosure to each other. The statutory foundation of this obligation, according to some commentators and case law, can be found in Article 242 BGB. Both the Franchisor and Franchisee are under a duty to provide such information to each other as is reasonably necessary to enable the other party to make an informed decision as to whether or not they enter into the franchise agreement with the other party (“culpa in contrahendo”). The doctrine of “culpa in contrahendo” means that the franchisor has to provide and prepare site studies, profit and turnover forecasts and other financial information. This burden is particularly heavy for foreign franchisors who have no knowledge of the German market and have no experience of running a business there. There are several examples of foreign franchisors with no knowledge or experience of the German market giving their German developer or master franchisee such information as they had about the franchise business’s performance outside of Germany and subsequently finding that this has resulted in them

rescind from the contract within one year from learning of the misrepresentation and can also claim damages for any loss suffered (Article 7 of the Slovenian Civil Code). Despite its civil law system there is no express duty of good faith in Denmark and misrepresentation or fraud must be established (Law no 781 of 26.08.1996). Bulgaria also embraces the concept of misrepresentation (The Bulgarian Obligations and Contracts Act 275 of 22.11.1950). In Finnish law (Unfair Business Practices Act (1061/78)) for example, the Unfair Business Practices Act prohibits, “the use of false and misleading expressions concerning one’s own business operations or those of another party if the said expression is likely to affect the demand for or supply of a product or harm the business of another” (Section 2 of the Unfair Business Practices Act (1061/78)). The Court can prohibit an ongoing misrepresentation and impose a conditional fine. Fraudulent misrepresentation gives rise to the right to rescind the entire agreement (Hanna-Maija Elo, ‘Finland’ in: Getting the deal through – Franchise 2008, p. 36 para.17). In addition to the Unfair Business Practices Act, a franchisee may also claim damages under the Tort Liability Act as a result of the unlawful behaviour by the franchisor (which includes misrepresentation). In order to prove the claim the franchisee will have to show that it has suffered loss as a result of the actions taken by the franchisor (Hanna-Maija Elo, ‘Finland’ in: Getting the deal through – Franchise 2008, p. 36 para.17).

547 Article 311 BGB.
falling foul of the *culpa in contrahendo* doctrine. Even if the franchisee is an experienced business person, the Franchisor is under an obligation to provide information regarding the details of the franchise system. Technically disclosure should also be the other way round (e.g. where the franchisee withholds important information), but in practice of course it is the franchisor’s duty that usually becomes the basis of a dispute.

The franchisor has to provide all available information regarding the profitability of its franchise system. It is not considered sufficient for the franchisee to have had the opportunity to visit other businesses within the system in order to gain his/her own impression. It has also been regarded as a breach of the disclosure obligations to provide a misleading quote regarding the number of franchises that have failed within the contractual territory.

Breach of the duty of disclosure will lead to a cause of action against the franchisor. The franchisee will have the right to withdraw from the contract and claim damages in a sum equal to all expenses incurred in performing the contract (subject to the deduction of profits). However, the franchisee cannot claim for loss of the profit that it would have made had the contract continued. Generally speaking a franchisee who has suffered a loss can demand to be restored to the position he would have been in if the breach had not occurred.

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549 For example, the US family restaurant franchise Applebee’s.
550 Giesler, Franchiseverträge, Rn. 206.
551 Palandt BGB, § 311 Rn. 20.
552 OLG Muenchen NJW 1994, S. 667ff; Braun NJW 1995, S. 504, 505. The plaintiff claimed for refund of the franchise license fee. The agent of the franchisor had provided untrue information on revenue and profit and assured that the figures were accurate and proven. In the materials provided it was stated that a "cautious" profit expectation would be between 8,000 and 15,000 DM/month. The plaintiff entered into the franchise contract without having conducted own research or calculations before conclusion of the contract. He rented a salesroom, bought two cars for delivery services and paid a franchise fee of 22,800 DM. Nine months after the conclusion of the franchise contract, the franchisee cancelled the Franchise Agreement and claimed for damages (franchise fees, price of cars). The defendant argued that a certain amount must be deducted from the damages as the plaintiff failed to assess the information on its own. The judges dismissed this notion, arguing that if one assures that certain figures are proven and accurate the other party can rely on such assurance. There are two key lines in the judgment: (i) that a franchisor must provide true and comprehensive information on the profitability of a system, and (ii) the franchisee's claim must not be reduced because of contributory negligence when the franchisee (thoughtlessly/frivolously) trusts in the statements of the franchisor without conducting own research.
553 BGH NJW 1981, S. 1673ff; Schulze, in: Schulze/Dörner/Ebert, BGB Kommentar, 5th edition 2007, § 311 Rn. 20 and Flohr, BB 2006, pp. 389, 392. A German municipality issued an invitation to tender for building a gym by a general contractor. The plaintiff, a general contractor, instructed an architect to prepare the tender. After the architect had been finished his work, but before the official opening date of the tender, the municipality (the defendant) withdrew the invitation. The plaintiff claimed for reimbursement of the costs of the architect. The Federal Court of Justice confirmed the judgment of first instance, cancelling the judgment of the court of appeals. Even though the court found that there has been a pre-contractual relationship resulting fiduciary duties of both parties, the court negated that there has been a loss on the plaintiff's side, as he would have incurred costs for the architect even if the invitation to tender had not been cancelled. Even in case the invitation had not been cancelled, the plaintiff would not have been sure that his effort would have resulted in the acceptance of his tender.
Normally the franchisee will argue that it would not have entered into the contract if it had been aware of the full facts. He will ask for his money back and for rescission of the contract.

The duty of pre-contractual disclosure starts at the point where the franchisor and the potential franchisee meet for the first time and the franchisor presents his franchise system in detail\textsuperscript{555}. This can happen, for example, through an advertisement, information material or participation in a fair. It is the franchisor’s responsibility to ensure that the information it presents reflects the truth and that it has released all necessary information\textsuperscript{556}. However, Section 311 (3) of the Civil Code provides that the franchisee’s right to claim for damages is not only against the franchisor, but also against any third parties, who have established a fiduciary relationship with the franchisee, and hence influenced the franchisee’s conduct during the contract negotiations and his/her decision to enter into the contract. In particular, managers of franchise brokers, can be liable personally in damages.

Theoretically the obligation could apply to franchisees but it is the more experienced party (here the franchisor) that is under an obligation to make available information to the less experienced party (usually the franchisee). In case of a violation of the duty to make pre-contractual disclosure, the franchisee can either claim damages or rescind from the contract provided that the franchisee can prove that entering into the agreement lead to a loss. The ordinary limitation period for claim based on \textit{culpa in contrahendo} is 3 years\textsuperscript{557}. This is a distinct right from the right of rescission which arises in the case of a right to rescind from the contract due to fraudulent misrepresentation. If the right to rescind is to be based on fraudulent misrepresentation alone without proof of damages, then this right has to be exercised within one year following the discovery of the fraudulent misrepresentation\textsuperscript{558}.

\textsuperscript{555} Giesler, Franchiseverträge, Rn. 207.
\textsuperscript{556} OLG Muenchen NJW 1994, S. 667ff.
\textsuperscript{557} Sections 195, 199 of the German Civil Code.
\textsuperscript{558} OGH 19.01.1989, WBl 1989, 131; Liebscher/Petsche, \textit{Franchising in Österreich} (2. Auflage 2002), S. 112. Flohr, \textit{Franchise-Vertrag}, S. 10. The defendant claimed, by way of counterclaim, that the plaintiff, although having agreed to non-compete in the area of the Franchise business, has had a third party opening up another franchise in the area. The defendant claimed that, because of that, the revenue that has been expected has never been achieved. However, the non-compete agreement, as well as the extent of the fiduciary duty of the Franchisor, was irrelevant to the decision as the shop of the third party had been in another district of the city, miles away from the defendant's premises and thus neither covered by the non-compete, nor by a (possible) fiduciary duty. This is an Austrian case. The court, although it had been considering the question whether the Franchisor's fiduciary duty would prohibit the Franchisor from allowing for another franchise close the the Franchisee's premise (and showed some sympathy for that position) has eventually not decided upon the question as it was irrelevant for the case at hand. The judgment did not address the fiduciary duty of the Franchisee, but the one of the Franchisor.
Similar duties to make full disclosure are found in other civil law jurisdictions such as Estonia\textsuperscript{559}, Greece\textsuperscript{560}, Hungary\textsuperscript{561}, the Netherlands\textsuperscript{562}, Portugal\textsuperscript{563}, Lithuania\textsuperscript{564}, Slovakia\textsuperscript{565}, Austria\textsuperscript{566} and the Czech Republic\textsuperscript{567}. A slightly lesser duty is found in Estonia\textsuperscript{568}.

\textsuperscript{559} In Estonia general pre-contractual disclosure requirements are found in section 14 of the Law of Obligations Act and they apply to franchise contracts. The main rule of disclosure is enacted in subsection 2 of section 14, which provides that persons who engage in pre-contractual negotiations or other preparations for entering into a contract shall inform the other party of all circumstances which are of essential interest to the other party of the contract, taking into account its purpose. However, there is no obligation to inform the other party of circumstances which it could not reasonably be expected to be informed of.

\textsuperscript{560} There is a strong German influence on Greek law, so unsurprisingly, parties in Greece must act in accordance with the requirements of good faith and business ethics (Article 281 of the Greek Civil Code and Yanos Gramatidis, Chapter on Greece in Mendelsohn, The International Encyclopaedia of Franchising Law, p. 6). During the pre-contractual period, the franchisor is required to provide data on comparable activities in its system and a full set of information on how much the prospective franchisee will have to financially contribute. However, it is up to the franchisee to draw conclusions on the prospects of entering and trading on the market and to evaluate the reputation of the franchisor’s business. If prospective franchisees draw the wrong conclusions based on the correct information, the franchisor will not be liable. However, if the franchisor deliberately makes a misrepresentation, it will be liable (Yanos Gramatidis, Chapter on Greece in Mendelsohn, The International Encyclopaedia of Franchising Law, p. 20). A party which has been misled, threatened or defrauded by the other contractual party may seek the annulment of the contract and/or compensation under the conditions provided (Articles 140, 147 and 150 of the Greek Civil Code). The conclusion of the agreement must not be a result of mistake, threat or fraud (Articles 140, 147 and 150 of the Greek Civil Code).

\textsuperscript{561} Hungarian law also imposes strict control over the pre-contractual relationships in accordance with good faith principles (Section 206 of the Hungarian Civil Code). It requires the parties to act reasonably and imposes a duty of disclosure on both franchisor and franchisee (Section 206(4) of the Hungarian Civil Code). If the franchisor fails to disclose information which is relevant to the agreement, the franchisee who enters into a contract can challenge the disclosure within one year after misdisclosure comes to light in writing. If the challenge is successful the agreement can be treated as null and void “ab initio” and the parties are put back into the position they were in before entering into the contract (Section 210, 235-237 of the Hungarian Civil Code). Alternately, the agreement can be affirmed and damages opted for (Section 339 of the Hungarian Civil Code).

\textsuperscript{562} In Dutch law the pre-contractual relationship is also governed by the principle of good faith, or reasonableness and fairness (Article 6:248 sub 1 of the Dutch Civil Code). A party may annul an agreement if the agreement was concluded on the basis of incorrect understandings (provided that certain conditions are met) (Article 6:228 of the Dutch Civil Code). The parties are obliged to take reasonable steps to ensure that an agreement is not entered into by mistake (Supreme Court of 15 November 1957 (NJ 1958, 67 (Baris/Riezenkamp))). Although the principle of reasonableness and fairness does not mean that the franchisor is always obliged to provide the franchisee with a projection of the franchise’s financial performance, in some circumstances such an obligation may arise (LJN: AD7329, C00/118HR (Paalman/Lampenier)). Parties are entitled to assume that the information which has been provided by the other party is correct and so any forecasts provided by the franchisor should be based on a thorough market- and location research which was carried out with due care (E.g. 18 June 1999, Prg 1999, 5211 (Schouten Fashion B.V./Brown Fashion B.V.) and 14 April 1998, Prg 1998/4976 (Aviti/Kinderparadijs)).

\textsuperscript{563} In Portugal, the parties must act in good faith during their negotiations and have to provide all and any necessary information prior to the execution of a franchise agreement although, there is no law which clearly states what needs to be disclosed (See Article 762 of the Portuguese Civil Code). No false or misleading information about the franchisor’s business or those of its franchisees should be submitted to potential franchisees (Santos Cruz/Krupenski, IBA Legal Practice Division International Franchising Committee Newsletter, May 2007, p. 24). As in Germany, the culpa in contrahendo doctrine means that non-compliance with the general rules on disclosure will lead to liability (“Outline of franchise issues in Portugal”, questionnaire with answers provided by Jose Alves Do Carmo, associate, Barrocas Sarmento Neves).

\textsuperscript{564} The Lithuanian Civil Code imposes a duty to disclose certain information based on the general duty of good faith during contract negotiations (Lithuanian Civil Code Article 6.163(1)). It states in very general terms that all parties to the negotiation must disclose to each other the information they possess, which is essential for the conclusion of the contract (Lithuanian Civil Code Article 6.163(4)).
However, pre-contractual disclosure of material facts is not required in all civil jurisdictions. In the common law jurisdictions of England, Scotland, Ireland and Cyprus there is no duty to make pre-contractual disclosure.

This positive obligation to disclose reduces the risks to which franchisees are exposed. It does not reduce the risks to which franchisors are exposed and imposes a substantial burden upon them. It could support the drivers that attract franchisees to franchising but will not support those that attract franchisors to it.

3.5.2.3 The Third Element - The Right to Withdraw

The application of consumer protection law to franchising means that in some member states franchisees are entitled to a “cooling-off period” after signing a franchise agreement.

Many consumer rights such as product liability, are regulated at EU level, resulting in a harmonised approach throughout the EU member states.

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565 Slovakian law arrives at a similar position via a different route. Section 43 of the Slovakian Civil Code obliges the parties to resolve anything which could possibly result in a dispute at a later stage in advance. The parties therefore need to disclose certain facts before entering into a contract. Misrepresentation, whether intentional or unintentional, means that the innocent party has a right to rescind from the contract if it has relied on the false information while making the decision to enter into the agreement (Section 40a and 49a of the Slovakian Civil Code).

566 Although it is not explicitly provided for under Austrian law (Petsche, A, Riegler, S and Theiss, W, 2004, “Franchising in Austria”, International Journal of Franchising, Volume 2, Issue 3), it is historically accepted that franchisors have a similar duty of disclosure under the doctrine of “culpa in contrahendo” (Ibid Petsche, Riegler and Theiss, p. 3. doctrine derives from §918AGBG). The disclosure duty of the franchisee is limited to properly answering the questions asked by the franchisor. This means that the franchisor is carrying a considerably greater disclosure duty. The franchisor must provide the franchisee with appropriate information in particular regarding market opportunities, sales forecasts and profitability calculations. If the franchisor provides faulty or insufficient information it may be liable under the doctrine of culpa in contrahendo (OGH 19.01.1989 WBl 1989, 131; Petsche, Riegler and Theiss, 2004, p. 10, p. 5). However there are limits to the scope of this duty of pre-contractual information. In one decision the highest Austrian civil court decided that a franchisor does not have to provide a prospective franchisee with a detailed market survey before giving an estimate regarding the turnover (OGH 19.01.1989, WBI 1989, 131). Failure to comply with these disclosure obligations entitles the franchisee to damages caused by the disclosure or the lack of it (This entitlement is based on the concept of culpa in contrahendo which derives from § 918 AGBG).

567 Whilst there are no express good faith pre-contractual duties of disclosure, under Czech law, if a franchisor causes damage to its franchisees by intentionally withholding relevant information, it will be unethical and render it liable for any resulting damages (Section 424 of the Czech Civil Code). This amounts to an indirect positive duty to disclose. Failure to disclose relevant information to potential franchisees may amount to misrepresentation inducing them to enter into the franchise contract (Section 49 (a) of the Czech Civil Code) and so entitling them to challenge the validity of the franchise agreement.

568 In Estonia (Section 94 subsection 3 of the General Part of the Estonian Civil Code Act –June 1994 and Section 14(2) of the Law of Obligation Act), on the other hand, the prohibition on misrepresentation is closely linked to a duty to take reasonable account of the other’s interests and rights. Consequently a franchisor must inform a potential franchisee of all circumstances that are of essential interest to the potential franchisee. Although there is no obligation to inform the other party of any circumstances of which they could not reasonably expect to be informed this is still significantly different to an obligation not to make false representations.

569 For example, “Poland” – “Franchising” - Getting the Deal Through, 2008 ed. Zeidman P.

In some EU jurisdictions, such as Germany, franchising has triggered a debate over exactly what a consumer is, resulting in franchisees enjoying protection that was not originally intended for them.

Germany, treats individual franchisees as consumers if they are entering into substantial financial commitments. Franchisees that start a business for the first time are treated as if they were consumers. Consequently they have, and must be notified of, cooling off rights in accordance with the consumer protection legislation in Germany\textsuperscript{571}.

A consumer may withdraw from a contract within 2 weeks of its execution\textsuperscript{572} if it contains a long-term purchasing commitment. Section 507 of the Civil Code extends the cooling off right to individual franchisees setting up a new business for the first time (but not companies) if they fall below a €50,000 threshold. This means that a start-up franchisee enjoys protection if the value of the long-term purchase commitment does not exceed this amount during the life of the franchise agreement\textsuperscript{573}. If this threshold is exceeded then the franchisee will lose its right of withdrawal.

The franchisee has to be notified in writing by the franchisor of his rights of withdrawal including its commencement date, its 2 week duration, the fact that timely dispatch of the withdrawal notice will suffice to comply with the withdrawal period, the required form and content of the withdrawal notice and the name and address of the recipient of the withdrawal notice. If notification of the franchisee’s withdrawal right is provided after conclusion of the contract, the withdrawal period is extended to one month\textsuperscript{574}. The period does not commence until the day after the franchisee is notified of his/her right of withdrawal. If the instruction is not provided in a clear manner, the withdrawal period is extended to six months. If no notice of the right of withdrawal is given, the right becomes a perpetual one\textsuperscript{575}.

Some German commentators\textsuperscript{576} suggest that the €50,000 threshold is not appropriate in the context of a franchise relationship. It is argued that the a small franchisee whose long-term purchase commitment may very well exceed €50,000 is not any less vulnerable than a franchisee where the value of the purchase commitment does not exceed the threshold figure. The basis for this argument is a decision by the German Supreme Court in connection with

\textsuperscript{571} Until 31.12.2001 cooling off rights were governed by the Consumer Credit Act (VerbrKrG). As of 01.01.2002 the Act has been incorporated in the Civil Code. However, court decisions dealing with the former Consumer Credit Act are still referred to. The Consumer Credit Act was the national implementation of Council Directive 87/102/EEC.
\textsuperscript{572} Section 505 (1), 355 of the Civil Code BGH NJW 2003 S. 1932ff.
\textsuperscript{573} Palandt BGB, § 507 Rn. 7.
\textsuperscript{574} Section 355 (2) of the Civil Code
\textsuperscript{575} Section 355 (3) of the Civil Code Timmerbeil NJW 2003, S.569, 570.
\textsuperscript{576} Section 505, 355 Giesler, Franchiseverträge 2. Auflage 2002, Rn. 131 with further references; Palandt BGB, § 507 Rn. 7; Möller, in: Beck Online Commentary BGB (Bamberger/Roth), § 507 Rn. 8; other opinion Schünnbrand, in: Münchener Kommentar BGB, 5th edition 2007, § 507 Rn. 7.
the former German Consumer Credit Act a franchisee has the right of withdrawal irrespective of the amount of the purchasing agreement.

However, a ruling of the ECJ makes clear that German application of consumer legislation to franchising cannot be imposed on other EU member states. The Italian Consumer Code provides, amongst other things, that a consumer is a “natural person … acting for purposes which are outside his/her trade, business or profession” and a professional is a “natural or legal person … acting for purposes related to its trade, business or profession, …” In the case of Francesco Benincasa v Dentalkit Srl, a German franchisee sought a declaration from a German court against an Italian franchisor that the agreement between them was void, despite the fact that it was subject to the jurisdiction of the Italian courts. The Claimant invoked Article 14 of the Brussels Convention 1968, which states that if a consumer files an action against a contractual counterparty, the court in the Claimant’s domicile has jurisdiction. The franchisee claimed that it was a consumer as it was not carrying on the business when the contract was concluded. The ECJ held that whilst reference must be made to the contractual party’s position and type and aim of the contract, “a plaintiff that concluded a contract with a view to pursuing a trade or profession … in the future, may not be regarded as a consumer”.

The application of consumer protection legislation can substantially reduce the risks that franchisees expose themselves to in entering into a franchise. However, the way in which such legislation is applied to franchising varies from member state to member state, so reducing its impact on cross border franchising, as illustrated by the Francesco Benincasa v Dentalkit Srl case. Not only does it not reduce the risks that franchisors take on when franchising their business, but it increases them in some member states by over protecting franchisees.

However, Germany is not the only member state that applies consumer protection legislation to impose a cooling off period in franchising. In the UK, Franchisors which extend credit and/or hire out goods or equipment to non-corporate franchisees must comply with the

578 Austria follows the German lead in applying Consumer law to individual franchisees (Section 1 subsection 3 of the Austrian Consumer Protection Act, (“Konsumentenschutzgesetz”, in short “KSchG”) ). A Franchisee that is a founder of a new business will enjoy the same protection as a consumer (Liebscher/Petsche, Franchising in Österreich, p. 77), including a right of withdrawal (Austrian Consumer Protection Act S.1 553), however, if an existing business is restructured or enlarged the consumer law will not apply (OGH 21.01.1981 SZ 54/10.)
579 Case C-269/95 Francesco Benincasa v Dentalkit Srl [1997] ECR I-3767
580 Legislative Decree 206/2005.
581 Article 3.
582 Article 3.
583 Ibid.
Consumer Credit Act 2006. This act is complex and wide ranging. It allows the courts a wide discretion to re-write credit agreements that are "unfair" to non-corporate franchisees. Franchisors must be licensed, the franchise and other agreements must comply with the complex set form prescribed by the law and they must be executed in accordance with very specific requirements which include a “cooling-off” period for the franchisee. Franchisors must also send out annual statements to their franchisees for all "fixed sum" credit - this includes hire purchase and conditional sale agreements.

The UK’s Fair Trading Act 1996\(^{584}\) also impacts upon franchising and seeks to prevent consumers joining multi-tier trading schemes and imposes a complex procedure on recruitment. It generally prohibits consumers selling on to other consumers further down the pyramid and making a mark up on the goods. It aims to prevent the lower tiers being stuck with over priced stock that they cannot sell on to end users. Any franchise that has more than two levels in the UK must comply with the Act’s provisions\(^ {585}\) Exemptions are granted\(^ {586}\) for those franchisors (and others) who operate single-tier schemes and for pyramids in which all the parties trading in the UK are registered for VAT\(^ {587}\). Franchisees in non excluded schemes that do not comply with the detailed requirements of the act are free to leave the franchise at will without restriction.

3.5.2.4 The Fourth Element – Confidentiality

A number of EU member states impose a duty of confidentiality on potential franchisees as the “quid pro quo” for the franchisor having to make disclosure to it\(^ {588}\). English law imposes no duty of confidentiality and it is an entirely contractual matter.

Article 18 of German Unfair Competition Act imposes a duty of confidentiality upon potential franchisees and prohibits the use of samples and technical guidelines supplied by the franchisor to compete with it or their disclosure to third parties.

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\(^{585}\) The Trading Schemes (Exclusions) Regulations 1997 SI 1997/31 Regulation 3.

\(^{586}\) The Fair Trading Act 1973 s.188 (6)(b) and the Trading Schemes (Exclusions) Regulations 1997 SI 1997/31 Regulation 3.

\(^{587}\) The aim being to protect small franchisees whose turnover is below the VAT threshold.

\(^{588}\) In Hungary a duty is placed on the franchisee as the quid pro quo for the franchisor’s duty of the disclosure and is regulated by the Civil Code (Section 81 of the Hungarian Civil Code). In the Czech Republic all information disclosed is protected by the Civil Code (S.271 Czech Commercial Code Skrdlík, WiRO 2005, p369). The Polish Code imposes a similar obligation (Polish Civil Code 72\(^ {1}\) § 1 KC) as does the Lithuanian Civil Code (Lithuanian Civil Code Article 6.164(1)), the Slovenian Code (Slovenian Civil Code Article 1040Z), the Slovakian Commercial Code (Slovak Commercial Code, Section 271) and the Estonian Code (Estonian Law of Obligations Act Section 14(4)). In Belgium both parties are placed under a duty of confidentiality as regards information that they obtain “with a view to entering into a [franchise] agreement, and may not use the information, either directly or indirectly, other than for the purposes of the commercial partnership agreement to be entered into” (Article 6 of the Law governing pre-contractual information within the framework of commercial partnership agreements).
This element potentially reduces the risks to which franchisors are exposed by the heterogeneous nature of the approach taken by member states reduces its impact substantially. It does not reduce the risks to which franchisees are exposed. Nor does it support the economic drivers that attract franchisors and franchisees to franchising.

3.5.2.5 The Fifth Element - Obligation to Execute an Agreement

Some jurisdictions penalise the franchisor if, once negotiations with a potential franchisee have developed, the franchisor does not grant it a franchise.

German law has developed rules regarding good faith in negotiations, with the Courts consistently holding that a late withdrawal from negotiations without good cause and frustration of reliance investment will entail liability. It does not reduce the risks to which franchisees are exposed. Nor does it support the economic drivers that attract franchisors and franchisees to franchising.

In France, Courts consider that an agreement has been formed once the parties have reached an agreement on essential points. Based upon the concept of a duty of good faith commentators suggest that French law has used tort law to establish that the parties are subject to a duty to negotiate in good faith but

“once the negotiations have reached a mature stage the parties are subject to a contractual obligation ….to continue to negotiate in good faith. This obligation is sometimes express, but most often implicit in the structure of the preliminary dealings …. the obligation strengthens as negotiations proceed. Its extent grows: it makes one party furnish information to the other, it prevents his putting up unacceptable proposals with the aim of ….causing a break-off of negotiations, or of merely pretending to negotiate seriously, while in fact he has decided to deal with a competitor, it compels him to work towards the reaching of a definite decision within a reasonable period”.

The essential points vary from one contract to another, but in the context of franchising, essential points are generally the provision of the trademark, the transfer of know-how and the financial arrangements. As the franchisor usually provides a potential franchisee with a draft of the franchise agreement as part of its pre-contractual disclosure without an express statement by the franchisor that the information provided is only for discussion purposes and

590 E.g. Cass req., 1 December 1885, Grands arrêts, no. 146.
that an agreement will not be formed until the express acceptance of the franchisor, the franchise agreement could be deemed to be concluded if the franchisee agrees to the proposed terms.

If negotiations are terminated wrongfully, the party terminating the agreement may be held liable\textsuperscript{594}. Generally, the more advanced the negotiations are, the more difficult it will be for franchisors to terminate negotiations without incurring liability as the more the negotiations progress, the more the other party’s confidence that an agreement will be reached, is protected\textsuperscript{595}. The French courts take the view that the damage corresponds to the costs incurred during the negotiations and sometimes even the lost chance of entering into an agreement with another party is taken into consideration. Under recent case law however, a party has been refused a claim of compensation for the loss of the chance to obtain revenue from another agreement that it did not enter into\textsuperscript{596}. Once an agreement is concluded, it is the franchisor’s duty to perform the agreement. If the franchisor fails to do so, the franchisee can claim damages under Article 1142 of the Civil Code, but cannot require specific performance. Both claims for damages are claims in tort and subject to Articles 1382 and 1383 of the Civil Code. Some of the other EU member states take a similar approach\textsuperscript{597}.

3.5.2.6 Sub-Conclusion

Non franchise specific laws impact upon the pre-contractual regulatory environment in the EU in five distinct ways. They impose a duty not to misrepresent facts, an obligation to disclose relevant information to potential franchisees, an extra contractual obligation to disclose relevant information to potential franchisees, an extra contractual obligation of confidentiality, an obligation to enter into the franchise agreement once negotiations have passed a certain point and a right to withdraw from the contract within a limited time period. Each member state takes a different approach to each of these issues resulting in the lack of any homogenous approach. This in turn substantially weakens their impact upon cross border franchising within the EU and creates a technical barrier to franchising between EU member states.

\textsuperscript{595} Cass. Ire civ., 14 June 2000, no. 98-17494.
\textsuperscript{597} In the Netherlands if the franchisor unreasonably breaks off negotiations for a franchise agreement, he can, depending on the phase of the negotiations, be held liable in damages to the other party or even be obliged to enter continue negotiations with the other party (Article 6: 248 Dutch Civil Code (Article 6: 248 Dutch Civil Code). When considering such a case the courts consider: (i) the extent and manner in which the party that broke off negotiations gave rise to such legitimate expectation, (ii) the terminating party’s justified interests; and (iii) any unforeseen circumstances that arose during the course of the negotiations (Supreme Court (Hoge Raad), in its decision of 18 June 1982, NJ 1983/723 (Plas-Valburg)). A similar approach is found in Hungary, where such failure may lead to an award of damages (Section 6 of the Hungarian Civil Code).
3.5.3 The Ongoing Franchisor/Franchisee Relationship

This is critical analysis to the second objective of the thesis and suggests that the regulatory environment in the EU fails to both adequately re-enforce the economic drivers that attract the parties to franchising and to reduce the inherent consequential risk to an appropriate level.

It suggests that the legal environment as it impacts upon the ongoing franchisor/franchisee relationship does not adequately support and re-enforce the economic drivers that attract franchisors to franchising. Nor does it adequately reduce the consequential inherent risks to franchisors. It does reduce the risks to which franchisees are exposed and support some of the economic drivers that attract them to franchising in some member states. However, the lack of an homogeneous approach in all member states substantially reduces its impact on cross border franchising in the EU.

The relevant legal regulatory environment comprises the duty of good faith, anti-trust, unfair competition and consumer law.

Neither the UK, Germany nor France have specific laws that impact upon the franchisor/franchisee relationship. Although franchise laws in non EU jurisdictions, for example Indonesia, Malaysia, Russia, Ukraine, Georgia and Vietnam,

598 In Indonesia, a franchise agreement must contain the following (Regulation of the Minister of trade No 12/M-DAG/PER/3/2006 dated 29 March 2006, which revoked The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter II, Article 7.1): the name, address and domicile of the company of each party; the name and position of each party authorized to sign the agreement; the name and type of right over intellectual property, invention or a unique business characteristic, for example a management system, a selling or display method or a distribution method which constitutes a special characteristic which is the object of a franchise; the rights and obligations of each party and the aid and facility given to a franchisee; the marketing area; the period of the agreement and the method of and the requirements for the extension of the agreement; the method for settling a dispute; mutually agreed basic provisions which may result in the termination or expiration of an agreement; compensation in the event of agreement termination; the procedure for the payment of compensation; the use of domestically produced goods or materials produced and supplied by small scale enterprises; nurturing guidance and training for franchisees.

599 Malaysia simply prohibits discrimination between franchisees in respect of the charges offered or made for franchise fees, royalties, goods, services, equipment, rentals or advertising services if such discrimination will cause competitive harm to a franchisee who competes with a franchisee who receives the benefit of the discrimination, unless it can be objectively justified (the Franchise Act 1998 Part III Section 20.It also requires that termination must be for good cause), be by written notice, and offer an opportunity to remedy a breach (The Franchise Act 1998 Part IV Section 30(1)) cited as cause for termination must be given. A franchisor refusing to renew or extend a franchise at the end of its term must compensate the franchisee if it does not waive the post termination restrictive covenants or give the franchisee six months prior notice of the termination or non-renewal (The Franchise Act 1998 Part IV Section 32).

600 In Russia the law lays down the rights and obligations of both parties to the agreement by merely stating the essential elements of the franchise relationship (Russian Civil Code Part II Chapter 54 Articles 1030 to 1033). Somewhat unusually it does grant a right of renewal to franchisees properly performing their agreements (Russian Civil Code Part II Chapter 54 Article 1035). There is some case law on this point which suggests that the requirement can be circumvented in some circumstances (Decision of the Federal Arbitrazh Court of East-Siberian District (FAS VSO decision) of 16.10.2003, Case No. NA19-3914/03-13-FO2-3459/03-C2). However, it permits termination of a franchise agreement upon six months' notice by
commonly regulate the contents of franchise agreements, only 4 of the EU member states (Italy, Romania, Lithuania and Estonia) have franchise focused laws which do so.

Despite occasional passing suggestions that an EU relationship law for franchising would be appropriate one has never been seriously considered\(^\text{604}\).

The Romanian, Lithuanian, Estonian and Italian\(^\text{605}\) laws all specify core terms that must be in a franchise agreement, all of which are found in all of the sample franchise agreements considered above\(^\text{606}\). Only the Lithuanian Code imposes certain minimum provisions which were not found in any of the sample agreements considered above\(^\text{607}\).

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\(^{601}\) In the Ukraine the law (Civil Code Chapter 76 Articles 1115 to 1129) imposes statutory liability of the franchisor for defective products sold by the franchisee. This is symptomatic of Socialist legal traditions and is also found in (Latvia and Estonian) franchise law.

\(^{602}\) The Georgian Civil Code (Adopted on 26 June 1997, Book Three, Special Part, Title One, Chapter Seven (Articles 607-614)) specifies the obligations of the parties including confidentiality and the liability of the Franchisor.

\(^{603}\) In Vietnam early termination is possible in accordance with the conditions set out in Article 16 of the Decree. Article 16 provides that amongst other things a franchisee has the right to unilaterally terminate the franchise agreement if the franchisor breaches its obligations specified under Article 287 of the Commercial Law.

\(^{604}\) For example, there was a proposal by the Austrian Standards Institute to the European Committee for Standardisation to overcome this inconsistency by drafting a set of European standards for franchising, focusing on terminology and market practices. The European Committee for Standardisation develops voluntary European standards which are national standards in each of its 30 member countries, which comprise all 27 EU member states, Norway, Switzerland and Iceland (www.cen.eu/cenorm/members/national+members/members.asp.). The Austrian Standards Institute suggested that the lack of qualitative guidelines for franchising has led to the failure of numerous franchise systems and claims that the legal framework of franchising in Europe is underdeveloped (Project to Standardise Franchising Terminology and Marketing Practices, Frignani, A and Mendelsohn, M, 2009, “Project to Standardise Franchising Terminology and Marketing Practices”, International Journal of Franchising Law, Volume 7, Issue 2, 200 p. 27). However, it produced no evidence to support these claims and seems to have been ignored by the Committee for Standardisation.

This is probably because European standards are designed for technical processes and products rather than business formats. The wide spectrum of commercial structures that come within the term franchising and the differing sectors in which they are applied all militate against there being any meaningful common standards. This is the problem faced by the national franchise associations.

\(^{605}\) The Italian Franchise law provides that in case of disputes, before filing suit or commencing arbitration, the parties must undertake to seek conciliation in accordance with the rules of the local chamber of commerce (Law of 6 May 2004, No. 129 Article 7). Similar provisions are found in some non EU jurisdictions such as Canada and Korea (In Canada the New Brunswick Franchises Act is the first of the provincial statutes to provide for a comprehensive dispute resolution mechanism (S.8(1) of the New Brunswick Franchises Act 2007 (June 26th)). The Korean franchise law also provides for a dispute resolution mechanism and establishes a Franchise Transaction Dispute Mediation Committee (Korean Act on Fairness in Franchise Transactions Chapter IV).

\(^{606}\) Article 4(1) of the Romanian Ordinance specifies the issues that must be dealt with by the franchise agreement (Articles 4(1), 4(2) and (3) respectively; Herzfeld & Rubin (Romania) S.R.L., Romania’s New Franchising Law in “The Romanian Digest”) and states the general principle that the franchise agreement must define, free of any ambiguity, the obligations and liabilities of each of the parties. It does not impose minimal terms. There is no standard form prescribed for franchise agreements. Article 5 of the Ordinance states that a franchise agreement must be in writing and contain clauses in respect to the object of the contract; the rights and obligations of the parties; the financial conditions; the term of the contract; and the modification, prolongation or termination of the contract. Article 6(1) of the Ordinance provides a list of general principles that a franchise agreement must include concerning term, renewal, termination, transfer
3.5.3.1 The Duty of Good Faith

The duty of good faith has a substantial impact upon the economic drivers and consequential inherent risks in the ongoing franchisor/franchisee relationship. It seeks to deliver a degree of equilibrium to the inherent tension within the franchise relationship between the desire of both parties to obtain the best commercial deal for themselves and a need to have a good ongoing commercial relationship based upon a modicum of mutual trust. It exists in many of EU member states but not all, and even in those jurisdictions that do acknowledge a duty of good faith it is frequently interpreted in different ways.

Good faith

“lacks a fixed meaning, because it is loose and amorphous”608 and some see it as

“an elusive term best left to lawyers and judges to define over a period of time as circumstances require”609.

and the franchisor’s pre-emptive rights on a transfer. The Lithuanian Civil Code also requires certain contractual terms to be detailed in the franchise agreement (Lithuanian Civil Code Articles 6.769, 6.770(1), 6.771), all of which are found in the sample franchise agreements, although some of them, such as the provision of ongoing assistance can be contracted out of (Lithuanian Civil Code Article 6.770(2)). The Estonian law of Obligations (Section 375 Chapter 19) takes a similar approach to the Romanian law and requires franchise agreements to address certain issues, all of which are found in the sample franchise agreements (Section 376-378 of the Law of Obligations Act). It does not impose minimal terms. The Italian law requires that all franchise agreements must specify (Law of 6 May 2004, No. 129 Article 3.3) the exact amount of the franchising fee and of the franchisee’s investment; the method of payment of royalties and the determination of a possible minimum turnover to be guaranteed by the franchisee; an exact identification of the exclusive territory granted to the franchisee, if any; a description of the know-how; a description of the services to be provided by the franchisor, such as technical and commercial assistance, planning and training and; the contractual conditions relevant to the renewal, termination and the transferability of the contract.

607 It grants franchisees an automatic right of renewal if they are not in breach. The only exception is if the franchisor undertakes not to enter into a franchise agreement with another franchisee in the same territory within the next three years (Lithuanian Civil Code Article 6.774(1) and (2)). If the franchisor wishes to enter into an agreement with another franchisee in the same territory before the three year term has passed, the franchisor must either offer the existing franchisee renewal of the contract on equivalent terms, or compensate the existing franchisee for its loss connected to the expiration of the contract (Lithuanian Civil Code Article 6.774(2)). It also provides that in the event of death of either franchisor (unlikely as mostly corporations) or franchisee, its rights and obligations under the franchise agreement will be transferred to its heir, provided that the latter is an entrepreneur and continues to undertake an entrepreneurial activity within six months from the date of inheritance, failing which the agreement will be terminated. Its most noteworthy, and inappropriate, provisions relate to the franchisor’s liability. A franchisor can be held liable for claims against the franchisee with respect to the quality of goods (works, services) sold by the franchisee under the franchise agreement (Lithuanian Civil Code Article 6.773(1)). The franchisor is also jointly and severally liable for any faults in goods manufactured by the franchisee under the franchise agreement (Lithuanian Civil Code Article 6.773(2)). These provisions undermine the fundamental concept of the franchisee’s independence.

There are generally considered to be three main “families” of law in Europe\textsuperscript{610}; German, French and English. Each take a different approach to the concept of good faith\textsuperscript{611}. These each have a different impact upon the economic drivers and consequential risks associated with franchising.

### 3.5.3.1.1 English Law

As Bingham, LJ. commented\textsuperscript{612}

> “in many civil law systems, and perhaps in most legal systems outside of the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognise; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as “playing fair”, “coming clean” or “putting one’s cards face down on the table”. It is in essence a principle of fair and open dealing”.

Although civil law systems all adopt the principle of good faith based upon the Roman concept of “bona fides”\textsuperscript{613}, they interpret it in a variety of ways. Common law theory, takes a far more literal approach to contracts using classical interpretive tools such as “plain meaning”. However although it has

> “little room for a notion as malleable as the implied covenant of good faith”\textsuperscript{614},

common law abhors certain acts such as misrepresentation that amount to breaches of good faith.

In contrast to the civil law jurisdictions in the EU and English law has always been reluctant to adopt an overriding principle of good faith, although there are elements of it to be found in certain aspects of it, such as the concept of equity and the dictates of EU Directives.

There has been much debate whether good faith is the behaviour of one who acts with a

> “pure heart and empty head”\textsuperscript{615}

or merely the

> “prudence and causation of a reasonable man”\textsuperscript{616}.

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\textsuperscript{610} Op cit Whittaker and Zimmermann, p.48  
\textsuperscript{611} Ibid  
\textsuperscript{612} Interfoto Picture Library Ltd v Stilleto Visual Programmes Ltd [1988] 1 All E.R. 384 at 352 (CA).  
\textsuperscript{615} Sir John Lawson  v Weston 170 ER 640 (K.B. 1801) per Lord Kenyon.  
\textsuperscript{616} Gill v Cubitt (1824) 3 B. & C. 466, 107 ER 806.
However, the English courts seem to agree that,

“the concept of a duty to carry on negotiations in good faith is inherently repugnant to
the adversarial position of the parties when involved in negotiations.”617

and that it is

“as unworkable in practice as it is inherently inconsistent with the position of a
negotiating party.”618

Nevertheless, although English law has not committed itself to any such overriding principle619 it has

“developed piecemeal solutions in response to demonstrated problems of
unfairness,”620

which amount to a species of good faith. In other words, the law is suffused with good faith but does not use it as a general legal basis for intervention621.

The common law rules of mistake, misrepresentation and duress all require the fairness and honesty that are indicative of a general duty of good faith. The principles of equity are also similar to the concept of good faith. Their origins lie in the jurisdiction of the Chancellor who would grant remedies to mitigate the harshness and rigidity of the common law.622 The rules of promissory estoppel, specific performance, injunctions, consideration, undue influence and more recently the notion of unconscionable bargains623 all focus on the need for honesty and fairness and so have all led to a whittling away of the common law principles. Therefore, in certain circumstances equity works almost as much as a corrective instrument as the principle of good faith does in civil jurisdictions. It can take a restrictive, adaptive and collateral approach624.

The courts have also seriously interfered with the express terms of contracts as regards exclusion and exemption clauses625, whilst statutes, such as the Partnership Act 1890 and the Unfair Contract Terms Act 1977 also impose good faith principles.

617 LORD ACKNER in Walford v. Miles [1992] 1 All ER 453 at 460.
618 Ibid at 461.
619 The doctrine of “Uberrima Fides” in insurance contracts and the concept of good faith in partnership and agency are notable exceptions.
620 Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd [1988] 2 WLR 615 per Bingham LJ at 621.
621 Op cit Whittaker and Zimmerman
623 Hughes v Metropolitan Ry Co (1877) 2 App Cas 439; Cross v Cross (1983) 4 FLR 235; Stiff v Cassell (1856) 2 Kay & J. 279; Maythorn v Palmer (1864) 11 Jur NS 230; Nocton v Lord Ashburton [1914] AC 932; Credit Lyonnaise Bank Nederland NV v Burch [1997] 1 All ER 144, CA.
624 See section 3.5.3.1.2 below
The case of *Fleet Mobile Tyres Limited v Stone and Another (trading as Tyre 20)*\(^{626}\) shows how in franchise disputes although English law will not imply into a franchise agreement, an obligation on a franchisor to act fairly or reasonably towards their franchisees, the courts can look beyond the strict wording of a franchise agreement and utilise less known legal principles in order to protect what the court considers to be the “innocent” party.


It should perhaps not come as a surprise then that the Law Commission indicated in 1999 that it was considering a commercial code that would force English lawyers and judges to think about general legal principles such as good faith\(^{627}\). Whether such a code ever sees the light of day however, remains to be seen.

As regards franchising, perhaps the biggest difference between the civil concept of good faith and the common law defacto implementation of such a duty is that common law does not relieve franchisees from responsibility for their own actions.

The common law use of good faith does not have a significant impact upon the franchisor/franchisee relationship and does not significantly support the economic drivers that attract franchisors and franchisees to franchising or reduce the consequential risks to which they are exposed.

Over time, legislation has reduced common law’s inherent sympathies towards “laissez-faire” in commerce, to such an extent that one should acknowledge the existence of a loose and implied form of good faith in those EU member states that have a common law system. A good example of the equivalent of a duty of good faith being inferred into a franchise agreement under English law is provided by two cases. In *MGB Printing v Kall Kwik*\(^{628}\) the court implied an obligation on the franchisor to ensure that it provided services to the franchisee using reasonable skill and care on the basis of “business efficacy”. In *Stream*

\(^{626}\) (2006) EWCA Civ 1209 Fleet Mobile Tyres Limited v Stone and Another (trading as Tyre 20)

The House of Lords refused an application by the franchisor, Fleet Mobile Tyres, to appeal against a controversial decision by the Court of Appeal which allowed a franchisee to terminate its franchise agreement following a forced re-branding by the franchisor. Deducting more than the agreed 6% from the franchisee and changing its brand focus were such fundamental breaches in the opinion of the Court of Appeal that they entitled the franchisee to terminate.


\(^{628}\) 2010 EWHC 624 para 43
Healthcare v Pitman\textsuperscript{629} the court ruled that services should be provided to the franchisee by the franchisor when reasonably required or requested.

Section 13 of the UK’s Sales of Goods Act can also be applied to reach a similar result, as it provides that services must be supplied with reasonable care and skill.

3.5.3.1.2 The German Approach to Good Faith

In Germany, the concept of good faith is extremely sophisticated and far reaching. It has “been used as a convenient legislative peg on which to place a whole raft of developments by German courts to deal with perceived problems either technical or social…. It remains a ‘general principle’ of German contract law …. but its effects have been worked out and elaborately classified into particular categories (known as \textit{Fallgruppen})\textsuperscript{630}.

Each category takes a markedly different approach. In order to understand how these various interpretations of the duty of good faith work together one commentator has broken them down into three different approaches\textsuperscript{631}, “collateral”, “restrictive” and “adaptive”. This categorisation is subjective. More often than not a particular provision contains elements of two or three different approaches. A black and white categorisation is usually not possible. Most jurisdictions follow the “restrictive approach” to a certain extent, whereas the “collateral approach” is primarily confined to pre-contractual disclosure and most heavily used in countries which have a long standing tradition of protecting the weaker party. An Adaptive approach is the least common and tends to be used in the circumstances in which the English law concept of “frustration” of contract would be applied. There is an important distinction between “\textit{Treu und Glauben}” (objective good faith) and “\textit{guter Glaube}” (subjective good faith) which has to do with knowledge. \textit{Treu und Glauben} has become an “open” norm and although not a legal rule with specific requirements takes shape in the way it is applied\textsuperscript{632}.

3.5.3.1.2.1 The Collateral Approach to Good Faith under German Law

In Germany, Article 311 BGB takes a “Collateral Approach”. It imposes totally new obligations on the parties to the agreement and in doing so can reduce the risks to which both the franchisor and franchisee is exposed.

In Germany, the franchisor has certain continuing implied obligations\textsuperscript{633} which include advising, instructing and supervising the franchisee. The franchisor also has a fiduciary duty to refrain from interfering in the franchisee’s business, especially if the franchisor is active.

\textsuperscript{629} Ibid, para 55
\textsuperscript{630} Whittaker, The ‘\textit{Draft Common Frame of Reference}’ - An Assessment, Commissioned by Ministry of Justice, Appendix II p. 138.
\textsuperscript{631} Kroppholler, Studienkommentar BGB, 10th edition 2007, § 242 Rn. 1.
\textsuperscript{632} Hesselink (n.35) 289
\textsuperscript{633} See above under 1. Introduction; BAG 30.05.1978, BB 1979, 325.
himself in the same market area. Thus encroachment and the adequacy of support are dealt with.

The Franchisee’s main duty of good faith and fair dealing is to pay the royalty and other fees to the Franchisor. In return he receives access to the Franchisor’s know-how, trademark equipment and so forth. Usually the Franchisee will be obliged to purchase certain kinds of products from the Franchisor. Even without a non-compete clause the business secrets of the Franchisor will be protected by the Franchisee’s fiduciary duties to the Franchisor. Accordingly the risks to which the franchisor is exposed are reduced.

3.5.3.1.2.2 The Restrictive Approach to Good Faith under German Law

The duty of Treu und Glauben takes a “Restrictive Approach” to the concept of good faith. It requires that a franchisor is

“bound to perform its obligations according to the requirements of good faith, ordinary usage being taken into consideration.”

It seeks to restrict the ability of parties to the agreement to exercise their agreed contractual rights in an unreasonable manner.

This means that the franchisor must exercise its discretion reasonably for it to be considered valid by the German Courts. It can be a substantial fetter on the ability of the franchisor to act in the best interests of the franchise network as a whole rather than an individual franchisee. What may seem to be reasonable in the context of a bilateral relationship between the franchisor and a particular franchisee may be totally unreasonable in the context of a multilateral relationship between the franchisor and all of its franchisees.

Article 138 BGB, provides that a legal transaction which offends good morals (“contra bonas mores”) is void. It seeks to adjust the terms agreed by the parties to the agreement to new and unforeseen circumstances that arise so if the franchisor exploits the predicament, inexperience, lack of judgment or considerable (economic) weakness of the franchisee or gains a financial benefit which is clearly disproportionate to its performance the agreement will be void. Agreements which breach the duty of Treu und Glauben in Article 242 of the German Civil Code are therefore void under Article 138. This is clearly far from the English concept of “Caveat Emptor” and the freedom of the parties to negotiate the contractual terms.

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635 BGH, WBI 1989, 131.
636 Article 242 of the German Civil Code (“BGB”).
of their relationship is thus limited\textsuperscript{638}. The German courts have ruled that the following did not comply with the principle of good faith and fair dealing: Lack of consideration\textsuperscript{639}; if the franchisor’s obligations are merely discretionary,\textsuperscript{640} if the franchise system is based on pyramid selling or multilevel marketing systems;\textsuperscript{641} if the franchisee is obliged to buy overpriced goods or and excessive amount of them;\textsuperscript{642} or provisions providing the franchisor’s access to the franchisee’s accounts twice a month (on the basis that this unduly restricts the franchisee’s entrepreneurial freedom)\textsuperscript{643};

3.5.3.2.3 The Adaptive Approach to Good Faith under German Law

The prime example of the “adaptive approach” is Section 313 BGB which stipulates that if circumstances upon which a contract was based change substantially after the conclusion of the contract and if the parties would not have concluded the contract or would have done so on different terms if they had foreseen the change, adaptation of the contract can be claimed if a party cannot reasonably be expected to continue to be bound by the contract in its unaltered form. German courts will only make very limited use of the adaptive powers under this provision in situations in which the English courts might apply the concept of “frustration”. It is used to save a contractual relationship rather than to invoke termination from the beginning. This has the potential to re-enforce the economic drivers that attract both franchisors and franchisees to franchising and reduce the consequential risks.

The German concept of good faith has a substantial impact upon the franchisor/franchisee relationship and, as is evident from the above, reduces the risks to which both franchisor and franchisee are exposed and re-enforce the economic drivers that attract franchisees to franchising.

3.5.3.1.3 The French Approach to Good Faith (“Bonne Foi”)

The restrictive, adaptive and collateral approaches to a duty of good faith can be found in differing combinations and degrees in most of the civil jurisdictions in the EU despite the fact that some of them have a very different historical perspective and approach to the concept of good faith.

\textsuperscript{638} But see the decision in Fleet Mobile Tyres Limited v Stone and Another (Trading as Tyre20) (2006) EWCA Civ 1209 which shows that the English Courts will not always implement the strict letter of a franchise agreement.
\textsuperscript{639} LG Paderborn NJW-RR 1987, S, 672f; LG Karlsruhe NJW-RR 1989, S. 822f.
\textsuperscript{640} BGH NJW-RR 2000, 1159ff.
\textsuperscript{641} OLG Muenchen NJW 1986, S.1880ff.
\textsuperscript{642} Giesler, Franchiseverträge, Rn. 60.
\textsuperscript{643} Giesler, ibid, Rn. 62.
In France, although the general concept of good faith or bonne foi is found in Article 1134 of the French Civil Code, until the last quarter of the twentieth century it was substantially limited by the judicial view that

“If a person says something it is fair”\(^{644}\).

Since the late part of the last century, the doctrine has become controversial amongst French lawyers\(^ {645}\). Increasingly the legal profession seems to be advocating that it should be more interventionist and less “liberal” to ensure more “socially” appropriate outcomes, although some feel that this interferes too much with contractual freedom\(^ {646}\). Other provisions of French law also contain notions of good faith\(^ {647}\). The ascendency of the interventionist school is evidenced by the fact that although the wording of the provision only requires good faith in the performance of the contract\(^ {648}\), French courts have extended this obligation to impose a duty of good faith at the earlier stages of pre-contractual negotiations\(^ {649}\), the formation of the contract\(^ {650}\) and even its termination\(^ {651}\).

The notion of good faith has also been used by the French courts, in “restrictive” and “adaptive” and “Collateral” manners, to import morality and justice into contracts commonly by way of interpretation and implied terms.

Although no judge can award an injured party more than the law allows under the contract, it is possible to prevent a party from exercising the fullest rights which the law would otherwise permit him to do. The French Courts have taken a “restrictive approach” and held that a party who has acted in bad faith cannot require the other party to perform the contract as if nothing had happened or claim damages\(^ {652}\). French courts have the power to terminate the contract when requested by the victim of the unfair behaviour\(^ {653}\). In addition, a French court can

\(^{644}\) (“Qui dit Contractuel dit juste”) Whittaker, The ‘Draft Common Frame of Reference’ - An Assessment, Appendix II p 139.


\(^{647}\) Article 1135 of the Civil Code, Articles 111-1 and 113-3 of the Consumer Code and Article 330 of the Civil Code.

\(^{648}\) See www.legifrance.gouv.fr for a translation by Georges ROUHETTE, Professor of Law, with the assistance of Dr Anne ROUHETTE-BERTON, Assistant Professor of English.


\(^{650}\) Cass. com. 4 February 2004, no. 00-21.319: Juris-Data no. 2004-022354; D.2005, p.151 – In this case the franchisor was held liable for failure to provide pre-contractual information necessary to allow the franchisee to enter into the contract with full knowledge of the facts.

\(^{651}\) Cass. com. 11 July 1978, no. 76-13752; Cass. com, 23 Mai 2000, no. 97-10553 – A franchisor may refuse to renew the franchise agreement, but should not let the franchisee believe that the agreement will be renewed whereby inducing him to make investments in the franchise.

\(^{652}\) Cass 1re ch. civ., 16 February 1999 no 96-21997, Bull. Civ. I no. 52 p.34.

prevent the breaching party from relying on a limitation or exclusion of liability clause when it acts in a deceptive manner. A restrictive approach was taken by the courts when an open price term to be determined by the franchisor was deemed enforceable under French law only so long as it is proportional.

An “adaptive approach” to the concept of good faith comes into play when there is a change in circumstance which prevent a distributor from being competitive. The French duty of good faith requires the supplier in these circumstances to renegotiate the terms of the contract in order to allow it to be competitive. A more recent case raised an important doctrinal debate around a possible duty of “solidarity” between the parties, (suggesting an adaptive approach to good faith) but the French Supreme Court failed to clearly state its position on the question. One party claimed that good faith imposed an obligation to renegotiate, when a change in circumstances significantly altered the initial balance of the contract. The Supreme Court rejected the claim on the basis that the imbalance already existed when the contract was formed, so failing to clarify whether or not the courts have the power to vary the terms of a contract in such circumstances.

There are no cases which suggest that the concept of bonne foi can be applied to prevent encroachment by the franchisor.

The French courts have also considered adopting a collateral approach to the duty of good faith. From the formation of the contract until the end of the contract, a franchisor has the continuing duty to support its franchisees with commercial and technical assistance. A lack of advice and support during the start-up period can lead to the termination of the agreement. The level of support which needs to be provided depends on the needs of each franchisee and therefore needs to be adapted.

The French concept of good faith has a substantial impact upon the franchisor/franchisee relationship and, as is evident from the above, reduces the risks to which both franchisors and franchisee are exposed and re-enforce the economic drivers that attract franchisees to franchising.

### 3.5.3.1.4 Comparison of the Different Concepts of Good Faith

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658 Philippe le Tourneau, les contacts de franchisage, 2e édition, Litec 2007, no. 89.
659 CA. de Reims, 8 November 2000, no. 2000-152146, SARL L’a ge d’or expansion.
The German and French law of good faith supports the economic drivers that encourage franchisees to become involved in franchising and reduce the risks to which both franchisees and franchisors are exposed. However, the lack of a homogeneous approach in other member states greatly reduces the impact on cross border franchising in the EU.

Different jurisdictions have different ideas about what good faith is and the existence of a general doctrine of good faith does not guarantee a particular outcome. The German approach is influential in those jurisdictions in which it has a historical connection such as Greece and Austria and is also gaining influence over certain jurisdictions that were previously more influenced by French law, such as Italy and the Netherlands.

The French Civil Code has historically been the most influential civil code in Europe. Belgium was formerly directly subject to the French Civil Code but, perhaps due to German influence, has relied more on Article 1134 than the French.

The Spanish Civil Code Article 1258 provides that contracts give rise not only to obligations to accomplish what has been expressly agreed but also the results that are in accordance with good faith, custom and the law. Whilst Article 7, inter alia, provides that rights must be exercised in conformity with the requirements of good faith.

Whittaker and Zimmerman observe that the relationship between member state laws are changing. While Italian reports cite French decisions they also show the influence of the

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661 The Greek Civil Code (Article 288) in a verbatim translation of 242 BGB. Also, Article 200 of the Greek Civil Code reflects 157 BGB. The terms of the franchise agreement must not unduly restrict the freedom of the franchisee or allow the franchisor to exploit the need or inexperience of the franchisee to obtain for himself or a third person benefits which are clearly disproportionate to the franchisor’s obligations (Article 179 of the Greek Civil Code). To do so would be contrary to public policy (Articles 174 and 178 of the Greek Civil Code). The parties must also act towards one another with loyalty, fairness and good faith (Article 281 of the Greek Civil Code). The franchisee may not assign its obligations to a third party (Article 715 of the Greek Civil Code) and must provide the franchisor with information about its business (Article 718 of the Greek Civil Code). The franchisor has a general obligation to assist the franchisee in the exercise of its activities and supply him with documents, brochures and other information in order to enable him to promote the franchise system (F.I.C. of Salonica 1671/71, JCL (1972) 52). In return, the franchisee has to pay the fees and royalties agreed and has a duty of confidentiality which continues after the termination of the agreement (Articles 200 and 288 of the Greek Civil Code as well as Law 146/14 on unfair competition). In the absence of a specific provision to the contrary in the franchise agreement, the franchisee is under an obligation not to compete with his franchisor during the duration of the agreement (Article 919 of the Civil Code F.I.C. of Athens 11486/80 JCL (1981) 50, 131).

662 Although the Austrian Civil Code does not refer to “Treu und Glauben” it does refer to honest business usage which is used to determine the circumstances under which a contract has been concluded (ABGB § 863) and how they should be interpreted (ABGB § 914). The Austrian Supreme Court has used these two rules as a route to asserting that “Treu und Glauben” and reliance on honest business usage are ethical principles which are so generally acknowledged that they may be applied without having been included in the Civil Code. There are subtle differences to the BGB 242 (Whittaker. S and Zimmerman. R, 2000, “Good Faith in European Contract Law” CSICL Cambridge University Press pp 51).

663 Ibid p.53

664 The old Dutch Civil Code reflected Article 1134 of the French Civil Code. However, the new Civil Code (Articles 6:248; 6:258 and 6.2) shows more of a German influence and has been described as “the culmination of the statutory career of the concept of good faith”.

German doctrine of good faith. Belgian law often differs from French law despite its common historical roots. Dutch law has abandoned French law for German influences and Austrian law, whilst mostly following German law nevertheless differs from it in some aspects of good faith.

Although some jurisdictions, such as Poland\textsuperscript{667}, the Czech Republic\textsuperscript{668}, Finland\textsuperscript{669}, Malta\textsuperscript{670}, Bulgaria\textsuperscript{671} and Portugal\textsuperscript{672} follow the German lead as regards good faith, others, such as

\textsuperscript{666} In the Netherlands, all contracts must be construed and performed in good faith (Article 6: 248 Dutch Civil Code (the rules of reasonableness and fairness \textit{(redelijkheid en billijkheid)}). However, a contractual provision of a franchise contract will only be set aside on the basis of ‘good faith’ in limited situations. For example, if the provision concerned is manifestly not in accordance with the character of the franchise contract, or if the franchisee could not be aware of the breadth of the provision concerned. It has been established by case law that in certain circumstances it may be contrary to good faith to invoke an exclusion of liability clause (Judgment of May 19, 1967, (Supreme Court) ‘Hoge Raad’ (HR), 1967 (Dutch Court Reporter) ‘Nederlandse Jurisprudentie’ (NJ) No. 261; Judgment of Feb. 20, 1976, HR, 1976 NJ No. 261; Judgment of Dec. 18, 1981, HR, 1982 NJ No. 71; Judgment of May 7, 1982, HR, 1983 NJ No. 509).

\textsuperscript{667} Polish Civil Code Art 56. Under Polish law, Art. 56 KC imposes a duty of good faith and provides that; “an action produces not only those effects expressly intended by it, but also those arising from law, principles of community life and accepted customs”. Thus the parties to the franchise agreement are bound by not only the express contractual terms but also those implied by law. These obligations can be collateral, adaptive or restrictive. An example of the franchisor’s collateral obligations is the requirement to provide advice and guidance the franchisee would not be able to put the contractual provisions into effect (Bagan-Kurluta, Umowa franchisingu Monografie prawnicze, p. 77, 79).

Revealing or taking advantage of the Franchisor’s trade secrets or obtaining them from an unauthorised person, if it may harm or endanger the entrepreneur’s interest, is deemed to be an act of unfair competition (Art 11 § 1 ZNKU). Breach of this duty of confidentiality entitles the franchisor (Art. 18 ZNKU) “to end the infringement and to prohibit further violation; to eliminate the consequences of the infringement by requiring the infringer to make an appropriate public declaration or declarations; pay damages according to general compensation rules and account for any profits made according to general unjustified enrichment rules.” Breach can lead to imposition of a fine or a custodial sentence of up to two years imprisonment (Art. 23 ZNKU). Damages are limited to the actual loss directly resulting from the unsuccessful continued negotiations (Article 72\textsuperscript{1} § 1 KC). The Polish Act Against Unfair Competition (ZNKU (\textit{Ustawa o zwalczaniu nieuczciwej knokurencji}) may also apply.

\textsuperscript{668} Czech Civil Code Art 6-228(1). In the Czech Republic the doctrine of good faith means that a contractual obligation is enforceable only to the extent that it does not conflict with “principles of fair dealing”. Given the lack of precedence in franchise matters, judges have wide discretion in defining whether or not a term is fair (Marc. P and Theiss. W, 2004, “Franchising in the Czech Republic”, International Journal of Franchising Law, Volume 2, Issue 6 , p.25-34, 27).

\textsuperscript{669} Section 1 the Finnish Unfair Business Practices Act (1978). In Finland, the duty of good faith is well protected. Section 36 of the Contracts Act (228/1929) imposes a duty of good faith and states that unfair contract terms may be adjusted or set aside if their application lead to an unfair result. The rest of the contract may also be adjusted or declared terminated under this provision, if it is unfair to enforce the rest of the contract after the adjustment of a contract term (Section 36 of the Contracts Act (228/1929). The Act on Regulating the Contract Terms between Entrepreneurs (Section 38 of the Act on Regulating Contract Terms between Entrepreneurs (1062/1993)) provides that the use of an unfair contract term in contracts between business parties is prohibited, if one of the parties is in a weaker bargaining position and therefore needs protection (Hanna-Maija Elo, ‘Finland’ in: Getting the deal through – Franchise 2008, p. 37 para. 22). It is difficult to predict the way in which the courts will amend a contractual term to make it more reasonable (Petri Rinkinen, Franchising Legislation in Finland, www.franchising.fi/ukindex). In one case the courts declared it possible for a franchisee to terminate the franchise agreement on the grounds that the franchise business was no longer profitable, even though this was not a contractual ground for termination. It was also held to be unreasonable to charge franchising fees for a period once a franchisee had already ceased trading (Vaasa District Court judgment, dated 20.11.2003 in the case of Kotipizza Oy v. Ekosmart Ky). The Act on Regulating the Contract Terms between Entrepreneurs also prohibits unfair contract terms if one of
Danish, Latvia and Slovenia make far less use of the doctrine. Only Romania has a franchise specific duty of good faith. No other EU member state franchise law contains such a provision.

the parties is in a weaker bargaining position (Hanna-Maija Elo, ‘Finland’ in: Getting the deal through – Franchise 2008, p. 37 para. 22). Unfair terms will be adjusted in accordance with the general rules of adjustment under the Contracts Act (Riitta Ahonen “Unconscionability and adjustment of unfair contract terms”, (Master’s thesis, University of Joensuu 2004) p.9) by the Market Court (Section 1(1.3) of the Market Court Act and Section 2(3) of the Act on Certain Proceedings before the Market Court) by way of an injunction and a conditional fine (Hanna-Maija Elo, ‘Finland’ in: Getting the deal through – Franchise 2008, p. 37 para. 22).

670 Maltese Civil Code Article 993. See Chapter 8 p. 151.

671 Bulgarian law recognises a duty of good faith, which only has an impact on the ongoing franchise relationship. The parties to a franchise agreement or any other commercial agreement for that matter owe each other a duty of good faith when exercising their rights under the agreement. In addition, although the parties may freely determine the content of the franchise agreement and the parties’ obligations, a contract may not contravene the mandatory provisions of law and the duty of good faith. Article 26 (1) of the Bulgarian Obligations and Contracts Act stipulates that a contract which contravene or circumvent the law as well as a contract which infringes the duty of good faith shall be null and void. This means that Bulgarian law recognises a restrictive approach to good faith as well as possibly an adaptive approach.

672 In Portugal, the ongoing relationship between franchisor and franchisee is governed by general contract law particularly the principal of good faith (Article 762 of the Portuguese Civil Code). This requires honesty of intention, the absence of malice, the absence of a desire to defraud or to seek an unconscionable advantage and a duty to supply to the franchisee all the information and cooperation which is needed for the performance of the agreement and discharge of the obligations by and of the other parties (“Outline of franchise issues in Portugal”, questionnaire with answers provided by Jose Alves Do Carmo, associate, Barrocas Sarmento Neves).

673 The general starting point in Danish law is the principle of freedom of contract, but this general rule has been restricted over time, notably by the Danish Contracts Act (Law no 781 of 26.08.1996). The most important provision in relation to franchise agreements is Section 36, which provides that a contract may be found entirely or partly void if it, or specific clauses in it, are found to be “unfair” to one of the parties. Although this duty of good faith is very rarely applied by the courts to contracts between business partners. It is an assessment based on the facts in each individual case. It may therefore be applied to modify the franchise agreement (Christensen. L. A, 2008, Franchising in Denmark, International Franchising, Kluwer.

674 Latvian Civil Code Art. 14. Section 14 of the Latvian Civil law regulating leases is not restricted to real estate but also applies to franchise agreements (Article 2113 of the Latvian Civil Law). The franchisor is responsible for the quality of the rights granted to the franchisee (Article 2135 of the Latvian Civil Law). The franchisee is required to use the rights of the lease “wisely and with care” (Article 2150 of the Latvian Civil Law) and has to exercise them according to the purpose of the intended agreement (Article 2151 of the Latvian Civil Law). This is interpreted widely, and includes preserving the franchisee’s distinct image. It means that the franchisor has the right to ensure that the franchisee complies with the franchisor’s business and marketing concept (“Legal framework of franchising development in Latvia” on the website www.franchising%20.lv/new_site/it/legislation-latvia.html.) There is a general duty to fulfil all responsibilities and rights in good faith (Article 1 of the Latvian Civil Law).

675 Article 5 of the Slovenian Civil Code. See Chapter 8 p.154

676 Article 3 of the Romanian Ordinance provides that a franchise agreement must include the principle of fairness, stating that it must reflect the interests of the members of the franchise network, as well as protect the franchisor’s interests. This idea of fairness is further reflected in Article 7 of the Ordinance, under which the franchisor, in case of breach, has to notify the franchisee in writing of the breach and grant him a reasonable time to remedy the contravention of the franchise agreement (The Canadian Provinces, China, Korea and Malaysia impose a duty of good faith on both the franchisor and the franchisee which impacts upon what the franchisor is permitted to do during the relationship. In Canada all franchise agreements impose upon the parties a duty of fair dealing in its performance and enforcement (Alberta Franchise Act Section 7, The Arthur Wishart Act ( Franchise Disclosure) 3(1); The Prince Edward Island Franchises Act Chapter 36 Bill 43 s.3; The New Brunswick Franchises Act s 3). In Korea, both parties to a franchise
Given the quasi-fiduciary and long term nature of the relationship between a franchisor and its franchisee, the flexibility of some form of duty of good faith may be appropriate. However, this needs to be tempered by a degree of commercially appropriate certainty. The wide range of ways in which the doctrine currently manifests itself in the EU and the resulting lack of certainty means that it can have a negative impact on franchising between member states.

3.5.3.2 The Regulation of Vertical Restraints

It is submitted that EU law’s focus on the public interest when regulating the vertical restraints found in the franchisor/franchisee relationship means that it undermines the economic drivers that attract franchisors to franchising but it does potentially support some of the economic drivers that attract franchisees to franchising. It does nothing to reduce the consequential inherent risks to franchisors or franchisees.

All relevant EU member state anti-trust law is based on the concepts contained in Article 101 of the Treaty on the Functioning of the European Union (TFEU) (formerly Article 81 of the Treaty of Rome). Like all competition law it seeks inter alia to regulate vertical relationships to ensure that they do not contain terms which are against the public interest.

Article 101(1) of the TFEU prohibits:

‘…. all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market …’

These include attempts to directly or indirectly fix purchase or selling prices, sharing markets or sources of supply and applying dissimilar conditions to equivalent transactions with other trading parties, thus placing them at a competitive disadvantage.

A franchise agreement incorporating measures restricting the ability of franchisees to trade freely potentially falls foul of Article 101(1). If an agreement falls foul of Article 101(1), Article 101(2) provides that the agreement will be void and that the parties may be subject to a substantial fine. The English decision in the Crehan case makes it clear that if a franchisee suffers loss as a result of his franchise agreement breaching Article 101(1) of the transaction must exercise good faith in the performance of their duties and enumerates several specific franchisor and franchisee duties (Fair Franchise Transactions Act, Chapter II Article 4). In Malaysia both the franchisor and the franchisee are under a duty of good faith to each other and must “act in an honest and lawful manner” and “endeavour to pursue the best franchise business practice of the time and place” (The Franchise Act 1998 Part IV Section 29 (1)).

See the EC Treaty Article 81(1).

Treaty of Rome, the franchisor may, as well as being liable for a fine, also be liable in damages to the franchisee.

The ECJ in *Pronuptia de Paris GmbH v Pronuptia De Paris Irmgard Schillgallis* undertook the first detailed analysis of the application of Article 101 to franchise agreements. It found that restrictions intended to protect the franchisor's know-how and to maintain the identity and reputation of the franchise network are not incompatible with Article 101(1), in so far as they are 'indispensable' to achieving such protection. However, restrictions causing the division of markets between the franchisor and franchisee or between franchisees constitute an infringement of Article 101(1) as could attempts at price-fixing. Essentially the court's decision in Pronuptia drew a line between those clauses which it deemed to be necessary for the maintenance of the identity and reputation of the franchise network and for the protection of IP rights and know-how, and those clauses which it deemed to be prima facie anti-competitive such as those aimed at retail price maintenance. The court required Pronuptia to remove a clause requiring the franchisee not to harm the brand image of the franchisor by its pricing level.

There are five decisions which have been instrumental in developing the attitude of both the ECJ and the Commission to certain provisions common to franchise agreements. These are the *Pronuptia* case discussed above, *Yves Rocher*, *Computerland*, *Servicemaster* and *Charles Jourdan*. Each involved a franchise agreement notified to the Commission under Article 101(3). The Commission took positive views of exclusivity, some forms of territorial restraints and post term restrictions.

However, retail price maintenance was not viewed favourably. In both *Pronuptia* and *Yves Rocher* there were clauses inserted into the agreement, at the Commission's request, allowing the franchisees to set their own retail prices. This is consistent with the ECJ's and Commission's general attitude to price-fixing, which will normally lose an agreement the benefit of the exemption under Article 101(3) from the prohibition in Article 101(1). In *Pronuptia* itself, the ECJ held that the fact that the franchisor had suggested prices to the franchisee would not in itself constitute a restriction upon competition, subject to the proviso

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681 ibid, para. 12(c).
that there had not been a concerted practice between franchisor and franchisee, or between the franchisees themselves as to the imposition of such prices.

If a franchise agreement prima facie contravenes Article 101(1), it may be able to take advantage of three exemptions. Firstly, Article 101(3) provides that the prohibition contained in Article 101(1) does not apply to agreements, decisions or concerted practices which contribute to improving production or distribution of goods, or promoting technical or economic progress whilst allowing consumers a fair share of the resulting benefit and not imposing unnecessary restrictions (i.e. restrictions unnecessary to the attainment of the above objectives) or otherwise enabling the parties to eliminate their competition to a substantial degree.

Secondly, under the ‘de minimis’ principle an agreement will only infringe Article 101(1) if it has an ‘appreciable’ effect on trade. The 1997 Notice on Agreements of Minor Importance (the “Notice”) provides guidance on how parties are to evaluate whether their activities are having an appreciable effect on trade. Paragraph 9 sets out qualitative thresholds in relation to the aggregate market share of those involved. Article 101(1) will not apply to vertical agreements where the aggregate market share of participating undertakings is less than 15% of the relevant market.

Even if an agreement contains price fixing or territorial restrictions it will not necessarily lose the benefit of the exemption if the parties’ aggregate market share does not exceed the relevant threshold. The Commission will not take action in these instances unless national authorities urge it to do so.

Thirdly, there is the Vertical Restraints Block Exemption. Article 2 provides that Article 101(1) does not apply to “agreements or concerted practices” entered into by undertakings operating at different levels of the production or distribution chain. Key points to note about the application of the Regulation are the exemption is only available to suppliers with a market share of less than 30%; it applies to both exclusive and non-exclusive arrangements; services and goods are included; multi-party agreements are covered; some vertical

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686 The ‘de minimus’ principle was first introduced by the ECJ in the case of Völk v Établissements Vervaecke Sprl, case 5/69 [1969] ECR 295.
687 Notice on agreements of minor importance which do not fall within the meaning of Article 85 (1) of the Treaty establishing the European Community OJ [1997] C 372/13.
689 Notice on agreements of minor importance which do not fall within the meaning of Article 85 (1) of the Treaty establishing the European Community OJ [1997] C 372/13.
agreements between competitors at the same level will be exempt and suppliers may impose maximum price restrictions on buyers (but not minimum price restrictions).

Franchising itself is not expressly mentioned in the Regulation, but franchise agreements are covered by the Regulation as they are vertical agreements. However, franchise and other vertical agreements cannot benefit from the exemption if they contain so-called ‘hard-core’ restrictions, as set out in Article 4 of the Regulation. These include inter alia certain territorial restrictions, price-fixing and restrictions on cross supply.

Article 5 of the Regulation sets out ‘black-listed’ restrictions such as non-compete clauses. However the inclusion of such clauses will not lose an agreement the protection of the block exemption altogether; as long as the offending term is deleted or modified the exemption will still be applicable to the remainder of the agreement. Exclusive territories are not permitted, although a location clause is allowed. Franchisees must be free to actively promote their sales to end users wherever they are located. According to the Commission’s current guidelines on the application of the block exemption, the area outside which mobile outlets may operate can also be restricted. During the term, non-compete clauses of more than five years are not permitted unless the franchisor is the landlord of the franchisee. This will often not be the case. At the same time the Guidelines on the block exemption provide that a non-compete clause relating to the goods or services supplied under the franchise agreements, whilst not exempted under the block exemption will not be caught by Article 101(1) as long as the franchisor is not dominant in the market and the restraint is necessary to maintain the common identity and reputation of the franchised network.

A post-term non-compete clause may be imposed if it relates to goods or services which compete with the goods or services dealt with by the franchisee under the terminated agreement; is limited to the premises from which the franchisee operated during the contract period; is indispensable to protect the franchisor's know-how; and is for a period of one year after termination.

This may present a problem for some franchise agreements with terms that have post-termination provisions that relate to a ‘territory’. If the franchisor cannot rely on the de minimis or small and medium-sized undertakings exemption then the post-restriction will be unenforceable. The franchisor will need to amend the agreement.

693 Commission Regulation (EC) No. 330/2010
694 Ibid, para 200(2).
Franchisees may not be restricted from selling the brands of particular competing suppliers. Quality specifications may, however, be laid down.

The 30% market share test applies to the franchisor's market share. The franchisor's market share includes connected undertakings and relates to the sales value of the contract goods or services, together with competing goods or services. The benefit of the exemption will not be lost if the 30% share rises to 35%. If the market share rises above 35% however the exemption will only continue to apply for one further year. These two dispensations cannot be combined.

Article 7 of the Regulation enables national authorities to withdraw the benefit of the block exemption where the effects of the agreements are felt in particular in that Member State and it constitutes a discreet geographic market. Where the geographic market is wider than a single Member State the Commission reserves the exclusive right to withdraw the benefit of the exemption695.

Antitrust laws properly regulate potentially anti-competitive aspects of franchising, although they can at times be over restrictive and overlook some of the pro competitive aspects of franchising. EU antitrust law erodes the economic drivers that attract franchisors to franchising as it places franchise chains at a disadvantage compared to corporate chains.

Resale Price Maintenance is a hardcore restriction under the Vertical Restraint Block Exemption696 and was ruled against in both the Pronuptia and Yves Rocher cases697. Concerted practices having as their direct or indirect object the establishment of a fixed or minimum resale price or a fixed or minimum price level to be observed by the franchisee are not permitted. They are considered to be “per se” anti-competitive. Contractual provisions or concerted practices that enable the franchisor to directly establish the franchisee’s resale price are also forbidden. Likewise other commercial practices that may have the same effect are prohibited. Examples include the franchisor fixing the franchisee’s margin, fixing the maximum level of discount the franchisee can grant from a prescribed level, making the grant of rebates or reimbursement of promotional costs by the franchisor subject to the observance of a given price level, linking the prescribed resale price to the resale prices of competitors, threats, intimidation, warnings, penalties, delay or suspension of deliveries or contract terminations in relation to observance of a given price level. Measures to identify price-cutting franchisees, such as the implementation of a price monitoring system,

696 Commission Regulation (EC) 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, Article 4(a).
698 Technically, it is possible to justify the retail price maintenance on the grounds of efficiency under Article 81.3, but this has proved to be theoretical rather than practical.
or the obligation on retailers to report other members of the franchise network who deviate from the standard price level are also prohibited as are measures which may reduce the franchisee’s incentive to lower the resale price, such as the supplier printing a recommended resale price on the product or the franchisor obliging the franchisee to apply a most-favoured-customer clause. Thus only the provision of a list of recommended prices or maximum prices by the franchisor to the franchisee is permitted. In contrast to this, those businesses which have sufficient financial and management resources to expand their network on a corporate, rather than franchised basis are free of all these restrictions.

EU Competition law gives vertically-integrated corporate chains a monopoly of the ability to deliver a price promise that potentially leads to them being seen as a more consistent and reliable supplier and hence stronger brand than franchised brands that cannot deliver the same price consistency. This in turn disadvantages not only the franchisor but also their franchisees and ultimately consumers. This view is supported by the Chicago School of antitrust’s analysis, which acknowledges that retail price maintenance has positive, consumer-welfare enhancing aspects. In contrast to the EU’s “per se” approach, the Chicago School advocates an analysis of each individual retail price maintenance provision on its merits, under a “rule of reason” approach which assumes the practice to be permitted until proven otherwise.

The OECD has also recognised that, in the specific context of franchise agreements, retail price maintenance can have desirable effects. In its report on “Competition Policy and Vertical Restraints: Franchising Agreements” the OECD acknowledged that although

“vertical price restrictions are often suspected of being anticompetitive as well as undesirable for limiting the freedom of franchisees to set prices..., such price restrictions may generate the same benefits as territorial restraints which it deems to be

“reducing intra-brand competition and giving franchisees more adequate incentives to provide desired levels of service, at least from a profit-maximising point of view”.

It considers that if

“there is enough competition from other brands and retailers, either from competing franchises or from non-franchised rivals, franchisees will have incentives to provide the best possible bundle of prices and services…”

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699 OECD, Competition Policy and Vertical Restraints: Franchising Agreement.
700 Ibid, p. 196.
It suggests that

“by limiting intra-brand competition, and, accordingly, by increasing franchisees’ expected profits, territorial restrictions (and vertical price restrictions) can give would-be franchisees greater incentives to invest in specific skills and effectively enter a market… if they reduce intra-brand competition sufficiently”.

It concludes that

“the stricter the restriction, the more intra-brand competition is reduced, increasing both the incentives to exert effort and the efficiency gains obtained.” 701

It then continues by dismissing the concern that vertical price restraints may be used by cartels to sustain collusion, explaining that such action is less of a risk in the context of franchising than with more loosely organised distribution arrangements. It states

“In the case of franchisees, price restrictions applied only to franchisees following relatively uniform methods of retailing are unlikely to block the development of new retailing methods and most likely will reduce intra-brand rather than inter-brand competition.” 702

It considers that

“price restrictions may promote efficiency by improving vertical co-ordination between franchisor and franchisees”,

and

“can be an alternative to territorial restrictions for encouraging franchisees to provide adequate efforts and services – an alternative that does not generate double mark-up problems. In any case, the better the alternatives available to consumers from other brands and retailers, the less likely that franchise control over services will increase profits but reduce consumer surplus.” 703

It concludes that

“As with territorial restrictions, price restraints can serve desirable functions most effectively when prices are well controlled. This supports sometimes not only “suggested” or “recommended” prices, accepted by some competition authorities for their usefulness in communicating information to consumers and franchisees, but also true price restrictions. Also, it should be noted that one possible anticompetitive use

701 Ibid.

702 Ibid.

703 OECD, ibid, p. 197.
of price control often cited – sustaining a dealer cartel – is in fact a type of horizontal agreement and in principle could still be controlled as such even if the “per se” ban on vertical price restrictions were lifted.”

Price (and non-price) vertical restraints are unlikely to be anti-competitive or reduce economic efficiency when the franchise system faces substantial upstream and downstream competition. Where there is sufficient inter-brand competition, vertical price restraints within franchise networks should not generally raise competition concerns. Such an approach could be implemented without creating uncertainty or resulting in high costs of analysis or litigation. The instances in which franchises face strong inter-brand competition are identifiable by clear criteria for example market shares of the franchise in the upstream and downstream markets, the concentration of players in these markets, and evidence of dynamic market competition such as recent entry of the franchise in question, recent entry and growth of other upstream suppliers, retailers or franchisors providing substitutable products, and substantial fluctuations in market shares.

The rule of reason approach to price restrictions in franchising has now been embraced by the US courts, which for the previous 100 years held such restrictions to be “per se” illegal. In December 2006, the US Supreme Court granted review in the case of Leegin Creative Leather Products, Inc v. PSKS, Inc. In this case a small manufacturer of ladies accessories such as handbags and shoes required that all its retailers “pledge” that they would comply with the pricing policy. One of the retailers acceded to the pledge, but then discounted the product line and was subsequently suspended as a Leegin distributor. The brief filed by the FTC and the Department of Justice at the Supreme Court argued that

“because the effects of retail price maintenance can be either anti-competitive or pro-competitive depending on the facts in the given case, a per se rule is clearly inappropriate.”

The Supreme Court held that the manufacturers decision to agree with its retailer on the resale price of its products was no longer “per se” unlawful, and was instead subject to the rule of reason.

It is interesting for present purposes to consider the arguments advanced by Leegin. In support of its argument it suggested that minimum resale pricing can result in pro-competitive

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704 Ibid.
705 OECD, ibid, p. 186.
706 Since the 1911 US Supreme Decision in Dr. Miles Medical Co v. John D. Park & Sons Co, 220 U.S. 373 (1911).
708 Brief of the United States as Amicus Curiae supporting petitioner, para. 3-4.
709 (No. 06-480) 171 Fed. Appx. 464.
effects, such as: in giving retailers the incentives to provide necessary service levels; promoting product sales; eliminating free riding by rival retailers; and inducing capital and employment investments which are needed for innovation in the development of new products. Leegin argued that because these effects promote inter-brand competition, maintenance of the per se rule is inappropriate.

Whilst it may be the case that the US legal environment is not directly analogous to that pertaining in the EU, the OECD and most economists and scholars recognise that retail price maintenance may enhance distribution efficiencies and increase competition. It is therefore reasonable to suggest that, in order to improve the regulation of franchising in the EU, the Commission should change its absolutist rule on retail price maintenance and carefully consider the important role which a uniform pricing policy plays in assisting franchisors (which as stated above, tend to be small or medium sized companies) to compete effectively with large integrated companies. To this end the Commission should follow the OECD’s suggestion for a “simple rule”, such as the block exemption, which allows franchisors to use retail price maintenance in certain circumstances.

Happily the guidance notes to the latest draft of the proposed new vertical restraints block exemption\(^\text{710}\) suggests that the Commission may have been influenced by the OECD’s suggestion.

This makes it more likely that efficiency arguments may be run with more success in whatever forum they are being pursued, be it the Commission, national competition authorities, EC or national courts, all of which have the ability to apply Article 81.3 directly. Indeed there have been other signs of a greater willingness on the part of the Commission and EC courts to look at the economic realities of retail price maintenance in a more favourable light. In the Court of First Instance’s judgment in the GSK Spain case\(^\text{711}\) on the issue of restrictions designed to limit parallel trade in the pharmaceutical area. The CFI annulled the Commission’s decision fining GSK on the grounds that the Commission had failed adequately to consider the specific legal and economic context of the distribution of the pharmaceuticals.

Nevertheless, whatever the Commission’s view of retail price maintenance in the draft guidelines as expressed in the draft Vertical Restraint Block Exemption Guidelines, it remains an object-type restriction and therefore hard to justify.


\(^{711}\) Cast T – 168/1 GlaxoSmithKline v Commission, judgment 26 September 2006.
3.5.3.3 The Impact of Unfair Competition and Confidentiality law

It is suggested that Unfair Competition and Confidentiality laws impact upon the economic drivers and consequential inherent risks in some jurisdictions but there is a lack of homogeneity which dilutes this impact on cross border franchising in the EU.

In addition to a franchisee’s good faith duty not to compete with its franchisors, all jurisdictions recognise that as a fundamental part of the bargain between a franchisor and its franchisees the franchisor can, during the term of the relationship and for a period after its termination, require that a franchisee should refrain from competing with the franchisor or misusing the franchisor’s confidential information. In some jurisdictions such as England, it is a purely contractual term which can be absolute during the term of the agreement but must be reasonable in terms of time and scope after termination. In others such as Germany\textsuperscript{712}, the non-compete and confidentiality obligations during the term is imposed by law as is the post term right to use confidential information.

An obligation of confidentiality is imposed upon the franchisee during the term under Article 18 of the German Unfair Competition Act. This stipulates that the use of samples, technical guidelines (drawings, models and templates) for the purpose of competing with the disclosing party is prohibited. It is also prohibited to disclose such material to third parties without authorisation. In case of violation, the Courts can impose a fine or give the violator a prison sentence of up to two years. All other confidential information is protected by the implied duty to protect the franchisor’s interest\textsuperscript{713} which is yet another example of the collateral approach to good faith.

A number of other member states take a similar approach\textsuperscript{714}.

3.5.3.4 The Impact of Prohibited Terms

It is suggested that the prohibition of terms by unfair contract terms provisions do tend to support the financial drivers that encourage franchisees to become involved in franchising and reduce some of the inherent consequential risks they expose themselves to.

Although the duty of good faith has the greatest impact upon the fairness of contractual terms in franchise agreements, some consumer laws have a similar impact. The Unfair Contract Terms Directive (1993/13/EEC) means that there is a generally common approach to unfair contract terms in the EU. These provisions can apply to franchise agreements.

\textsuperscript{712} Article 18 of the German Unfair Competition Act
\textsuperscript{713} Sections 675 (1), 611, 241 (2) BGB.
\textsuperscript{714} For example Italy: Under the Italian Franchise Law franchisees and their employees are subject to a duty of strict confidentiality about the franchising business, during and after the term of the agreement (Law of 6 May 2004, No. 129 Article 5.2).
Although there is no general legal requirement in the UK for a franchise agreement to be either fair or reasonable, the Unfair Contract Terms Act 1977 (“UCTA”) provides that a franchisee who has signed a standard form franchise agreement can challenge a term that excludes or limits liability for breach of contract and the clause will only be enforceable if it is fair and reasonable. This will change if the Unfair Contract Terms Bill (“UCTB”) becomes law in the UK. It will allow individuals and micro-businesses (businesses employing 9 or fewer staff) to challenge any standard term of franchise agreements if the clause in question has not been negotiated between the parties and is not the main subject matter of the contract or the price.\(^{715}\)

In the UK franchisees also enjoy an implied term that any goods purchased from the franchisor are of satisfactory quality.\(^{716}\) This implied term can be excluded by contractual terms provided that such exclusions are reasonable.\(^{717}\) However, the Unfair Contract Terms Act 1977 provides that a franchisee who signs a standard form contract can challenge an unreasonable exclusion or limitation of its rights.

Likewise, in Ireland, when a franchisee purchases goods from its franchisor there will be an implied term that they will be of satisfactory quality and fit for normal use.\(^{718}\)

Articles 305 – 310 of the German BGB which deal with unfair contract terms are at least partially applicable in a business to business relationship such as a franchise agreement. Very often the franchisee is considered to be the “weaker party” and is protected by the unfair contract terms provisions.\(^{719}\) Over the years, the courts have developed a list of clauses which are null and void because they violate unfair contract terms provisions. These prohibited terms include those that leave the franchisor’s contractual performance duties entirely to his discretion;\(^{720}\) restrict the entrepreneurial freedom of the franchisee unless they are necessary to ensure the franchisor’s corporate identity;\(^{721}\) empower the franchisor to reduce the size of the franchisees territory or end its exclusivity if the franchisee is not able to reach a certain target and without giving the franchisee the opportunity to make up for missed

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\(^{715}\) Many franchisee businesses are micro-businesses. The new law will not affect existing franchise agreements or franchise agreements with a total transaction value of more than £500,000 (including the initial franchise fee and all on going royalties).


\(^{717}\) Section 6 (3) Unfair Contract Terms Act 1977.


\(^{719}\) Palandt BGB, Überbl. v. § 305, Rn. 11.

\(^{720}\) §§ 305 to 310 BGB, formerly the German Unfair Contract Terms Act.

\(^{721}\) Section 307, 308 and 309 of the Civil Code.

\(^{722}\) BGH NJW-RR 2000, 1159ff; Giesler, Franchiseverträge, Rn. 111.

\(^{723}\) Giesler, ibid, Rn. 108.
targets\textsuperscript{724}; and provide the franchisor with short notice termination rights. A period of notice of three months is null and void\textsuperscript{725} whereas a notice period of one year or a little less is not\textsuperscript{726}. This means that many terms that are commonly used in common law franchise agreements are void (and accounts for some of the “softer” language in the 5 German franchise agreements considered in the sample in Chapter 2 above). Effectively the Courts “negotiate” for the franchisee, where the franchisee itself cannot, as failure to comply results in the provisions being struck out completely rather than applying a blue pencil approach.

Sections 339, 340 of the German Civil Code permit the imposition of penalty clauses that take effect if a party is breach of the contract\textsuperscript{727}. The penalty must not be excessive and if it is agreed upon in a standard form agreement (see the above) it must not be unduly burdensome in terms of Section 307 of the Civil Code\textsuperscript{728}. If agreed upon in standard contract terms a contract penalty can only apply to negligent or intentional non-performance\textsuperscript{729}. A clause that seeks to impose an excessive penalty is void.

Germany is not the only EU jurisdiction that takes this approach\textsuperscript{730}.

However, not all jurisdictions take this approach to franchisees. The ECJ, in Francesco Benincasa v Dentalkit Sr.\textsuperscript{731}, confirmed that under Italian law franchisees are self evidently not consumers and that they should not therefore be regulated by consumer laws. If, as inexperienced individuals dealing with sophisticated corporations they require protection, such protection should be crafted specifically for them. The imposition of consumer laws on franchising is inappropriate and risks damaging the legitimate interests of both franchisors and franchising as a whole.

\textsuperscript{724} BGH NJW 1984, S. 1182ff.; Giesler/Nauschütt, Franchisrecht, Chapter 9, Rn. 84 and 89.
\textsuperscript{725} BGH NJW-RR 2003, S. 1635, 1638 (“Apollo-Optik”).
\textsuperscript{726} Giesler, ibid, Rn. 119.
\textsuperscript{728} Grüneberg, in: ibid, Rn. 12.
\textsuperscript{729} Palandt BGB, § 309 Rn. 39.
\textsuperscript{730} In Portugal, the Law of General Contractual Clauses (LGCC) (Decree no. 446/85 of 25 October as amended) also applies to all standard form contracts which have not been negotiated by the parties and cannot be contracted out of (Santos Cruz/Krupenski, IBA Legal Practice Division International Franchising Committee Newsletter, May 2007, p. 24). Even if the parties have chosen a foreign law to govern the agreement, the LGCC will apply where the agreement is more closely connected with Portugal than any other country. This means in practice that whenever the franchisee, its assets and the establishment are located in Portugal, the LGCC will apply with the consequence that a certain set of clauses is prohibited such as: exclusion to the right of compensation; or any provisions which goes against the principle of good faith. Clauses which do not comply with the LGCC are null and void.
\textsuperscript{731} Case C-269/95 Francesco Benincasa v Dentalkit Srl [1997] ECR I-3767.
3.5.3.5 Sub-Conclusion

The ongoing franchisor/franchisee relationship in the EU is impacted by a regularity environment that comprises a duty of good faith, antitrust, unfair competition and consumer law.

The common law and civil law take a very different approach to the concept of good faith. Whereas the German and French approach is loose and amorphous based upon the Roman law concept of bona fides, the common law takes a for more literal approach to contracts, using a variety of legal tools to ensure fairness on the relationship. However, even with the Civil approach to the concept of good faith differences exist between member states. The influence of Article 101 of the TFEU mean that all member states take a similar approach to the regulation of vertical restrictions within the franchisor/franchisee relationship whereas Unfair Competition and Confidentiality lies very substantially on a member state by member state basis. Unfair Contract term provisions are harmonised by the Unfair Competition Terms Directive.

3.5.4 The termination of the Franchisor/Franchisee relationship

This is critical analysis to the second objective of the thesis. It suggests that on the termination of the franchisor/franchisee relationship the legal environment in the EU does not support any of the economic drivers that encourage franchisors to become involved in franchising and does not significantly reduce any of the risks that franchisors are exposed to. However it excessively reduces the risks to which franchisees are exposed to and over re-enforces the economic drivers that encourage them to become involved in franchising.

3.5.4.1 The Contractual Right to Terminate a Franchise Agreement

Termination is the ultimate means by which both franchisor and franchisees can enforce their contractual rights against each other and so support the economic drivers and reduce the consequential inherent risk in franchising. However, the right to terminate is regulated in a number of different ways in EU member states. In the event that a party breaches the contractual terms of the franchise agreement, subject to the nature of the breach and the impact of the concept of good faith, employment law and commercial agency law, all EU member states allow the party not in breach to terminate the agreement and/or sue for damages.

In the UK franchisees and franchisors have the right to terminate the franchise agreement if the other party has committed a repudiatory breach or has breached a term of the agreement which is of major importance.
Franchise agreements will commonly contain clauses preventing the franchisor competing with the franchisee’s business during the term of the franchise agreement. Such a condition of the contract would be regarded as a term of major importance.

A repudiatory breach is one that goes to the root of the contract and shows the breaching party’s intention not to honour its obligations under it. When it is implied the test is whether the franchisor has acted in “such a way as to lead a reasonable person to the conclusion that he does not intend to fulfil his part of the contract”\(^{732}\). It must be established that the breaching party has made it clear beyond reasonable doubt that it no longer intends to perform its part of the franchise agreement, otherwise the franchisee may be in breach of the contract itself\(^{733}\).

Following such a breach the party not in breach has the choice of whether to treat the contract as continuing (affirmation of contract) or to bring the contract to an end “ab initio” (as if it had never been in force), but it must exercise this right within a reasonable time of the breach or else it will be held to have affirmed the franchise agreement\(^{734}\). However, the party not in breach can take a period of time to make his mind up about what to do\(^{735}\). There is no prescribed way to accept the breach\(^{736}\) but it is usually done by the party not in breach communicating to the other party that it is terminating the contract\(^{737}\). A repudiatory breach can occur before the time for performance (an anticipatory breach). If the franchisee affirms the contract, such affirmation is irrevocable and the party cannot go back upon the decision not to terminate the contract\(^{738}\).

Where there has been a breach of a term which goes to the root of the contract and amounts to repudiation the party not in breach may terminate the contract “ab initio”\(^{739}\). For the breach of a lesser term however, the party’s right to terminate will depend on the consequences of the breach\(^{740}\).

If the party not in breach accepts the breach, the contract will be terminated for the future as from the moment the acceptance of the breach is communicated to the breaching party. The contract is treated as having come into existence (obligations and performance that occurred

\(^{732}\) Devlin J in *Universal Cargo Carriers Corporation v Citati* [1957] 2 QB 401, 436.

\(^{733}\) *Mersey Steel and Iron Co v Naylor, Benzen & Co* (1884) 9 App Cas 434.

\(^{734}\) *Cox Toner (International) Ltd v Crook* [1981] IRLR 443.

\(^{735}\) Per Rix LJ in *Stocznia Gdanska SA v Latvian Shipping Company (no 2)* [2002] EWCA Civ 889.


\(^{737}\) *Heyman v Darwins Ltd* [1942] AC 356.

\(^{738}\) *Bentson v Taylor Sons & Co* [1893] 2 QB 274.

\(^{739}\) *Poussard v Spiers and Pond* [1876] 1 QBD 410.

\(^{740}\) *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 1 All ER 474.
before the breach are not affected) but that it has come to an end discharging future obligations741.

Courts interpret contractual termination clauses in light of the commercial purpose that was intended to be served by the clause742. For a non repudiatory breach, the franchisee can only recover loss that is suffered at the date of termination and not future loss743. For a repudiatory breach, damages for future loss can be recovered744.

Where the terms of the franchise agreement provide that the right of termination for a specified breach can be exercised upon notice given to the breaching party, such notice must be sufficiently clear and unambiguous to constitute a valid notice745.

Breach of the franchise agreement will usually lead to an award of damages. It is possible for franchise agreements to provide for specific sums to be payable on the occurrence of certain breaches (liquidated damages). In principle such clauses are only valid746 so long as they do not constitute a penalty designed to enforce the offending party to compensate the innocent party for its loss747 and are a genuine pre-estimate of loss748.

In Germany there is a distinction between serious and less serious breaches. A party can terminate the franchise agreement without notice depending on the particular circumstances and an objective evaluation of the interests of the franchisor and the franchisee749. This is similar to the distinction between material breach of a substantial term and other breaches. Termination without notice is reserved for irremediable material breaches of substantial terms. Non payment of the franchise fee is deemed remediable and therefore requires notice unless the payment is more than six weeks overdue750. The period can be longer or shorter depending on the amount outstanding751.

Although termination without notice is possible in some circumstances752, termination is rarely without some form of notice. The party in breach must be given a clear opportunity to

741 As per Lord Wilberforce in Johnson v Agnew [1979] 1 All ER 883 at 889.
743 Financings Ltd v Baldock [1963] 2 QB 104.
744 Yeoman Credit Ltd v Waragowski [1961] 1 WLR 1124.
746 Cellulose Acetate Silk Ltd v Widnes Foundry [1933] AC 20.
748 Philips (Hong Kong) Ltd v A-G of Hong Kong (1993) 61 BLR 49; these were first laid down by Lord Dunedin in Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79.
752 Palandt BGB, §314 Rn. 7.
remedy the breach\textsuperscript{753}. Termination must take place within a reasonable time of notice\textsuperscript{754}. The Federal Supreme Court has ruled that two months can be reasonable\textsuperscript{755} but after eight months the right of termination is deemed to have been waived\textsuperscript{756}. This is not dissimilar to the English concept of waiver.

In France, any material breach by the franchisor may lead to the termination of the contract by the franchisee. Jurisprudence provides useful examples of what amounts to a material breach. Failure to enable the franchisee to use the trademark\textsuperscript{757}, the transmission of specific know-how and the permanent provision of assistance of the franchisee are considered as fundamental to a franchise agreement. A material breach of one of these conditions by the franchisor may lead to the termination of the agreement\textsuperscript{758}.

An abusive unilateral modification of the financial conditions of the contract\textsuperscript{759}, breach of the territorial exclusivity granted to the franchisee\textsuperscript{760} and abandonment of the concept proposed to the franchisee\textsuperscript{761} have also all been held to be material breaches that justify termination of the franchise agreement by the franchisee\textsuperscript{762}.

All jurisdictions allow termination for breach on reasonable notice\textsuperscript{763}. Distinctions are made between material breaches of substantial terms and lesser breaches in terms of the

\textsuperscript{753} § 314(2) BGB; KG Berlin BB 1998, S.607ff (“Burger King”).
\textsuperscript{754} § 314(3) BGB; Palandt BGB, §314 Rn. 10.
\textsuperscript{755} BGH NJW 1994, S. 722ff.
\textsuperscript{756} BGH NJW 1985, S. 1894, 1895 (“McDonalds”).
\textsuperscript{757} - Not grant any right to use the trademark to the franchisee - Paris Court of appeal, 20 May 1988, 20 ans de jurisprudence de la franchise, n° 26.
- Abandoning the trademark and gives priority to another trade mark - Rouen Court of appeal, 9 November 2000, Lettre européenne des réseaux commerciaux, 1\textsuperscript{er} trim 2001
- Not defending the trademark against infringes or does not renew the registration of the trademark - Versailles Court of appeal, 9 December 1987, Cah. Dr. Entr. 1988, 2, 42.
\textsuperscript{758} - Paris Court of appeal, 20 May 1988, 20 ans de jurisprudence de la franchise, n° 26.
\textsuperscript{759} - Rouen Court of appeal, 13 October 1994, Jurisdata 050353.
\textsuperscript{761} Cass. Com., 7 June 1996, Jurisdata 022009.
\textsuperscript{762} However, the practicalities of termination are far more mechanistic in France and as a matter of principle, termination must be declared by a court. However, there are two exceptions to this principle of judicial termination. Firstly, the Cour de cassation has been ruling since 1998 that a party may unilaterally terminate the agreement “at his own risk” without going to court when the breach is such that it makes impossible to continue with the agreement (Cass. Civ. 1e, 13 October 1998, Bull I n° 300, p. 207). Secondly, a termination clause may be included in the franchise agreement stating that it can be terminated for breach without going to court.
\textsuperscript{763} In Belgium the general rules for the termination of an agreement apply to franchising agreements. Fixed term agreements can terminate due to effluxion of time, whilst agreements of indeterminate length (which include fixed term agreements that have been renewed several times) can only be terminated by giving reasonable notice. Breach of contractual terms by one of the parties entitles the other to terminate the
agreement and claim damages (Belgian Civil Code Article 1184). Only a serious breach of the franchise agreement will entitle the other party to immediately terminate the franchise agreement, without having to give a reasonable term of notice. However the parties to the agreement can provide for automatic termination when certain conditions or events occur (Cass., 19th April, 1979, Pas., 1979, 1, 981; Court of Commerce Brussels, 22nd November, 1985, BRH, 1987, 120 and Court of Commerce of Neufchâteau, 10th December, 1985, BRH, 1987, 123). The death or bankruptcy of one of the parties will result in the termination of a franchise agreement as it is a contract {	extit{intuita persona}}, unless there is a clause granting successors a right to continue the franchise agreement. Greek law also requires that termination must be on reasonable notice, taking into account the particular circumstances. A period of 6 to 12 months will usually be considered reasonable (Yanos Gramatidis, ‘Greece’ in: Getting the deal through – Franchise 2008, pp. 46-51). In Estonia, the franchisor may terminate the contract by giving reasonable notice unless otherwise prescribed by the franchise agreement (Law of Obligations Act s195 subsection 3 (“ordinary termination”). Termination without notice is permissible, in particular if the terminating party cannot reasonably be expected to continue performing the contract due to the nature of the breach (Law of Obligations Act s 196 subsection 1 (“extraordinary termination”)). The agreement must be terminated within a reasonable time of the notice. In Malta, if the franchise agreement expires, the franchisor may be obliged to renew it under a duty of good faith (Maltese Civil Code Art 993 See Chapter 9 p. 150), if the franchisee has substantially invested in the franchise and has not been able to amortise that investment. In Latvia, the general principle of \textit{pacta sunt servanda} applies to franchise agreements, i.e. the franchise agreement can be terminated by mutual agreement or for the reasons set out in the franchise agreement. However, an agreement may also be terminated unilaterally if “excessive loss” is suffered by one party (for example the price of the purchase (lease) is less than half of its actual value) and \textit{mala fide} of the other party can be proven (Articles 2170, 2042, 2043 of the Latvian Civil Law). In Austria, as a Franchise Agreement is a continuing obligation it can be terminated “for an important reason at anytime”. No party can be forced to continue the contractual relationship if it has lost faith in the other party or the other party is in default (Section 918 (2) and \textit{per analogiam}. Section 1117 and 1162 ABGB).

\textsuperscript{764} For example, under Slovakian law (Section 345 (1) of the Slovakian Commercial Code 513/1991 amended on 7 Jan 2002) although a fundamental breach gives rise to a right to terminate on notice, a non-fundamental breach, entitles the party in breach to a reasonable time in which to remedy the breach. (The parties may deviate from these presumptions subject to there not being a substantial imbalance between their rights to terminate). This distinction also usually impacts upon the rights of the party not in breach and the precise moment from which termination is effective (i.e. from the date of termination or ‘ab initio’). Likewise, as in Greece (Yanos Gramatidis, ‘Greece’ in: Getting the deal through – Franchise 2008, p. 50 para. 24) termination for good cause can also lead to the party in breach being under an obligation to pay damages (Article 673 of the Greek Civil Code and Article 330 Greek of the Civil Code), although wrongful termination will generally result in damages (F.I.C. of Athens 401/77, JCL (1971) 200).

\textsuperscript{765} Polish law takes a similar approach and distinguishes between termination of an agreement with effect from the date of termination (“\textit{Wypowiedzenie}”) (cancellation) and material breach of substantial obligations which might give rise to repudiation of the agreement (ab initio) (“\textit{Jednostrome odstąpienie od umowy}”; Art. 491 KC; Bagan-Kurluta, Umowa franchisingu Monografie prawnicze, p. 125) The parties can expressly stipulate both circumstances in which the recission is permissible (Bagan-Kurluta, Umowa franchisingu Monografie prawnicze, p. 128), and a period during which they have the right to rescind the contract (in consideration for paying an agreed amount of money) (Art. 395 KC). However, unlike English and Irish law, freedom of contract is limited by the principle of good faith which requires the franchisor to allow the franchisee an opportunity to remedy the failure. Only if the franchisee refuses to perform its obligations, may a franchisor terminate the franchise agreement with immediate effect (Polish Franchise Organisation under www.franchiseportal.pl). The right to terminate the contract for material breach cannot be excluded (See “Civil Law in Poland”, on the website of the Commercial Law Center Foundation of Poland, www.prawo.org.pl). Estonian law recognises not only the right to terminate a contract on reasonable notice (Section 116, section 195 and section 196 of the Estonian Law of Obligations) (unless otherwise prescribed by law or the contract) (Estonian Law of Obligations Act Section 195(3) as well as the right to terminate for fundamental breach (What amounts to fundamental breach is listed in Section 116(2)(1-5) of the Estonian Law of Obligations) without notice (Estonian Law of Obligations Act Section 199(1)), although a set procedure must be followed (Estonian Law of Obligations Act Section 106). Termination must be within reasonable time and is effective from the date it takes place (Estonian Law of
The duty of good faith can limit a franchisor’s ability to terminate in some jurisdictions. In Germany termination for good cause may result in the franchisor having to pay compensation to the terminated franchisee. If the upfront franchise fee is not just a contribution towards the franchisor’s costs in incorporating the franchisee into the system, but also a fee for the know-how and goodwill of the franchise and for other ongoing costs incurred by the franchisor, the upfront franchise fee is partly repayable as far as there has been only partial consideration. According to the principles of good faith, upon termination there is also an obligation on the franchisor to repurchase any stock the franchisee was contractually committed to buy from the franchisor, unless the franchisor has terminated for a material breach of the franchise agreement.

The French concept of good faith takes a restrictive approach to the termination of a franchise agreement and determines that a reasonable notice period needs to be given. As a general rule, the longer the franchise agreement has run the longer the notice period will have to be. L. 442-6 I of the Commercial Code prohibits a sudden termination of a well established business relationship and obliges the terminating party to give sufficient notice to the other party in order to allow it to reorganise its activity and to find alternative solutions. Failing that, the terminating party may be held liable and may have to pay damages to the other party. Wrongful termination generally gives rise to damages.

In the UK good faith has no impact upon termination.
Many EU jurisdictions struggle with the concept of franchising. They find it hard to reconcile the obligation of a franchisee to follow the franchisor’s system and directions with the independence of a stand alone business. As a consequence they apply aspects of employment law to protect franchisees. Despite the fact that the franchisees invest in their own business they are deemed to be employees. This has an impact on the Franchisor’s ability to terminate the agreement for breach. This is perhaps due to the fact that some jurisdictions have extremely strict employment laws and some employers are suspected by the Courts of using a veil of franchising to camouflage what is nothing more than an employment contract, and so escape the rigorous controls of the law. Certainly a small number of franchises do look rather “thin” with little or no know-how and offering little or no training and support. However, this is not true of the majority of franchises.

This underlying distrust of the description of individuals as franchisees is very evident in Germany, where franchisees cannot be contractually restricted more than is necessary to ensure the proper functioning of the franchise system. If the franchisee is restricted more than this, he/she can be viewed as an “employee in disguise” and so considered as an employee of the franchisor, placing on the franchisor all of the consequential obligations, particularly the liability to pay social insurance and the obligation to report all staff members to the Inland Revenue, health insurance funds and social security institutions. There is also an obligation to deduct income tax and social insurance contributions of the employee’s salary. This can be expensive. A franchisee is seen as an employee in terms of Section 23 of the German Termination Protection Act (KSchG), if the franchisee is financially dependent on the franchisor and in need of protection like an employee.

Simply adhering to the corporate identity of the franchise system does not mean that the franchisee will be considered as an employee. As long as the franchisee is in control of its own business and can, for example, determine its sales prices, employ its own staff, sell the products and services for its own account and in its own name and determine its own working hours it will not be considered to be an employee.

The more the franchisee’s day to day conduct is regulated by the franchisor the more likely it is that the franchisee will be considered as employee. This is especially so if the franchisor is the only supplier/customer of the franchisee and if the franchisee has no employees of its

772 Giesler, ibid, Rn. 165ff; Flohr, DStR 2003, 1622-1626; Skaupy, NJW 1992, pp. 1785, 1789f.
774 Ibid.
own. A franchisee can be self-employed even though the franchisee is contractually committed to fit out the premises according to the franchisors instructions, needs the permission of the franchisor to refurbish the premises, is tied to the franchisor as regards the goods it sells/uses in his/her business, must use the advertising material provided by the franchisor, must employ such numbers of individuals so as to be able to keep the business open during the statutory opening times. However these guidelines are not conclusive. The Courts always stress that each contract is individual and all circumstances of the individual case must be considered.

French law also follows the same approach as Germany. If the franchisor interferes in the franchisee’s business beyond what is necessary to ensure that the proper functioning of the network the franchisee may be regarded as an employee especially where the degree of supervision is such that the franchisee appears to be subordinated to the franchisor, regardless of what is stipulated in the agreement. Even where the franchisee is not subordinated to the franchisor the provisions of the French Employment Code may also apply if the franchisee’s business consists essentially in the sale of goods; there is a supply exclusivity or quasi-exclusivity to the benefit of the franchisor and the franchisee carries on his business in premises made available or approved by the franchisor under its conditions and prices. If the franchise is deemed to be an employee, the franchisor may be prosecuted for illegal employment and required to pay social security contributions for the past 3 years and late payment penalties; the statutory minimum salary to the franchisee; holidays, overtime and dismissal compensation.

A similar approach is found in several other member states such as Austria, Finland, the Netherlands, Greece, Sweden, the Czech Republic.

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775 BGH NJW 1999, S. 218, 220 (“Eismann”).
779 OGH, RdA 1980, 136. In addition, if the Austrian Labour Law Court considers an individual franchisee to be a “quasi-employee” it will assume and exercise jurisdiction over disputes arising from the Franchise Agreement (Op cit, Petsche, Riegler and Theiss, 2004, p.3). If a franchisee loses his ability to make independent business decisions it might be seen a violation of “bonos mores” and therefore void the whole Agreement.
780 Finnish employment legislation can also affect the franchisor-franchisee relationship (Hanna-Maija Elo ‘Finland’ in Getting the Deal Through – Franchise 2008, p. 37 para.22) where a single private person or entrepreneur enters into a franchise agreement or where the franchisee is a company but owned and run totally by one person. This is because the franchisor is giving orders and instructions to the franchisee and the latter is getting “paid” by the franchisor through the issuance of its service fees which are only paid back in parts to the franchisor in the form of franchise fees.
781 In the Netherlands franchisees may be treated as employees by both the courts and the tax authorities. Pursuant to Article 7:610 of the Dutch Civil Code, there is a contract of employment and franchisees may be considered to enjoy employee protection rights, (such as protection against unfair dismissal, minimum wages and minimum holidays), if the franchisee has to perform the work personally, the franchisor is
This approach clearly reduces the franchisor’s ability to terminate for breach and so undermines the economic drivers that encourage it to become involved in franchising and does not reduce the consequential inherent risks the franchisor is subject to.

The English and Scottish courts have not considered the case, but it is considered unlikely that they would see bona fide franchisees as employees.

3.5.4.4 The Impact of Commercial Agency Law on Termination

The EU Commercial Agency Directive provides that a commercial agent is a person acting in the name of and for the account of its principal and so clearly does not therefore apply to franchising. Merely labelling an agent a franchisee will not enable the principal to circumvent the provisions of the Directive as they focus on the form rather than the substance of the relationship. There are numerous examples of this. However, some jurisdictions go much further than this and apply commercial agency law to franchises by analogy as a matter of course.

In Germany, if the franchise has the characteristics of an agency or distributorship, it will be treated accordingly. However, the courts go much further than this and use the doctrine of

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782 Greece takes a similar approach and under certain circumstances, a franchise may be identified as an employee on the basis that certain elements arising form a contract for independent services may be regarded as “work” and thus fall into the scope of Article 648 of the Greek Civil Code (Yanos Gramatidis, ‘Greece’ in: Getting the deal through – Franchise 2008, pp. 46-51).

783 Given Sweden’s strong tradition of protecting the rights of employees, it is not surprising that the application of employment law to franchise agreements was one of the most controversial issues in the 1987 official report (Chapter 3 p. 41). The topic was not within the scope of the Government Report, but reappeared in the discussions in the Cabinet on the proposal that was to be put forward to the Parliament. However, the matter in question on both occasions was not whether or not a franchisee can be an employee but the right for employees of the franchisee to negotiate directly with the franchisor. Such a measure was rejected by the Ministry (Prop. 2005/06:98 pp. 18-19). He concluded that the question of employees’ influence arising under such similar conditions should be discussed separately (Prop. 2005/06:98 pp. 18-19). Thus, the franchisee’s employee cannot negotiate directly with the franchisor (Lagen (1976:580) om medbestammande i arbetslivet. Prop. 2005/06:98 pp. 9-10).

784 In the Czech Republic, the franchisee is considered to be a “controlled party” and so the franchisor can be liable for its actions (Op cit, Marc. P and Theiss. W, 2004, p.25-34) even though the franchisee is not its employee. The franchisor can avoid liability only if it can show that the action or transaction would have been undertaken by an independent party acting with due care (Ibid Marc and Theiss, p.25-34).


786 E.g under Danish law Act no. 272 of 2 May 1990 on Commercial Agents and Travelling Salesmen (“Handelsagentloven”); Op cit, Christensen, Franchising in Denmark, pp. 18-19 and in Malta Articles 49 to 56 Commercial Code
analogy to extend the rights of a commercial agent to franchisees. Commercial agents are entitled to compensation upon termination of the agency agreement. The Federal Supreme Court has held that a distributor may also claim this compensation upon termination. Several of the lower courts (including decisions by the Higher Regional Courts) have ruled that this provision can be applied by analogy to certain forms of franchise agreements too.

As a result, franchise agreements which integrate the franchisee into the sales organisation of the franchisor are likely to attract compensation claims. Such a claim must meet two basic criteria. Firstly, like a commercial agent, the franchisee must be obliged to leave his established clientele to the franchisor. Secondly the franchisor must be able to use the franchisee’s customer base upon the termination. If the franchisee cannot identify his clientele by name or address (as is usually the case with a walk-in fast food business) a market analysis showing that there are regular customers is necessary to support a claim. The actual scope of compensation differs depending upon the average profit of the franchisee in the past and how far the profits are related to the established clientele that the franchisee leaves to the franchisor. Compensation is limited to the average annual profit of the last five years. A discount is made to the “general pulling power of the brand”. Compensation has to be claimed within one year of termination. A simple letter is enough to preserve the right. Section 90a of the Commercial Code, that deals with an agents’ rights on termination regarding restrictive covenants is also applied by analogy to franchising.

There are many examples of commercial agency law being applied to franchising.

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787 Section 89b of the Commercial Code (Germany).
790 Köhler, ibid, pp. 1689-1697, 1693.
791 Giesler, ibid, Rn. 148.
792 Section 89b (2) Commercial Code (Germany).
793 Section 89b (4) Commercial Code (Germany).
794 See below.
795 “Aquella” (Federal Court of Justice, judgment of 12 November 1986 – I ZR 209/84 (DB 1987, p. 1039, 1040)). The plaintiff has been a franchisee for mobile mineral water distribution franchise “Aquella”. The franchise contract contained a post-contractual non-competition clause for the period of two (2) years, without providing for financial compensation. The plaintiff applied for the declaration that (i) the non-competition clause is contra bonos mores, and, in the alternative, that the non-competition clause is only valid if the defendant pays compensation in the amount of annual earnings for two (2) years. The Federal Court of Justice dismissed claim (i), but approved the claim for compensation (ii). Even though the court clearly indicated that the provisions governing commercial agents (Art. 84ff. HGB) do not apply for franchise contracts automatically, the court held that the application of Art. 90a sec. 1 clause 3 German Commercial Code (hereinafter: HGB) is applicable by analogy in the case under consideration. Art. 90a sec. 1 clause 3 HGB provides for a waiting allowance if a commercial agent is obliged to omit business activities by a non-competition clause. According to the court, the obligation to pay a waiting allowance would serve to ensure the agent’s costs of living for the period of time he is contractually bound to the non-competition clause. The court pointed out that, because of the economic dominance of the franchisor, franchisees would often be forced to accept non-competition clauses. According to the court, the situation of the franchisee in this particular case was comparable to the commercial agent’s position as presumed in
The German approach is unsurprisingly also found in those member states which are heavily influenced by German law, such as Portugal\textsuperscript{796} and Austria\textsuperscript{797}.

\textsuperscript{796} In Portugal, the agency law also applies to franchise agreements in respect of termination and compensation, unless any foreign law referred to in the contract is more favourable for the franchisee (Article 38 of Decree No. 178/86 of 3 July as modified by Decree No. 118/93 of 13 April). This means that unless the foreign law offers even more protection, the Portuguese Agency Law will apply irrespective of a valid choice of foreign law. Where the performance of the franchisee is similar to that of an agent and the franchising parties are identical to those governed by the respective commercial agency law provision. The court argued that Art. 89a HGB serves to grant a protection period within which the commercial agent may seek a new principal, or a new field of business. Such a period would be a necessity for a franchisee, too, if its business operations were tailored to the sales and distribution concept of the franchisor. In the case, the franchisee was obliged to use the standard contract templates of the franchisor, its marks, and to employ a standard design for the business premises as well as for the outfıt of its employees. According to the court, these obligations resulted in a comprehensive integration into the franchisor’s distribution system which would not allow for readjustment on short notice. Even though the franchising contract has been entered into in 1984 only for a period of three years, and subsequently been renewed for periods of two or three years, these “chain contracts” would have to be regarded as one contractual relationship if the terms have not been altered, or subject to negotiations, before the renewal has been agreed on. Thus the contract must be regarded as having been entered into 1984, not the date of the most recent renewal (December 1993), which would have resulted in a cancellation period of three (3) years. “Beer Delivery Contract” (Federal Court of Justice, judgment of 15 December 1993, VIII ZR 157/92). In the decision the Federal Court found that the Art. 89a HGB (termination for causes) is applicable by analogy to franchise contracts. However, as since 2001 Art. 314 German Civil Code provides for a general regulation, thus Art. 89a HGB has since become meaningless.

\textsuperscript{797} Art. 90a HGB: The defendant specified the way its marks had to be used and the routes the franchisees had to take. Vis-à-vis the customers the franchisee did disclose his legal independence. For the customers, it did not become clear that each franchisee acted in its own name and on its own behalf. Advertising measures were directed and executed by the franchisor. The court stated that this would give rise to the assumption that the situation under consideration comes as close to the legally protected interests of a commercial agent that the application of Art. 90a sec. 1 clause 3 HGB by analogy must be regarded as necessary. “Chain Contracts between Franchisor and Franchisee” (Federal Court of Justice, judgment of 17 July 2007 – VIII ZR 59/01 (NJW 2002, p. 1554f)). The appellant, a former franchisee of an US car rental franchising system, has been sued by its German subsidiary for disclosure of information, and for cease-and-desist from using the company’s marks after the company decided not to renew the franchise contract after 12 years of contractual relationship. The company gave notice of the non-renewal only two weeks before expiration of the contract. By way of counter-claim the appellant (franchisee) applied for (i) the declaration that the plaintiff and its mother company are obliged to pay all damages which have arisen out of the non-renewal of the franchising contract causally determined by not having granted a termination period of at least one year, and (ii) disclosure of all advertising allowances paid by automotive manufacturers and importers to the plaintiff and/or its mother company. The Federal Court of Justice ordered the respondents to pay damages which have arisen out of the non-renewal of the franchising contract without granting a termination period of six (6) months. The court held that Art. 89 HGB, according to which a period of cancellation of 6 months is required when the contractual relationship lasted for more than five years, is applicable to the franchise contract at hand. The court stated that commercial agency law can be applied by analogy to franchise agreements if the fundamental idea of a specific commercial agency law provision applies for the franchise agreement at stake because the interests of the franchising parties are identical to those governed by the respective commercial agency law provision. The court argued that Art. 89 HGB serves to grant a protection period within which the commercial agent may seek a new principal, or a new field of business. Such a period would be a necessity for a franchisee, too, if its business operations were tailored to the sales and distribution concept of the franchisor. In the case, the franchisee was obliged to use the standard contract templates of the franchisor, its marks, and to employ a standard design for the business premises as well as for the outfit of its employees. According to the court, these obligations resulted in a comprehensive integration into the franchisor’s distribution system which would not allow for readjustment on short notice. Even though the franchising contract has been entered into in 1984 only for a period of three years, and subsequently been renewed for periods of two or three years, these “chain contracts” would have to be regarded as one contractual relationship if the terms have not been altered, or subject to negotiations, before the renewal has been agreed on. Thus the contract must be regarded as having been entered into 1984, not the date of the most recent renewal (December 1993), which would have resulted in a cancellation period of three (3) years. “Beer Delivery Contract” (Federal Court of Justice, judgment of 15 December 1993, VIII ZR 157/92). In the decision the Federal Court found that the Art. 89a HGB (termination for causes) is applicable by analogy to franchise contracts. However, as since 2001 Art. 314 German Civil Code provides for a general regulation, thus Art. 89a HGB has since become meaningless.
However, this approach can also be found in certain other member states that are not so heavily influenced by German law. Clearly this approach substantially restricts the franchisor’s ability to terminate for breach and so undermines the economic drivers that attract franchisors to franchising and does not reduce the risks to which the franchisor is exposed.

In France, the courts have not shown any signs of applying commercial agency law to franchising.

However, in some member states, such as the UK, it is clear that the agency regulations do not apply to franchising.
3.5.4.5 *Post Termination Restrictive Covenants*

In Germany, the law of commercial agency is applied by analogy. This means that the right to restrict a franchisee after expiry of the franchise agreement comes at a price with the franchisee being entitled to compensation. The franchisee may agree to post termination non-compete obligations for a maximum of two years after termination. In return the franchisee can claim compensation\(^\text{800}\) under the commercial agency laws which are applied by analogy as detailed above\(^\text{801}\). The obligation to pay compensation can be avoided by the franchisor if it waives the non-compete in writing at least six months before the end of the contract period. If the franchisor gives less than six months notice of the waiver it is required to pay compensation for each month difference between the mandatory period of six months and the actual notice period given.\(^\text{802}\) If the franchise agreement is terminated for material breach, the non-breaching party can waive the non-compete restriction on one month’s written notice\(^\text{803}\). Any contract terms excluding these rights of the franchisee are null and void\(^\text{804, 805}\).

In France, whereas courts are very strict regarding non-compete covenants binding employees, they take a less stringent view on non-compete undertakings by non-employees, notably franchisees. For such covenants to be enforceable they must be limited in time and/or space and the restriction must be proportionate to the legitimate interests of the franchisor\(^\text{806}\).

It is possible that in the future, the French courts follow the German example and rule that in order for non-compete covenants to be enforceable against individuals the franchisor must pay them compensation, as is the case with employment agreements\(^\text{807}\). However, this is not currently the case\(^\text{808}\). In 2002, the Supreme Court ruled that a franchisee was an ongoing business\(^\text{809}\), which prevented the franchisee from claiming any compensation.

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\(^{800}\) Section 90a (1); Baumbach/Hopt, HGB, § 90a Rn. 18.

\(^{801}\) BGH NJW 1987, S. 612, 613; Flohr, 3rd edition, Franchisevertrag, p. 193; Giesler, Franchiseverträge, Rn. 149ff; OLG Celle, BB 2007, pp. 1862; also see above.

\(^{802}\) Hopt, in: Baumbach/Hopt, HGB Kommentar, 33rd edition 2008, § 90a Rn. 23; Section 90a (2) German Commercial Code.

\(^{803}\) Section 90a (3) Commercial Code.

\(^{804}\) the right to claim for appropriate compensation according to Section 90a does not exclude the right to claim for compensation upon termination under Section 89b of the Commercial Code - Hopt, in: Baumbach/Hopt, HGB Kommentar, 33rd edition 2008, § 90a Rn. 18.

\(^{805}\) In Austria, there are limits to post term termination clauses deriving from anti trust law. The Austrian courts generally recognise the possibility of the application of agency legislation to franchise agreements by analogy for situations where the franchisee has a similar position to an agent. As post-term non-competition provisions under Austrian agency law are null and void (§ 25 HVertG), it is possible that depending on the structure of the contractual arrangement under the franchise agreement, a post-term non-competition clause may be void for that reason.


\(^{809}\) (Cass. Civ. 3e, 27 March 2002, Bull. III, n° 77, p. 66)
The restrictions on post termination restrictive covenants detailed in the EU Vertical Agreements Block Exemption¹⁰⁰, obviously have some impact, although it is greater in some jurisdictions than others.

In the UK provisions in franchise agreements that limit the franchisee’s right to operate a competing business after the termination of the franchise agreement will be void unless they are reasonable⁸¹¹. The burden of proving that a restriction is reasonable lies with the franchisor who wishes to enforce the clause. If such a clause is considered unreasonable and it will be unenforceable, but it does not mean that the entire contract is void. The parties must continue to perform the other obligations under the contract⁸¹². There is debate as to whether unreasonable parts of a non-compete clause can be severed. However, some courts have achieved this effect by constructing the clause by reference to circumstances existing at the time the contract was made and not necessarily giving it its literal meaning⁸¹³.

The restraint imposed must be reasonable in terms of the length of time and the geographical area which the restraint covers. In Dyno-Rod plc and Zockoll Group Ltd v Reeve⁸¹⁴ both a period of twelve months and the extent of the restriction limited to the territory the franchisee

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¹⁰⁰ EC Regulation No 2790/1999, OJ L 336, 29.12.1999 on the application of Article 81(3) of the Treaty to the categories of vertical agreements and concerted practices OJ L 336, 29.12.1999. For example, the laws of the Czech Republic also provide that although the parties can decide the grounds on which the franchise agreement can be terminated, post termination restrictions must comply with the limitations set forth in the Vertical Restraints Block Exemption and not exceed one year after the termination of the agreement.

¹¹¹ Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd [1894] AC 535.


¹¹³ Littlewoods Organisation Ltd v Harris [1978] 1 All ER 1026.

was permitted to operate the franchise were considered reasonable\textsuperscript{815}. In \textit{Prontaprint plc v Landon Litho Ltd}\textsuperscript{816} a covenant not to engage in a similar business within a radius of half a mile for three years was held to be reasonable. Similarly in \textit{Kall-Kwik Printing (UK) Ltd v Bell}\textsuperscript{817} a clause preventing involvement in competing businesses for a period of eighteen months and within a radius of 700 metres of the centre was upheld. In the UK confidentiality is entirely a contractual matter.

The nature of the franchise relationship means that it is only equitable that franchisees are generally obliged to restrict themselves to the franchise and not be involved in competing businesses. It is also appropriate for a former franchisee to be restricted from competing with its former franchisor for a reasonable period of time as otherwise it is inevitable that the franchisors’ know-how could be abused and that former franchisees will benefit from a “spring board” effect.

\textbf{3.5.4.6 Sub-conclusion}

The legal regulatory environment in the EU does not support any of the economic drivers that encourage franchisors to become involved in franchising and does not significantly reduce any of the risks that franchisors are exposed to. However, it over reduces the risks to which franchisees are exposed and an over re-enforces the economic drivers that encourage them to become involved in franchising. All member states recognise the right to terminate for breach, although some (e.g France) are more formulaic in how it has to be exercised than others. However the duty of good faith in some member states, such as Germany over protects franchisees, entitling them to refunds of upfront fees on termination in some circumstances. An inappropriate use of employment law in some member states can also over protect some franchisees. Likewise the application by analogy of commercial agency law in Germany erodes the economic drivers that attract franchisors to franchising and excessively de-risk it for franchisees. Post-termination restrictive covenants are an essential element in reducing the risks inherent in franchising for franchisors, but German law applies commercial agency by analogy to erode this protection.

\textbf{3.6 Empirical Research into the Regulatory Environment}

This is critical analysis to the second objective of the thesis and deals with empirical research undertaken for this thesis involving a selection of franchisors who are, or plan to, franchise in more than one EU member state.

\textsuperscript{815} This was also considered reasonable in the Court of Appeal in Office Overload Ltd v Gunn [1977] FSR 39.
\textsuperscript{816} [1987] FSR 315.
\textsuperscript{817} [1994] FSR 674.
The majority of franchisors in the sample would welcome some form of EU wide franchise specific statutory regulation of franchising instead of a self regulatory regime or the application of general member state laws to franchising which many see as creating a barrier to inter state franchising. They believe that the statutory regulation of franchising in France and Spain seems to have had no adverse impact on franchising there.
1. What are the main barriers to franchisors expanding into other EU member states? Do you consider the following factors to be very significant, significant or insignificant barriers?

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<tr>
<td></td>
<td>UK (25)</td>
<td>Germany (25)</td>
<td>France (25)</td>
</tr>
<tr>
<td>Language</td>
<td>1 (4%)</td>
<td>2 (8%)</td>
<td>6 (24%)</td>
</tr>
<tr>
<td>The extra burden created by each member state having different franchise regulations</td>
<td>14 (56%)</td>
<td>15 (60%)</td>
<td>22 (88%)</td>
</tr>
<tr>
<td>Finding a suitable master franchisee/developer</td>
<td>24 (96%)</td>
<td>23 (92%)</td>
<td>22 (88%)</td>
</tr>
<tr>
<td>Cost</td>
<td>5 (20%)</td>
<td>8 (32%)</td>
<td>3 (12%)</td>
</tr>
<tr>
<td>Different market conditions in each member state</td>
<td>4 (16%)</td>
<td>1 (4%)</td>
<td>8 (32%)</td>
</tr>
<tr>
<td>Others</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
</tbody>
</table>
2. What are the greatest risks that a franchisor incurs in deciding to franchise its business?

<table>
<thead>
<tr>
<th>Risk</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>VERY SIGNIFICANT RISK</strong></td>
<td>2 (8%)</td>
<td>9 (36%)</td>
<td>2 (8%)</td>
<td>1 (4%)</td>
<td>15 (60%)</td>
<td>14 (56%)</td>
<td>3 (12%)</td>
<td>7 (28%)</td>
<td>8 (32%)</td>
<td>2 (8%)</td>
<td>20 (80%)</td>
<td>17 (68%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Protection of your know-how from unauthorised use by the franchisee or their agents outside of the franchise system</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SIGNIFICANT RISK</strong></td>
<td>20 (80%)</td>
<td>18 (72%)</td>
<td>20 (80%)</td>
<td>1 (41%)</td>
<td>5 (20%)</td>
<td>6 (24%)</td>
<td>4 (16%)</td>
<td>6 (24%)</td>
<td>0 (0%)</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
<td>18 (72%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition from franchisees during the term of the Franchise Agreement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>INSIGNIFICANT RISK</strong></td>
<td>24 (96%)</td>
<td>14 (56%)</td>
<td>22 (88%)</td>
<td>10 (40%)</td>
<td>1 (4%)</td>
<td>8 (32%)</td>
<td>2 (8%)</td>
<td>14 (56%)</td>
<td>0 (0%)</td>
<td>3 (12%)</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition from franchisees after the term of the Franchise Agreement</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under payment of monies due</td>
<td>9 (36%)</td>
<td>22 (88%)</td>
<td>24 (96%)</td>
<td>25 (100%)</td>
<td>15 (60%)</td>
<td>3 (12%)</td>
<td>1 (4%)</td>
<td>0 (0%)</td>
<td>1 (4%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### VERY SIGNIFICANT RISK

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>from franchisees</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Franchisees not complying with system</td>
<td>3 (12%)</td>
<td>21 (84%)</td>
<td>12 (48%)</td>
<td>18 (72%)</td>
<td>20 (80%)</td>
<td>3 (12%)</td>
<td>3 (12%)</td>
<td>6 (24%)</td>
<td>2 (8%)</td>
<td>1 (4%)</td>
<td>10 (40%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>Under performance by franchisees during term of Franchise Agreement which has a significant impact on the brand</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
<td>11 (44%)</td>
<td>4 (16%)</td>
<td>6 (24%)</td>
<td>21 (84%)</td>
<td>13 (52%)</td>
<td>17 (68%)</td>
<td>18 (72%)</td>
<td>3 (12%)</td>
<td>1 (4%)</td>
<td>4 (16%)</td>
</tr>
<tr>
<td>Damage to the franchisees intellectual property</td>
<td>23 (92%)</td>
<td>23 (92%)</td>
<td>22 (88%)</td>
<td>16 (64%)</td>
<td>2 (8%)</td>
<td>2 (8%)</td>
<td>3 (12%)</td>
<td>9 (36%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
</tbody>
</table>

3. Why did you franchise your business? Do you consider the following factors to have been very significant, significant or insignificant?

### VERY SIGNIFICANT

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access to working</td>
<td>18 (72%)</td>
<td>18 (72%)</td>
<td>16 (64%)</td>
<td>13 (52%)</td>
<td>6 (24%)</td>
<td>4 (16%)</td>
<td>4 (16%)</td>
<td>4 (16%)</td>
<td>1 (4%)</td>
<td>3 (12%)</td>
<td>8 (32%)</td>
<td>8 (32%)</td>
</tr>
</tbody>
</table>
### 4. Which of the following obligations are very significant, significant or insignificant in protecting your business from franchisee abuse?

<table>
<thead>
<tr>
<th></th>
<th>VERY SIGNIFICANT</th>
<th>SIGNIFICANT</th>
<th>INSIGNIFICANT</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>UK</td>
<td>Germany</td>
<td>France</td>
</tr>
<tr>
<td>Non competition by franchisees during the term of the franchise agreement</td>
<td>20 (80%)</td>
<td>18 (72%)</td>
<td>20 (80%)</td>
</tr>
<tr>
<td>Agreement</td>
<td>VERY SIGNIFICANT</td>
<td>SIGNIFICANT</td>
<td>INSIGNIFICANT</td>
</tr>
<tr>
<td>--------------------------------------------------------------------------</td>
<td>------------------</td>
<td>-------------</td>
<td>---------------</td>
</tr>
<tr>
<td>Non competition for a reasonable period after termination</td>
<td>24 (96%)</td>
<td>14 (56%)</td>
<td>23 (92%)</td>
</tr>
<tr>
<td></td>
<td>10 (40%)</td>
<td>1 (4%)</td>
<td>7 (28%)</td>
</tr>
<tr>
<td></td>
<td>1 (4%)</td>
<td>13 (52%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td></td>
<td>4 (16%)</td>
<td>1 (4%)</td>
<td>2 (8%)</td>
</tr>
<tr>
<td>No challenge of franchisor's intellectual property by franchisees</td>
<td>24 (96%)</td>
<td>21 (84%)</td>
<td>20 (80%)</td>
</tr>
<tr>
<td></td>
<td>25 (100%)</td>
<td>1 (4%)</td>
<td>3 (12%)</td>
</tr>
<tr>
<td></td>
<td>5 (20%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td></td>
<td>0 (0%)</td>
<td>1 (4%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td></td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>Franchisees being obliged to follow the system</td>
<td>3 (12%)</td>
<td>21 (84%)</td>
<td>13 (52%)</td>
</tr>
<tr>
<td></td>
<td>19 (76%)</td>
<td>21 (84%)</td>
<td>3 (12%)</td>
</tr>
<tr>
<td></td>
<td>2 (8%)</td>
<td>6 (24%)</td>
<td>1 (4%)</td>
</tr>
<tr>
<td></td>
<td>1 (4%)</td>
<td>10 (40%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td></td>
<td>0 (0%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>UK                         youngest age</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany                    Payment of monies due to franchisor 12 (48%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>France                     Payment of monies due to franchisor 6 (24%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Spain                      Payment of monies due to franchisor 15 (60%)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>None</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
5. Are you in favour of the Statutory Regulation of Franchising in the EU?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>8 (32%)</td>
<td>14 (56%)</td>
<td>24 (96%)</td>
<td>23 (92%)</td>
</tr>
<tr>
<td>No</td>
<td>11 (44%)</td>
<td>6 (24%)</td>
<td>0 (0%)</td>
<td>1 (4%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>6 (24%)</td>
<td>5 (20%)</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
</tr>
</tbody>
</table>

6. If franchising is regulated by law, should it be done at an EU level rather than a national level?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>6 (24%)</td>
<td>22 (88%)</td>
<td>24 (96%)</td>
<td>25 (100%)</td>
</tr>
<tr>
<td>No</td>
<td>18 (72%)</td>
<td>2 (8%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
<td>0 (0%)</td>
</tr>
</tbody>
</table>

7. Has the statutory regulation of franchising in your country had an adverse impact upon your business?

<table>
<thead>
<tr>
<th></th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>0 (0%)</td>
<td>1 (4%)</td>
</tr>
<tr>
<td>No</td>
<td>24 (96%)</td>
<td>23 (92%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>1 (4%)</td>
<td>2 (8%)</td>
</tr>
</tbody>
</table>
8. Do you believe that specific statutory regulation of pre-contractual disclosure is more effective than self regulation in preventing abuse of franchisees?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>10 (40%)</td>
<td>13 (52%)</td>
<td>22 (88%)</td>
<td>20 (80%)</td>
</tr>
<tr>
<td>No</td>
<td>11 (44%)</td>
<td>8 (32%)</td>
<td>1 (4%)</td>
<td>1 (4%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>4 (16%)</td>
<td>4 (16%)</td>
<td>2 (8%)</td>
<td>4 (16%)</td>
</tr>
</tbody>
</table>

9. Do you believe that the legal regulation of duties and obligations of franchisors and franchisees during the term of the franchise agreement would significantly reduce disputes between franchisors and franchisees?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>1 (4%)</td>
<td>14 (56%)</td>
<td>6 (24%)</td>
<td>8 (32%)</td>
</tr>
<tr>
<td>No</td>
<td>24 (96%)</td>
<td>4 (16%)</td>
<td>14 (56%)</td>
<td>9 (36%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>7 (28%)</td>
<td>5 (20%)</td>
<td>8 (32%)</td>
<td></td>
</tr>
</tbody>
</table>

10. Do you believe that statutory regulation of franchising is more likely to improve the quality of franchising than self regulation?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>8 (32%)</td>
<td>14 (56%)</td>
<td>23 (92%)</td>
<td>21 (84%)</td>
</tr>
<tr>
<td>No</td>
<td>12 (48%)</td>
<td>7 (28%)</td>
<td>1 (4%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>5 (20%)</td>
<td>4 (16%)</td>
<td>1 (4%)</td>
<td>4 (16%)</td>
</tr>
</tbody>
</table>
11. Do you think that statutory regulation of pre-contractual disclosure in franchising will enable disputes between franchisors and franchisees to be resolved in a more effective manner?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>22 (88%)</td>
<td>21 (84%)</td>
<td>18 (72%)</td>
<td>18 (72%)</td>
</tr>
<tr>
<td>No</td>
<td>1 (4%)</td>
<td>2 (8%)</td>
<td>3 (12%)</td>
<td>6 (24%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>2 (8%)</td>
<td>2 (8%)</td>
<td>4 (16%)</td>
<td>1 (4%)</td>
</tr>
</tbody>
</table>

12. Are franchised businesses disadvantaged as compared to non-franchised businesses as regards

(a) Their ability to set prices in all of their outlets

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>19 (76%)</td>
<td>18 (72%)</td>
<td>19 (76%)</td>
<td>18 (72%)</td>
</tr>
<tr>
<td>No</td>
<td>3 (12%)</td>
<td>4 (16%)</td>
<td>5 (20%)</td>
<td>3 (12%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>3 (12%)</td>
<td>3 (12%)</td>
<td>1 (4%)</td>
<td>4 (16%)</td>
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</tbody>
</table>

(b) Their ability to control the franchisees use of the internet

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>14 (56%)</td>
<td>14 (56%)</td>
<td>4 (16%)</td>
<td>16 (64%)</td>
</tr>
<tr>
<td>No</td>
<td>8 (32%)</td>
<td>2 (8%)</td>
<td>15 (60%)</td>
<td>8 (32%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>3 (12%)</td>
<td>9 (36%)</td>
<td>6 (24%)</td>
<td>1 (4%)</td>
</tr>
</tbody>
</table>
13. In your experience if prospective franchisees are given lengthy documentation to read giving details about the franchise, its performance and the role of franchisees do they read it?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>9 (36%)</td>
<td>3 (12%)</td>
<td>6 (24%)</td>
<td>8 (32%)</td>
</tr>
<tr>
<td>No</td>
<td>13 (52%)</td>
<td>13 (52%)</td>
<td>10 (40%)</td>
<td>9 (36%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>3 (12%)</td>
<td>9 (36%)</td>
<td>9 (36%)</td>
<td>8 (32%)</td>
</tr>
</tbody>
</table>

14. In your experience do the cultural and commercial differences between different national markets give rise to different problems and issues for franchisors?

<table>
<thead>
<tr>
<th></th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>20 (80%)</td>
<td>22 (88%)</td>
<td>13 (52%)</td>
<td>12 (48%)</td>
</tr>
<tr>
<td>No</td>
<td>2 (8%)</td>
<td>2 (8%)</td>
<td>10 (40%)</td>
<td>8 (32%)</td>
</tr>
<tr>
<td>Don’t know</td>
<td>3 (12%)</td>
<td>1 (4%)</td>
<td>2 (8%)</td>
<td>5 (20%)</td>
</tr>
</tbody>
</table>
The above results suggest that the majority of franchisors surveyed in France\textsuperscript{818}, Spain\textsuperscript{819}, Germany\textsuperscript{820} and around a third of those surveyed in the UK\textsuperscript{821} are in favour of the EU wide statutory regulation of franchising and felt that it would improve the quality of regulation. Interestingly, of those who responded to the survey in both Germany and the UK a significant minority had no clear opinion of whether or not it was a good idea.

The French and Spanish respondents generally felt that statutory regulation of pre-contractual disclosure is more effective than self regulation in preventing abuse of franchisees\textsuperscript{822} whilst a small majority of German respondents\textsuperscript{823} and just over a third of UK respondents\textsuperscript{824} shared this view.

It is noteworthy that none of the French franchisors surveyed and only one of the Spanish franchisors surveyed felt that the statutory regulation of franchising in their jurisdiction had adversely impacted upon their business.

This belief in the EU wide statutory regulation of franchising is not a recent trend. Research carried out back in 1991\textsuperscript{825} showed that even then the majority of franchisors surveyed in 10 EU member states believed that franchising should be regulated by law\textsuperscript{826}. The vast majority of these believed that any franchise specific regulation should be EU, rather than nationally, based\textsuperscript{827}.

Despite the national variances, research in those member states in which franchising is most prevalent (the UK, Germany, France and Spain) seems to suggest that the majority of franchisors believe that franchising should be regulated statutorily in the EU and that voluntary regulation does not provide an appropriate level of protection.

Other empirical research undertaken for this study tends to support this lack of faith in self regulation and suggests\textsuperscript{828} that the majority of franchisees in the UK do not feel that the BFA represents their interests or the interests of franchising in general. Nor do they trust the

\textsuperscript{818} 96%
\textsuperscript{819} 92%
\textsuperscript{820} 56%
\textsuperscript{821} 32%
\textsuperscript{822} 88% in France and 80% in Spain.
\textsuperscript{823} 52%
\textsuperscript{824} 40%
\textsuperscript{825} Op cit Abell, European Franchising, p. 46 - 1,282 franchisors in 10 member states surveyed with a response rate of 25%.
\textsuperscript{826} 88% in Portugal; 57.6% in Spain; 85.7% in the Netherlands; 100% in Denmark; 65% in the UK; 66.7% in France; 69.4% in Germany and 50% in Belgium.
\textsuperscript{827} 60.4% in the UK; 70.5% in France; 84.6% in Spain; 100% in Portugal; 66.6% in Italy; 75% in Germany; 66.6% in Denmark; 88% in the Netherlands; 90% in Belgium.
\textsuperscript{828} Appendix 5
impartiality of the BFA’s dispute resolution procedure and they would rather litigate than use BFA arbitration.

Further empirical research undertaken for this study involved a survey of 25 leading franchise lawyers\textsuperscript{829}. The results of this survey suggests that leading practitioners also believe that statutory regulation of franchising is more effective than self regulation and that the EU should regulate franchising throughout the EU in a uniform manner rather than leaving it to individual member states to enact their own franchise law.

3.7 Conclusion

The second objective of this thesis has been achieved. It has been established that the regulatory environment in the EU is partly responsible for franchising’s under achievement in the single market. It has established that franchising needs to be regulated\textsuperscript{830} and that the contractual\textsuperscript{831} and regulatory\textsuperscript{832} environment in the EU (both self regulatory\textsuperscript{833} and legal) within which franchising operates does not adequately protect and re-enforce the economic drivers that attract franchisors and franchisees to become involved in franchising. Nor does it adequately reduce the consequential inherent risks\textsuperscript{834}. In some cases it over protects the franchisees, so increasing the risks to franchisors and eroding the economic drivers that attract them to franchising in the first place.

The contractual environment tends to support and re-enforce the economic drivers that encourage franchisors to become involved in franchising and reduces their consequential risk to a reasonable level\textsuperscript{835}. However, it does not always re-enforce the economic drivers that encourage franchisees to become involved in franchising and it fails to reduce the consequential risks for franchisees adequately\textsuperscript{836}. Self regulation of franchising does not work\textsuperscript{837}. Although the BFA sees its mandate as seeking “to deliver self-regulation frameworks and then (delivering) that product to prospective franchisees”\textsuperscript{838}, it seems to have achieved little. Such intransigence gives little credibility to those advocating self-regulation.

If the franchisor’s trade body fails to respond to its member’s request for a higher level of self-regulation, how can self-regulation be expected to gain the confidence of either the public or the legislature? Historically it has been unwilling to take steps to enforce its code of

\textsuperscript{829} Appendix 4.
\textsuperscript{830} See 3.2 above
\textsuperscript{831} See 3.3 and 3.4 above
\textsuperscript{832} See 3.8 above
\textsuperscript{833} See 3.6 above
\textsuperscript{834} See 3.8 above
\textsuperscript{835} See 3.6 above
\textsuperscript{836} See 3.5.1 above
\textsuperscript{837} ibid
\textsuperscript{838} ibid
conduct. These are substantial flaws in the BFA’s credentials as an effective self regulatory body.

The inevitable conclusion is that franchising needs to be legally regulated in the EU and that voluntary regulation will never be able to provide franchisees, potential franchisees or indeed franchisors with the level of protection that they require.

Much is made, by those who advocate self regulation, of the difficulties and delays created by legal regulation.

Self regulation of franchising in the EU is not transparent, consistent, accountable or proportionate. Even the most mature national franchise associations are struggling to make the change from representing the interests of franchisors to representing those of franchising. Even if they successfully make that change, they only account for just over a fifth of franchisors in the EU. Given the international nature of franchising, any self regulatory system must cover all 27 EU member states, and that is extremely unlikely to happen in a consistent manner given the current state of national franchise associations in the EU. There is a lack of suitably experienced, authoritative, fully representative and sufficiently resourced franchise associations.

As even the Director General of the BFA admits that self regulation is “simply not viable on a pan EU basis”, one is led to conclude that the self regulatory environment in the EU does not adequately support the economic drivers or reduce the consequential risks inherent in the franchisor/franchisee relationship.

Despite clear and substantial differences between the civil and common law approaches to drafting commercial contracts franchise agreements exhibit a uniform architecture which comprises provisions detailing the grant made by the franchisor to the franchisee, the term and renewal, targets, the obligations of both parties, confidentiality, non competition, transfer, product and services ties, good will and termination. There is a contractual asymmetry due to the multi-lateral nature of the franchise relationship (each franchisor having several/many franchisees) and the long term, dynamic and changing nature of the franchisor/franchisee relationship.

The contractual environment in the EU supports the economic drivers that encourage franchisors to become involved in franchising. It does not adequately support all of the

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839 Between 1997 and 2007 the BFA expelled fewer than 5 members.
841 Brian Smart in an interview with the author on 18 September 2008.
842 See 3.4 above
843 ibid
844 ibid
economic drivers that encourage franchisees to become involved in franchising. It provides for a brand, a format and support but it does not impose a qualitative measure for the format or assistance provided.

The contractual environment in the EU reduces the consequential risk inherent for the franchisor to a reasonable level, but it does not do so for the franchisee.

The self regulatory environment does not effectively support or re-enforce the drivers that attract either franchisors or franchisees to franchising. Neither does it reduce the consequential inherent risks for either party.

The self regulatory environment in the EU is marked by a complete lack of homogeneity, the lack of a clear or consistent approach to enforcement, a significant conflict of interest between the interests of franchisors and franchising as a whole and an inability to have any influence whatsoever on nearly 80% of franchise chains in the EU, as they are not members of the national franchise associations.

The regulatory environment in the EU seeks by way of franchise specific laws in six member states to reduce to risks to which franchisees are exposed by ensuring that they have sufficient information to allow them to take a view of the adequacy of the business format and the support delivered by the franchisor to its franchisees and the franchisor’s historical approach to encroachment. Its success in reducing those risks is dependent on the franchisee carefully considering the information it receives, particularly the feedback from existing franchisees and is comprised by the inevitable fact of life that the franchisor’s historical conduct may not be indicative of its future behaviour. The lack of homogeneity of approach between the different EU member states further substantially dilutes its impact on cross border franchising. The lack of any uniform approach to pre-contractual disclosure further weakens the impact of franchise specific laws.

They do not seek to reduce the risks of informational asymmetry and moral risk to which the franchisor is exposed. Some regulatory regimes seek to redress this imbalance by imposing a duty of pre-contractual disclosure on the potential franchisee but that is not part of the EU pre-contractual regulatory environment.

845 ibid  
846 ibid  
847 See 3.6 above  
848 ibid  
849 See 3.8 above  
850 ibid  
851 In Vietnam not only does the franchisor have to disclose information to the franchisee, but so does the franchisee to the franchisor. In order to assist a franchisor when deciding to grant commercial rights, Article 9 of the Commercial Law provides that, upon receiving a reasonable request from the franchisor the franchisee is under an obligation to supply the franchisor with information about itself. The earlier Chinese
The economic drivers which attract franchisors into franchising and those that attract franchisees to it are neither supported nor eroded in any particular way by the pre-contractual disclosure franchise specific regulatory environment in the EU.

Non franchise specific laws impact upon the pre-contractual regulatory environment in the EU in five distinct ways. They impose a duty not to misrepresent facts, an obligation to disclose relevant information to potential franchisees, an extra contractual obligation to disclose relevant information to potential franchisees, an extra contractual obligation of confidentiality, an obligation to enter into the franchise agreement once negotiations have passed a certain point and a right to withdraw from the contract within a limited time period. Each member state takes a different approach to each of these issues resulting in the lack of any homogenous approach. This in turn substantially weakens their impact upon cross border franchising within the EU and creates a technical barrier to franchising between EU member states.

The ongoing franchisor/franchisee relationship in the EU is impacted by a regulatory environment that comprises a duty of good faith, anti-trust, unfair competition and consumer law.

The common law and civil law takes a very different approach to the concept of good faith. Whereas the German and French approach is loose and amorphous based upon the Roman law concept of bona fides, the common law takes a for more literal approach to contracts, using a variety of legal tools to ensure fairness on the relationship. However, even with the Civil approach to the concept of good faith differences exist between member states. The influence of Article 101 of the TFEU mean that all member states take a similar approach to the regulation of vertical restrictions within the franchisor/franchisee relationship whereas Unfair Competition and Confidentiality lies very substantially on a member state by member state basis. Unfair Contract term provisions are harmonised by the Unfair Competition Terms Directive.

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franchise law (the Measures for the Regulation of Commercial Franchises issued by the Ministry of Commerce of the People’s Republic of China, December 31, 2004, Chapter III Article 9) also provided for this but it was dropped (without any explanation) from the most recent Chinese statute.

852 See 3.8 above
853 ibid
854 ibid
855 ibid
856 ibid
857 ibid
858 ibid
859 ibid
860 ibid
861 ibid
Thus there is a complete lack of harmony between the various regimes seeking to regulate the franchise relationship by statute in the EU. Some issues, deemed worthy of specific regulation in certain jurisdictions outside of the EU are not dealt with at all. Franchisors embarking upon a European “roll out” of their concept must expect to encounter delays and costs that are a direct result of this heterogeneous approach— an artificial barrier to pan European expansion. The duty of good faith has a significant impact upon the economic drivers that encourage franchisors and franchisees to become involved in franchising and reduces the consequential inherent risk. The lack of homogeneity through the EU greatly dilutes this impact on cross border franchising. The regulation of vertical restraints has an undermining impact upon the economic drivers that encourage franchisors to become involved in franchising.

The legal regulatory environment in the EU does not support any of the economic drivers that encourage franchisors to become involved in franchising and does not significantly reduce any of the risks that franchisors are exposed to. However, it over reduces the risks to which franchisees are exposed and an over re-enforces the economic drivers that encourage them to become involved in franchising. All member states recognise the right to terminate for breach, although some (e.g France) are more formulaic in how it has to be exercised than others. However the duty of good faith in some member states, such as Germany over protects franchisees, entitling them to refunds of upfront fees on termination in some circumstances.

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862 ibid
863 The role of third parties in franchising is not regulated by any of the EU member states. However, there are examples of such regulation in other jurisdictions such as Malaysia (Malaysia governs the activities of Franchise Brokers “doing business as an agent or representative of a franchisor to sell a franchise to any person for a certain consideration but does not include any director, officer or employee of the franchisor or franchisee” (The Franchise Act 1998 Part I Section 4)), Korea (In Korea the law provides for the registration at the Fair Trade Commission of Franchise Consultants (Act on Fairness in Franchise Transactions Chapter III Article 28) and impose on them a duty to act “with dignity” and honesty (Act on Fairness in Franchise Transactions Chapter III Article 30) and can be struck off for inappropriate behaviour (Act on Fairness in Franchise Transactions Chapter III Article 31)) and Kazakhstan (in Kazakhstan Licence brokers, (those “engaged in mediation activities in the course of concluding and performance of the complex business license contract”) are expressly acknowledged by the law which states that they “may act both on their own behalf and at their own risk, and on behalf and at the risk of the licensor, licensee or other subjects of franchising relations in consideration for a license broker’s fee which can be payable in the form of a fixed single or periodic payment, fixed payments or otherwise, as provided by the contract” (Law on Complex Business Licence (Franchising) (Law No 330: June 24, 2002.) Chapter II, Article 8.)). None of the EU member states stipulate a minimum term for franchise agreements. However, two jurisdictions outside of the EU do. In Malaysia the franchise agreement must be for a minimum period of five years (The Franchise Act 1998 Part III Section 25.). In Indonesia, there is a minimum period of 5 years (The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter II, Article 8.) and ten years for master franchise agreements (Cornwallis, R, 2006, “Indonesia – new franchise regulation”, International Journal of Franchising Law, Volume 4, Issue 3, p.5). The franchise agreement must be for a minimum period of five years (The Franchise Act 1998 Part III Section 25.). In Indonesia, there is a minimum period of 5 years (The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter II, Article 8.) and ten years for master franchise agreements (Cornwallis, R, 2006, “Indonesia – new franchise regulation”, International Journal of Franchising Law, Volume 4, Issue 3, p.5).
circumstances \textsuperscript{867}. An inappropriate use of employment law in some member states can also over protect some franchisees \textsuperscript{868}. Likewise the application by analogy of commercial agency law in Germany erodes the economic drivers that attract franchisors to franchising and excessively de-risk it for franchisees \textsuperscript{869}. Post-termination restrictive covenants are an essential element in reducing the risks inherent in franchising for franchisors, but German law applies commercial agency by analogy to erode this protection \textsuperscript{870}.

\textsuperscript{867} ibid
\textsuperscript{868} ibid
\textsuperscript{869} ibid
\textsuperscript{870} ibid
Chapter 4 Identifying a Catalyst to Re-engineer the Regulatory Environment

The previous chapters have achieved the first and second objectives of this thesis. They have established that although franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU and which stimulates economic activity by offering economic advantages to all those involved and imposing distribution and giving business increased access to the other member states, it is not fulfilling its potential to contribute to the realisation of the single market and that the regulatory environment in the EU is partly responsible for this under achievement.

This chapter provides critical analysis to achieve part of the third objective of this thesis by establishing what catalyst is best suited to re-engineer the EU’s regulatory environment so as to enable franchising to better fulfil its potential in the EU.

It is suggested that a directive is the most appropriate catalyst to re-engineer the regulatory environment in the EU so that it adequately supports the economic drivers that draw franchisors and franchisees to franchising and reduces the consequential inherent risks in franchising to an appropriate level.

4.1 Breaking Down Barriers to Trade in the EU

This is critical analysis towards the third objective of the thesis.

There may be disagreement about whether a self regulatory regime is more effective in preventing abuses than franchise specific regulations. There may also be little empirical evidence to prove irrefutably that franchise specific disclosure and relationship laws have reduced abuse, sharp practice, commercial failure or the number of franchise disputes. Nevertheless, the lack of a homogenous regulatory environment in the EU is a barrier to cross border trade. Eight EU member states regulate franchising in distinctly different ways. There is also a significant difference in the way that non franchise specific laws impact upon franchising.871 The heterogeneity creates legal barriers to interstate trade within the EU.

It is suggested that a regulatory environment comprising harmonized legal eco-systems in each member state would facilitate easier cross border franchising in the EU. This certainly seems to be the view of those most actively involved in franchising in the EU on a day to day basis.872 The EU

871 See section 3.5 above
872 A survey of franchisors and professional advisors involved in pan European franchising and interviews with a number of senior managers and in-house lawyers at companies actively involved in pan European franchising.
“set itself the goal of making its economy the most competitive and dynamic knowledge-based economy in the world”\textsuperscript{873}. 

In order to achieve this, it is clear to the Commission that it needs to create an economic environment which is

“underpinned by legal certainty and security….. to address the obstacles which prevent businesses and consumers from making the most of the internal market”.

It concludes that businesses

“can operate across borders efficiently to stimulate a more competitive supply of goods and services”\textsuperscript{874} and that

“this requires a common approach”\textsuperscript{875}.

It has stated plainly that if it

“continue(s) to accept a multiplicity of separate solutions for the same issue there is a risk that the uncertainty and complexity of the legal environment will undermine rather than enable legitimate economic activity”\textsuperscript{876}.

In other words a regulatory environment of harmonized legal eco-systems is needed to support the single market.

The Belgian Parliament came to a similar conclusion in 1986 when it rejected a bill aimed at regulating franchising if Belgium believing that franchising was becoming more and more a matter of general European interest and implementing a national regulation risked complicating cooperation between member states\textsuperscript{877}. Eight\textsuperscript{878} of the 27 EU member states already have franchise specific legislation creating a heterogeneous legal environment for franchising in the EU. The establishment of a true single market within the EU can only be achieved if all physical, fiscal and technical barriers are removed.\textsuperscript{879} The regulation of the distribution of goods or services in different ways by member states inevitably creates technical barriers that cannot be reconciled with the objective of creating a single market. The

\textsuperscript{872}Mr Robert Madelin, Ibid.
\textsuperscript{873}Mr Robert Madelin, Ibid.
\textsuperscript{874}Mr Robert Madelin, Ibid.
\textsuperscript{875}From the answer to a Parliamentary question Mr Legnean asked on 11th April, 1986.
\textsuperscript{876}France, Spain, Italy, Lithuania, Estonia, Belgium, Romania and Sweden.
European Commission claims that diversity in the laws across member states leads to higher transaction costs for businesses which discourages consumers and businesses from engaging in cross-border trade and makes it especially difficult for small businesses to exploit economies of scale in the single market.

The highly fragmented nature of laws within the European Union generates a need for harmonisation. Although the differences between member states’ laws reflect the legal cultures of the various countries, they

“threaten legal certainty and lead to high costs of legal actions; cases of dispute become more likely, and mostly harder to resolve too.”

For those involved in legal cases in foreign countries, such differences are often criticised as incomprehensible. These economic players would like to see the law becoming more compatible with the needs of the business world: simple, rapid, and predictable.

The lack of certainty from the combination of international, European and national laws of member states is particularly notable for continental lawyers who are used to the formal certainty of codified law. The codifications of civil law were viewed as the “science” of lawmaker. As Portalis, the principal draftsman of the French Code civil of 1804, observed:

“Laws are not pure acts of power; they are acts of wisdom, of justice and of reason …. The science of the legislator consists of finding for each area those principles which are most beneficial to the common good.”

They believe that change is possible and

“the differences between European continental legal systems and common law in style, method, legal culture, legal thinking and legal training are by no means insuperable.”

4.2 The Precedent of Commercial Agency

This is critical analysis towards the third objective of the thesis.

880 “Quelles juridictions économiques en Europe, du règne de la diversité à un ordre européen” edited by Yves Chaput and Aristide Lévi, CREDA, CCIP, Editions Litec. Quote from Robert Badinter, Emeritus Professor at the University of Paris I in the preface to the study.
882 “Towards a pan-European approach to commercial law” Annabelle Pando et Frédérique Perrotin (1 October 2007)
A heterogeneous regulatory environment in the EU once existed in respect of commercial agency. Before 1986 commercial agents were protected by specific laws in a number of EU member states, particularly France, the Netherlands, Belgium and Germany. The Commercial Agents Directive was introduced in order to harmonise these member state laws once it had been accepted by the Council of Ministers that commercial agents needed specific protection of their rights in relation to their principals. The possibility of each member state regulating agency in a different manner (as is currently the case with franchising) was seen as being in direct conflict with the creation of a single market within the European Community. It amounted to the creation of technical barriers to free trade.

The Council of Ministers felt that it was necessary to strengthen the position of the commercial agent in relation to his principal. Independent commercial agents were operating throughout the EU across member state borders. They were seen to be in a weak position when dealing with their principals, although it was acknowledged that this was not always the case. There was evidence to suggest that commercial agents were sometimes being abused by their principals. A European-wide solution was therefore felt to be appropriate. It could not be left to individual member states.

The Council of Ministers considered that the differing national laws on commercial agency were detrimental to the functioning of the Single Market. Their statement in the preamble to the Directive is extremely relevant to franchising. Indeed it could have been writing about franchising rather commercial agency. It states that,

“the differences in national laws concerning commercial representation substantially affect the conditions of competition and the carrying-on of that activity within the Community and are detrimental both to the protection available to commercial agents vis-à-vis their principals and to the security of commercial transactions”.

885 There are some basic similarities between franchising and commercial agency. “As in the case of commercial agency contracts, the franchise agreement generally bring together a strong party, the principal or franchisor, and the weaker party, the commercial agent or franchisee. Both parties are consistently, before, during and after the commercial collaboration, in this unequal position with each other”. The Belgian House Of Representatives, 28 Jan 2004 - Draft Parliamentary Bill Relating to Franchise Agreements (lodged by Mme Trees Pieters) [Doc 51 0747/001].


It continues

“those differences are such as to inhibit substantially the conclusion and operation of commercial representation contracts where principal and commercial agents are established in different Member States; trade in goods between Member States should be carried on under conditions which are similar to those of a single market, and this necessitates approximation of the legal systems of the Member States to the extent required for the proper functioning of the common market; in this regard the rules concerning conflict of laws do not, in the matter of commercial representation, remove the inconsistencies referred to above, nor would they even if they were made uniform”.

It therefore concludes that harmonization of member state law through a Directive is necessary. Exactly the same conclusion can be drawn about franchising. This is reinforced by the conclusion of the Organisation for Economic Co-operation and Development (OECD) that inefficient or unduly restrictive regulation in the distribution sector (which in its study includes franchising) results in increased direct and indirect costs.\textsuperscript{889}

4.3 Empirical Evidence

This is critical analysis towards the third objective of the thesis.

A survey of legal practitioners from around the world who work in the field of franchising supported the suggestion that a single EU franchise law was most appropriate.\textsuperscript{890} This is borne out by the BFA/Nat West Survey 2007 which found that legislation was seen by the majority of franchisors as the main barrier to international expansion.\textsuperscript{891}

Interviews with franchise lawyers experienced in cross border franchising in the EU supports this idea that the lack of a single EU franchise law is “a substantial problem” for at least

\begin{enumerate}
\item Appendix 4 - Survey of the 25 franchise lawyers. 76% feel that franchising should be regulated on a pan-EU basis and 8% thought that it should not be regulated on a pan EU basis, 16% thought may be it should not.
\item BFA/Nat West Survey 2007, page 20 – 53% cited foreign legislation as the most significant barrier to international expansion, whilst only 16% cited current EU regulations as a significant barrier.
\item Interview with Christopher Nowak, Vice President and General Counsel, Wyndham Worldwide Corporation (10 March 2006). All of those franchise lawyers interviewed shared the same view. Jane Colton, Vice President & Legal Counsel, Vanguard Rental GMBH (1 June 2006) stated that “the current form of national franchise laws in the EU makes cross border European franchising unnecessarily complicated. It goes against the whole rationale of the European Union increasing the cost and lead time of franchisors entering other EU member states. Nunns Moodliar, General Counsel, Hertz Europe Limited said “Even though the EU is a single market, when Hertz do business in any of the 27 member states we have to undertake particular legal advice which leads to us carrying extra costs and losing time. For any franchisor wanting to expand within the EU, harmonisation of franchise disclosure and other law would be a big benefit. It will make entry into other member states quicker, cheaper and far more certain. From the point of view of both franchisors and franchisees clear and harmonised disclosure in all EU member states
\end{enumerate}

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some franchisors seeking to establish their businesses in several EU member states and makes pan European franchising far more difficult than it need be. Although the interviews are not in themselves conclusive evidence of the need for a harmonised approach, they certainly support the evidence detailed above and are therefore worthy of consideration.

Franchisors in the UK, Germany, France and Spain seem to feel that the extra burden imposed upon them by each EU member state having different franchise laws is a very significant barrier to their expanding into other EU member states. A clear majority of those surveyed were also in favour of a pan European approach, although the majority of UK franchisors surveyed, reflecting their jurisdictions’ traditional antipathy to European legislation, felt that national legislation was more appropriate.

### 4.4 The Mechanisms Available to Harmonise EU Member State Law

This is critical analysis towards the third objective of the thesis.

There are seven options available for harmonising EU law. These are publication of non-binding model contract rules; a binding or non-binding “tool box” for EU law makers; a contract law recommendation that would call on EU member states to include a European contract law into their national legal systems; an optional European contract law which could be chosen freely by consumers and businesses in their contractual relations; an EU Directive on the harmonisation of national law; full harmonisation using an EU Regulation and the creation of a European Civil Code, replacing all national law.
This thesis does not intend to consider these options in detail. It does however make the observation that a regulation would not enact a franchise law that fits most easily into the legal environment on all 27 member states, as they vary so widely in respect of franchising. All but two of the other options would have no mandatory effect. There are therefore only two options that merit consideration as to which are the most appropriate to deliver a European franchise law. A Directive and a European Civil Code.

4.4.1 Directives as the way to harmonise member state law

The EU has harmonised a number of specific sectors, such as Commercial Agency by way of Directives. Directives are legal acts which member states are required to transpose into national law, but are free to implement as they wish provided the end result is achieved. Article 288 TFEC provides that

‘a Directive shall be binding, as to the result to be achieved, upon each member state to which it is addressed, but shall leave to the national authorities the choice of form and methods’.

Member states are under a duty to incorporate the aim of each directive into their national law by the given deadline. Failure to implement a directive, part implementation or incorrect implementation often leads to a complaint by the Commission to the European Court of Justice. However it has been suggested by the European Parliament that this sectoral approach does not ensure the proper functioning of the internal market. A more politically focused approach to the harmonisation of member state law has therefore been advocated by the European Parliament.

4.4.2 A European Civil Code as the way to harmonise member state laws

Proponents of a codified legal system claim that it brings “the legal unity desired by business, lawyers and citizens alike”.

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896 See 3.3 above
897 Article 249 of the Treaty Establishing the European Union
898 Directives that have not been transposed in time, or at all, will take “direct effect”. The doctrine of direct effect only applies vertically to directives. This allows individuals to rely upon the rights asserted in the directive against their member state, regardless of whether the directive has been implemented by such State, which reinforces their effectiveness. However, direct effect does not apply horizontally so individuals cannot assert rights against other individuals as confirmed in the case of Marshall (Marshall v Southampton and South West Hampshire Area Health Authority (Case 152/84) [1986] QB 401 etc..
899 Article 258 TFEU
900 Resolution of 1989, OJ C 158/400 (Resolution A2-157/89); Resolution of 1994, OJ C 205/518 (Resolution A3-0329/94) and Resolution of 2000, J C 377/323 (Resolution B5-0228, 0229-230/2000). Article 1 of the EP Resolution of 1989 reads: “Requests that a start be made on the necessary preparatory work on drawing up a common European code of private law, the Member States being invited, having deliberated the matter, to state whether they wish to be involved in the planned unification”.
901 See note 5 (p3)
If Europe were to adopt a civil code they argue that
“case law and doctrine would be shifted into a new European framework where they
could co-operate more effectively – as it were with economies of scale – something
that ought not least to benefit the quality of law”\textsuperscript{902}.

Although European private law principles are
“uncertain in scope, devoid of conceptual foundations, confused in their policy
orientation and disruptive in their effects on national legal systems”,
some academics believe that with a European code
“the most important basic civil-law questions would be regulated uniformly to the
advantage of businesses operating Europe-wide”\textsuperscript{903}.

As a result, in 2003 the European Commission established a “Common Frame of Reference”
to establish
“common principles and terminology in the area of European contract law”\textsuperscript{904}.

In 2005 the Commission engaged two main groups of academic lawyers to produce a draft
Common Frame of Reference which comprised the “Study Group on a European Civil Code”
(the “Study Group”) presided over by Professor Christian von Bar, and the “Research Group
on Existing EC Private law” or “Acquis Group”\textsuperscript{905}.

The European Commission believes that contract law reform would encourage cross-border
trading and has stated that
"only 8\% of consumers buy online from another member state,"
and
"in addition, 61\% of cross-border sales are rejected because traders refuse to serve the
consumer's country. This is largely due to regulatory barriers and legal uncertainty
about the applicable rules."\textsuperscript{906}

The European Commission’s work on European contract law, which has found a strong echo
in the European Parliament, is therefore an important step towards opening new doors for
businesses and helping 500 million consumers benefit from our single market\textsuperscript{907}.

\textsuperscript{902} Summers, ZEuP 7 (1999), 201
\textsuperscript{903} Schmid, C, 2010, “A European civil code as a building block for a European social model?” , European
Law Review, Volume 35, Number 1, p.102 - 112
\textsuperscript{904} Commission, Action Plan, at para.4.1.1
\textsuperscript{906} See:
reference=IP/10/872
The Commission consulted on seven options for contract law reform in the European Union. The consultation process closed on 31 January 2011. The options for reform include partial harmonisation through an EU directive and an EU civil code as a unified replacement for national contract law.

The Study Group, backed by the EU Commission, endorse the need to regulate franchising on a pan EU level

“With the benefit of and from the stand point of current legal science.” 908

Its Amsterdam Group909 has therefore presented proposals that regulate commercial agency, distribution and franchising on a European level910.

However, the adoption of a European Civil Code, which was announced in 2003, has raised much discussion about the political nature of such an initiative. Hesselink identifies four areas of political function in the initiative. The underlying ideology (autonomy or solidarity), the cultural conflict (National or European), Power (Levels of Governance) and the Symbolism of Codification (is Europe united or divided?)911.

The technocratic approach of the Commission, appointing a group of academics to prepare a “Common Frame Reference”, has not abated concerns that there will be winners and losers in the process without the opportunity for all relevant stakeholders to have any real input912.

In contrast to the manner in which a European Civil Code may ride rough shod over some member states’ legal traditions, a Directive offers a more sensitive and flexible approach to the regulation of franchising. Pierre Legrand explains in his paper913 that the difficulties of a fully harmonised legal system under a civil code stem from sociological findings that the English 'feel definitely uncomfortable with systems of rigid rules' and the English

“pride themselves that many problems can be solved without formal rules”914.

In English Law 'legal development is not a matter of inducing rules, terms or institutions out of a number of factual situations and applying these rules, terms or institutions to new factual situations. Rather it is a matter of pushing outwards from within the facts themselves. It is a matter of moving from one res, say a public highway, to another res like

909 http://ecc.uvt.nl/
910 On 23 December 2008 the Commission received the final version of the academic draft CFR.
912 Ibid
private property. This explains the House of Lord’s opposition to a harmonised code of European contract law.

In contrast, some commentators believe that the Germans

“have been programmed since their early childhood to feel comfortable in structured environments”

and

“look for a structure in their organizations, institutions, and relationships which makes events clearly interpretable and predictable”.

Likewise, the French believe in

“law with sharp edges, based on suspicion, realism and pessimism which contrasts with English law based on custom and trust”.

These different legal mentalities are the result of deep-rooted differences between the three legal traditions embodied in case-oriented English law, rule-oriented French law, and concept-oriented German law. The cultural legal differences are evident in the approach these countries take to harmonisation of EU law. England is used to dealing with fragmentation whereas civil law countries are more comfortable with unambiguous codified law and therefore are more likely to be in favour of full harmonisation.

For Legrand “the adoption of a European Civil Code is arrogant, for it suggests that the civil representation of the world is more worthy than its alternative and is, in short, so superior that it deserves to supersede the common law's world-view”.

Directives are important as a method of harmonisation because they preserve the legal and cultural differences of member states. Walter van Gerven argues that

“uniformity should not be an objective in itself, because it is not, of itself, a higher good than diversity is”.

The United States provides an example of a country without a civil code that is both unified, stable and coherent. In the European Union’s Committee Report on the EU Consumer Rights Directive, Professor James P. Nehf, Professor of Law at Indiana University argues

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917 Op cit Hofstede, p.121 and 116.
921 Ibid.
“that full harmonisation is neither necessary nor desirable ….Consumer legislation in the U.S. varies across the states and…the consensus among consumer representatives (is) that a state-by-state approach (is) preferred unless there (is) a strong need for uniformity in a particular area of commerce”.

This, he argues, allows for

“a healthy degree of experimentation and an evolutionary approach to consumer protection nationwide. State legislatures ha(ve) been able to react more quickly to emerging consumer problems than the U.S. Congress. In most areas of commerce, the differences among state consumer laws creates few obstacles to cross-border transactions”922.

There are also examples where codes have failed, in particular the failure of McGregor’s English Contract Code923. This is often cited as evidence that the common law cannot be codified.

To date diversity in the laws of member states has survived attempts at full harmonisation. This has made it possible for member states to experiment in their search for efficient and workable rules, in a similar way to the U.S924.

This is one of the reasons that the General Secretariat of the European Council’s publication of a consolidated version of the conclusions of the Council on the setting up of a CFR emphasised that both the option of using the CFR to harmonise the contract law of member states by creating a European Civil Code and that of a CFR consisting of complete set of standard terms and conditions of contract law have been rejected in favour of an optional “tool box” for law makers to use if and when they deem appropriate925. The problem with this approach is that it is not mandatory and will therefore not deal with the fundamental problem of heterogeneity in the regulatory environment.

Progressing to full harmonisation with no freedom as regards implementation would be a step too far. The proposed European civil code assumes the selection and formulation of contract law rules is merely a technical exercise926. It fails to put into context the differences between

926 Op cit Schmid. C, 2010
existing national provisions and European code which would need to be bridged by interpretation.

Common law systems do not formulate around rules and as Legrand argues that there is “much law to be found beyond the rules”.

Consideration of human rights and social and economic depends more on judges in their realisation than on legislators.

Full harmonisation through a European Civil Code would pose a clear challenge to the identity of member states. It would influence the moral and social values of a community and it would of course affect a country's legal culture927.

There is also the question of competence with a move towards full harmonisation. As it stands, EU directives leave governance with the member states’ legislators, with disputes handled by national courts. A shift away from directives will inevitably lead to a shift in power with national legislators and national judiciary losing power to Europe. It is doubtful that the European judiciary would have the resources to carry the burden of a code for all twenty seven member states.

4.4.3 A Directive is the most Appropriate Approach to Regulate Franchising in the EU

Having considered the relative merits and difficulties offered by both directives and a European civil code, it is suggested that directives allow for a middle ground by providing partial harmonisation as they require member states to implement certain laws but give member states the freedom to choose how to implement it into their national law. This flexibility

“induces individual states to enter into a `race to the top' when they would have otherwise have an incentive do nothing or to compete on the basis of the withdrawal of protective standards known as the `race to the bottom”928.

Directives support the European single market without loosing the diversity and deep rooted legal culture of individual states.

By giving member states a number of options for implementation, as well as allowing for the possibility that existing, self-regulatory mechanisms can be used to comply with EU-wide standards, harmonisation through directives actually stimulates regulatory innovation instead of suppressing it929. This is a strong argument in favour of the use of directives as a method

927 Ibid
929 Ibid Deakin. S
of harmonisation, as it strikes the balance between traditional national governance and self regulation of member states and full harmonisation across Europe in support of the single market.

Directives are therefore the preferred approach to legal harmonisation in Europe. They allow member states to choose how and in which form they implement laws and Directives allow member states to preserve the diversity of their legal culture. They provide a more effective method of harmonisation by recognising that it would be difficult to mould common law principles under the umbrella of a civil code.

Further, given that the dynamics of franchising are such that it differs in its nuances in each jurisdiction and the commercial differences between each national market it would seem appropriate for a pan EU franchise law to be promulgated by way of a Directive which imposes minimum levels of regulation that can be fine tuned to meet any particular needs of each member state rather than a uniform Civil Code or Regulation.

However, whether a new EU franchise law be imposed by way of a Directive or a European Civil Code, the same substantive issues as to what the law contains apply.

4.5 **Difficulties likely to be encountered**

This is critical analysis towards the third objective of the thesis.

The European Franchise Federation and some of its member national associations will vigorously oppose any proposal to regulate franchising. The BFA has been visiferous in its opposition to regulation and openly boasts that over the past 10 years it has

“successfully prevented several misguided attempts to regulate franchising which would have seriously damaged franchising throughout the Common Market”.

Indeed, when the Chairman of the EFF suggested that the organisation might support EU wide regulation of franchising at a statutory level, the BFA led a palace coup to have him and the full board of the EFF removed. Any proposal to regulate franchising at an EU level is therefore likely to face aggressive lobbying in Brussels and elsewhere by the EFF and at least some of its national association members.

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930 See 3.4.2 above
931 Sir Bernard Ingham, Chairman of the BFA at the BFA Annual Convention, 2005
932 Riding. B. Franchise World, Feb/March 2008 p.29
In Italy, Belgium and Sweden the passage of franchise laws through the respective national legislatures was difficult and suggests issues that may cause difficulties during the adoption of a Directive to regulate franchising\textsuperscript{933}.

All three jurisdictions endured long, drawn out and politically divisive debates about detailed aspects of the regulation of franchising in their legislatures. It took seven years and eight bills in Italy, twenty four years and five bills in Belgium and nineteen years and twelve bills in Sweden to produce a franchise law.

The issues that arose in Italy were agreeing a definition of franchising, too strong a franchisee bias in proposed bills\textsuperscript{934}; an obligation for franchisors to register with the authorities\textsuperscript{935}; the

\textsuperscript{933} In contrast the passage of the franchise laws in France, Spain, Romania, Estonia and Lithuania offers little guidance as to what problems these might be. In France the only substantial amendment to the bill proposing the “Loi Doubin” was the inclusion in it of a requirement for certain further mandatory precontractual information. There was also some discussion on the length of this cooling off period, and the initial 10 day period in the bill was lengthened by 20 days. On December 31, 1989 the law (The Decree was published on April 4, 1991) was enacted with its first article becoming Article L. 330-3 of the French Commercial Code (French Commercial Code Article L.330-1 – See Appendix 10). In Spain the passage of the LRCP bill through the Senate was uneventful except for a couple of amendments. The first amendment proposed that bill include a definition of franchising and was made by the bill’s original proponent. It was accepted by the Senate without discussion. The second amendment, proposed by the socialist parliamentary group, unsuccessfully tried to include a further provision regarding “franchise sales”. The lack of any substantial debate of the Catalan proposal (either in Parliament or elsewhere) suggests that Section 62 merely reflects the LRCP’s overall public policy, as stated in the LRCP Preamble. This provides that the law is intended to structure, organize and ensure the adequacy of existing legislation regulating the retail distribution and distribution sectors and to reduce the substantial imbalances that existed between large and smaller companies. Two years later, Section 62 LRCP was further developed by Royal Decree 2485/1998, November 13th and again in 2006 by a further Decree without debate (Royal Decree 419/2006, April 7th amending Royal Decree 2485/1998, November 13th regarding Retail Commerce Planning relating to the regulation of franchising and creating the franchisors’ register). Both the Lithuanian and Estonian laws passed through the legislature unnoticed as part of a general legislative preparation for their admission into the EU. No parliamentary debate or commentary can be found in either jurisdiction. Franchising was insufficiently developed in either of the Baltic States to warrant any interest from busy legislatures in the absence of high profile abuse or sharp practice by franchisors. The Romanian experience was similar to that of the Baltic States and there appears to have been no parliamentary debate about the bill at all.

\textsuperscript{934} On 6th March 1997 Bill no. 2093 was proposed by Senator Ascuitti. Inspired by the franchise laws in France and Spain, it proposed both pre-contractual disclosure and the establishment of a franchisors’ register at the Chamber of Commerce. However the bill failed to propose a clear definition of franchising, making it difficult to understand the real nature of the contractual relationship to be regulated. Later the same year, members of the Chamber of Deputies proposed an alternative strongly pro franchisee anti-franchisor regulation. (Bill no. 3869 of 16th June 1997) (e.g. Article 5 provided that “the determined time of duration of the contract must guarantee a minimum duration so as to allow the franchisee to depreciate its stocks”; Article .6 provided “the right for the franchisee to return the stocks and all the tangible assets at certain condition” and Article. 7 proposed that “it establishes a specific regulation with regard to the limitations for the competition rights”.) The Bill was strongly objected to by franchisors and their trade body resulting in a further two bills being introduced the following year. Senator Caponi of the Communist Party introduced a bill, similar to, but much briefer than bill no. 2093 (17th June 1998 Bill No. 3361). A fourth bill introduced by Senator Gambini of the Left Democratic Party (Bill No. 3666 of 24 November 1998). This was based in part upon the expired EU Franchise Block Exemption\textsuperscript{934} and contained many glaring errors (for example, its proposal that a post term non-compete obligation imposed upon the franchisee would be valid for 3 years and conflicted with Article 3.1(c) of the EU Regulation. This provision stated that the franchisee could not carry out, directly or indirectly, any competitive activity which might endanger the franchisor’s business for a reasonable period no longer than 1 year within the territory where the franchisee had exploited the franchising licence). It attracted little support. However it did make an impact in one respect. It proposed that franchisors should have proven experience of

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proposed mandatory testing period for franchises with criteria set in stone by statute; the lack of certainty about the need to pilot a franchise and the need for franchisees to make earning claims\textsuperscript{936} and give details of investment required\textsuperscript{937}.

In Belgium the problems comprised a failure to take account of the complexities of the wide number of sectors (including production, industry, distribution and services) that franchising covers; the adequacy of self regulatory regimes existing under the national codes of ethics were seen as offering a high level of protection for franchisees\textsuperscript{938} \textsuperscript{939}; inaccurate research\textsuperscript{940}; inappropriate fetters on the franchisor’s ability to maintain quality standards\textsuperscript{941}; inappropriate rights of termination for franchisees\textsuperscript{942}; restrictions on the franchisors right of termination\textsuperscript{943}.
In Sweden, the problems comprised a proposal that employees of the franchisee be allowed to negotiate directly with the employer’s organisation to which the franchisor was connected\(^{944}\).

All of these difficulties need to be borne in mind when considering how the EU regulatory environment should be re-engineered.

### 4.6 Lessons to be Learned from other Franchising Regimes

This is critical analysis towards the third objective of the thesis.

Of the 21 non-EU jurisdictions with franchise specific laws, the USA and Australia offer the most relevant guidance as to how franchising in the EU might be most appropriately regulated. The USA was the first to regulate franchising over 38 years ago and has the most complete franchise regulatory regime in the world, whilst Australia has hands on experience of trying to make self regulation of franchising work before adopting its franchising Code of Conduct which has legal force under the Trade Practices Act.

They both have state and federal law and have therefore had to deal with the difficulties generated by the relationship between EU and member state law. The two jurisdictions have, however, chosen approaches that differ in a number of important aspects. Australia has dealt with this by, on the whole, having only federal law deal with the regulation of franchising. The USA has taken a different approach and exhibits a complex mix of both federal and state law.

Both jurisdictions therefore offer relevant learning as regards both the form and substance of an EU franchise regulatory regime.

#### 4.6.1 The USA

As in the EU, franchise regulation in the USA began on a state level. The first statute regulating franchising as we know it today was introduced in California in 1971\(^{945}\). However, by the end of the decade, the US had wholeheartedly embraced the need to specifically regulate franchising. Not satisfied with Federal regulation many states adopted their own franchise specific regulations. The state and federal franchise laws can be divided into three basic types. Those that regulate the sale of franchises, those that regulate the relationship between the franchisor and the franchisee and those that require the registration documentation on public registers. Some, such as the Californian law regulate all three.

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\(^{943}\) The Belgian House of Representatives, 17 March 2004, Doc 51 0924/001 Second sitting of 51st Parliament Article 8

\(^{944}\) Statens offentliga (SOU) 1987:17 “Franchising”.

The preamble of the California Franchise Investment Law, states that its intent is prohibiting fraud and providing

“each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered”.

It requires sellers to register a franchise prior to making an offer within the state and deliver an offering circular to the prospective franchisee. In due course 17 other states followed suit with an array of laws varying in reach and complexity. The FTC Rules subsequently introduced a federal dimension to the regulation of franchising in the USA, but the rules do not supersede the state laws, they merely add an extra layer of regulation.

Disclosure laws were enacted because of a fear that small investors were not receiving sufficient information about their potential investment before committing themselves. Those that regulate relationships and termination were adopted because of a concern that small businesses were being eliminated or taken over unfairly by their franchisors. The need for “good cause” and “just cause” were therefore introduced. During the 1970s 14 states plus Puerto Rico adopted relationship laws. These laws focus on prohibiting the termination or non-renewal of a franchise without good cause and prior written notice. They also deal with franchise transfers, impose a duty of good faith, prohibited discrimination between franchisees and allow individual franchisees a private right of redress through injunctive relief and damages.

This complex matrix of regulation imposes a substantial burden on franchisors and so since the 1970s there have been some attempts to harmonise the differing franchise laws. Some of these efforts were successful. For example the Uniform Franchise Offering Circular (“UFOC”) created by the Mid West Securities Commissioners Association, was copied by the North American Securities Commissioners Association and was widely used in those states that did not have a franchise law until 1 July 2008, when the new FTC Rule became mandatory and the Uniform Franchise Disclosure Document (the “UFDD”) replaced the UFOC. However, other attempts, such as for example the Uniform Franchise and Business Opportunities Act have not been successful. Even though this was adopted by the National Conference of Commissioners on Uniform State Law in 1987, the proposal has yet to be

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946 ibid.
949 Koch, D. W, The End of Franchising As We Know It; Federal Bar Association Annual Convention, Cleveland, Ohio Sept 22, 2000.
enacted by any state. (A similar fate may await any Common Frame of Reference adopted by the EU). There have also been numerous attempts to enact federal franchise laws which would replace or harmonise state laws. In 1990 the House Small Business Committee commenced a series of hearings about the need for further federal regulation of franchising. In 1992 the Chairman of the Committee, Representative John J. LaFalce, sponsored federal franchise laws dealing not only with disclosure but also relationship and termination issues. In 1993 Representative LaFalce introduced similar disclosure and relationship bills, but these failed to gain Committee approval. Undaunted by this failure though, the Congressman introduced another similar relationship bill in 1995, which also failed.

In 2007 the Federal Trade Commission’s Trade Regulation Rule “Disclosure Requirements and Prohibition Concerning Franchising” became effective. This fine tuned the differences between the FTC Franchise Rule and the UFDD.

The complexity of the US regulatory regime is well summed up by the fact that although the Federal Trade Commission (FTC) Franchise Rule, formally entitled “Disclosure Requirements and Prohibitions Concerning Franchising” (the new FTC Rule) clearly defines franchising, differing definitions have been adopted by fifteen states which have formulated their own franchising laws. The USA is a patchwork of overlapping and sometimes conflicting federal and state franchise laws. What constitutes a “franchise” varies considerably from state to state and both the “marketing plan” and “community of interest approach” are found. The marketing plan definition is more common and is used not only by the majority of States but also the FTC.

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950 CCH, ibid, p. 456.
951 See Chapter 4 above
952 CCH, ibid, p. 457.
954 See 4.5 above.
955 See 5.1 below for a fuller explanation.
956 It has the following elements:
(1) grant of a 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 exerts or has authority to exert a significant degree of control over the franchisee’s method of operation or provides significant assistance in the franchisee’s method of operation;
(3) the payment of fees is a condition of obtaining or commencing the operation of the franchise.
FTC Rule 436.1(h).
Most state and federal laws have a “de minimis” exemption threshold for a franchise fee\textsuperscript{957} element. If the franchise fees paid by the alleged franchisee do not reach this threshold, no “franchise” exists\textsuperscript{958}.

This lack of uniform approach to defining a franchise greatly increases the uncertainty and expense of franchising in the USA and is therefore a state of affairs that should be avoided in the EU.

4.6.2 **Australia**

The regulation of franchising in Australia rests on three basic pillars contained in the Trade Practices Act; Sections 51AD and 51AE; which prescribe the Franchise Code and make it mandatory; Section 51AC (which prohibits unconscionable conduct); and Section 52 of (which prohibits misleading or deceptive conduct) and the common law duty of good faith.

The Franchise Code applies to franchise agreements entered into, renewed or extended after October 1998 and ensures that Section 51 of the TPA is directly applicable to franchising by giving clear definition to what amounts to unconscionable conduct.

The mandatory code is designed to

> “……..induce behavioural change on the part of big business to smaller business, and to provide to small businesses that are unfairly treated, adequate means of redress."\textsuperscript{959}

and

> “assist franchisees and franchisors make an informed decision prior to entering into a franchise agreement and to provide a framework for dispute resolution"\textsuperscript{960}.

The Code regulates the franchising sector by ensuring that franchisors disclose relevant information and documents to prospective franchisees; franchisees are aware of their rights under franchise agreements and appropriate and cost effective dispute resolution mechanisms are available.

\textsuperscript{957} The FTC rule provides that a sale is excluded from the scope of the regulation if the total required payments by the franchisee before and during the 6-month period after the business opens do not exceed $500. The amount thresholds under the various state laws range from $100 to $500. The time period over which franchise fees are aggregated for purposes of the amount threshold also varies.

\textsuperscript{958} In a 1998 decision involving the Illinois Franchise Disclosure Act the US Court of Appeals in Chicago determined that a dealer’s payment of more than $1,600 for parts and service manuals over the course of eight years satisfied the statute’s $500 fee threshold. To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc., No. 95 C 0836, US 7th Circuit Court of Appeals (6 August 1998).

\textsuperscript{959} Franchising Code of Conduct – Department of Workplace Regulations and Small Business / Australian Competition and Consumer Commission 1 July 1998.

It is administered by the Australian Competition and Consumer Commission but may be enforced both by the government and by private civil actions. To date, the Franchising Code is the only mandatory industry Code prescribed under the TPA.

Since its introduction, there has been considerable ongoing debate in relation to the certain aspects of the Code. This led to a comprehensive review of the operation of the Code by the Franchising Policy Council. Following recommendations by the Policy Council, some amendments to the Code were made on 1 October 2001. Although the Regulations clarified some areas of concern, they did not address all the concerns of the franchise industry. It was further reviewed by the Federal government in 2006 and again in 2008, when the Commonwealth Parliamentary Joint Committee on Corporate and Financial Services held an enquiry into improving franchising conduct. The government’s response to the enquiry was published on 5 November 2009 which led to the creation of an expert panel on franchising.

The Franchise Code regulates the franchise relationship in a number of ways. It prohibits the general releases of liability in franchise agreements, requires that franchisors disclose materially-relevant facts not mentioned in the disclosure document, regulates when the franchisor may withhold consent to a franchise transfer, requires notice of termination and an opportunity to remedy a contract breach cited as the reason for termination, and establishes a mandatory alternative dispute resolution procedures.

4.6.3 How successful are the US and Australian systems?

The most striking characteristics of US franchise regulation are not its completeness and attention to detail but its complexity, relative lack of uniformity and obsession with form over substance. None of these recommend themselves as hallmarks of effective and appropriate regulation.

According to the Franchise Council of Australia the Australian system

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961 See below.
964 Clause 16 of Franchising Code of Conduct.
965 Ibid Clause 18
966 Ibid Clause 20
967 Ibid Clause 21
968 Ibid Clauses 24-31
“strikes an ideal balance between contractual freedom and flexibility that encourages growth and entrepreneurial behaviour, and regulatory intervention to support the contractual process and ensure informal and fair bargains are made”970.

It sees Australia as having

“the most comprehensive franchise regulatory system in the world”971

and declares that

“it is now widely accepted that Australian franchising is world’s best practice in the relationship aspect of the franchisor/franchise partnership”972.

It believes that this success is a direct result of the Franchising Code of Conduct and “Part 2” disclosure requirements. Together with the TPA, it considers these to provide “comprehensive legal protection from all forms of misrepresentation or illegal behaviour”973.

It relies upon the low level of franchise disputes in Australia to support these bold claims. Around 1% it is substantially lower than the 6% in the USA estimated by the International Franchise Association974. It also points to the success of mediation in settling franchise disputes in Australia. 75% of franchise disputes in Australia are settled by mediation, whereas in the USA arbitration and litigation are the norm.

Despite this apparent success, the changes being currently adopted975 evidence the perceived need to continuously reappraise the regulatory regime and ensure that it is fit for purpose. Notably, the Federal Government decided against a mandatory obligation of good faith in franchise agreements on the ground that it would “increase uncertainty in franchising”. The Minister for Innovation, Industry, Science and Research, Dr Craig Emerson has announced the establishment of an expert panel to advise what other changes, if any, should be made to the Franchising Code976.

So the US and Australian regulatory regimes suggest how the EU regulatory environment might be most appropriately re-engineered and what might best be avoided.

970 Ibid, Executive Summary 1.1.
971 Ibid, Executive Summary 1.2.
972 Ibid, Part B 1.5.
973 Ibid, Executive Summary 1.2.
974 Ibid, Executive Summary 1.1.
4.7 Conclusion

The European Commission is unequivocal in its belief that a regulatory environment comprising harmonised legal eco-systems is necessary to ensure that franchisors and other businesses can operate across borders efficiently.\textsuperscript{977} The current heterogeneous regulatory environment creates obstacles that hinder franchisors from taking full advantage of the single market. The same problem confronted commercial agency and was overcome by the adoption of a directive.\textsuperscript{978} Empirical research supports the case for harmonisation.\textsuperscript{979} The catalyst for such harmonisation could be either a directive or a common civil code. It is suggested that a directive is more appropriate. This is because the considerable difficulties involved in a common civil code means that proposals for a non mandatory common frame of reference have overtaken those for a common civil code and the non binding nature of such a “tool box” will not achieve the homogenised regulatory environment required.\textsuperscript{980} An examination of existing member state franchise laws suggests that there will be much debate about the substantive content of a franchise directive, whilst consideration of US and Australian franchise law offers suggestions as to what a franchise directive might contain.

\textsuperscript{977} See 4.1 above
\textsuperscript{978} See 4.2 above
\textsuperscript{979} See 4.3 above
\textsuperscript{980} See 4.4 above
Chapter 5  Re-Engineering the Regulatory Environment for Franchising in the EU

In previous chapters, this thesis has achieved its first and second objectives. It has also established that a directive is the best catalyst through which to re-engineer the EU’s regulatory environment so as to enable franchising to better fulfill its potential in the EU and that EU member state franchise law and that of the US and Australia offer useful guidance and to what a franchise directive might contain and the difficulties it may encounter. In doing so, the thesis has partly achieved its third objective.

This chapter contains critical analysis towards achieving the third objective of this thesis and suggests how the directive should seek to re-engineer the regulatory environment so that it can better fulfill its potential in the EU, by imposing a harmonised approach across the EU which aims to accentuate the impact of three commercial imperatives; promoting market confidence in franchising, ensuring pre-contractual hygiene and ensuring that the franchise agreement imposes a mandatory taxonomy of rights and obligations on the franchise relationship.

Franchising makes a positive contribution to the EU’s economy\(^ {981}\) and has the potential to make a still greater contribution. An EU franchise Directive should therefore promote and support the economic drivers that encourage franchisors and franchisees to become involved in franchising\(^ {982}\). It should also reduce the risks that face both franchisors and franchisees\(^ {983}\).

It is suggested that in order to achieve this, the EU’s regulatory environment should clearly define franchising and be re-engineered by accentuating the influence of three commercial imperatives on the legislative eco-systems. These are market confidence in franchising, pre-contractual hygiene and a mandatory taxonomy of rights and obligations which ensures that an appropriate level of protection is afforded to both franchisors and franchisees. This necessitates a clear definition of what franchising is and a re-engineering process that results in environmental dynamics that are targeted, transparent, proportionate, accountable and consistent\(^ {984}\).

In other words, the fundamental objective of an EU Franchise Directive must be to define franchising as a specific, distinct and uniform business structure, to enable both franchisors

\(^{981}\) See 2.2 above

\(^{982}\) See 2.4 above

\(^{983}\) See 2.4 above

\(^{984}\) www.berr.gov.uk/whatwedo/bre/index.html  The UK’s Department of Business and Enterprise and Regulatory Reform Better Regulation Executive.
and franchisees to access the advantages which encourage them to become involved in franchising\textsuperscript{985} and to reduce, but not remove all of the risks involved\textsuperscript{986}.

An over-regulated environment with no chance of market failure or financial scandals would be undesirable as it would stifle innovation and competition\textsuperscript{987}. It would be undesirable as it would discourage companies from franchising out their businesses. This is supported by recent research in the US\textsuperscript{988} which shows that over regulation leads to a reduction in both the number of franchised units and the total number of chain outlets. Regulation must set, promote, monitor and enforce high standards, in order to contribute to the soundness of the system as a whole and to promote consumers’ and institutions’ confidence in its strength and integrity\textsuperscript{989}.

It is therefore important that a balance is struck between the need to afford protection to many of those entering into a commercial enterprise or making a financial investment on the one hand and the commercial risk that naturally arises for anyone wishing to enter into a potentially money making enterprise, on the other\textsuperscript{990}.

It is suggested that it should do this by establishing franchise agreements as “type” or “nominate” contracts with mandatory and essential terms that seek to preserve the above advantages and reduce the above risks, create a scheme of incentives to encourage business to adopt franchising as part of their market strategy and create an educational infrastructure to support potential franchisees in deciding whether or not to buy a franchise.

This approach has only been adopted by two of the EU member states that have adopted franchise laws\textsuperscript{991}. In the rush to regulate franchising in EU member states, be it by franchise specific legislation or the application of the general law, there has been little thought as regards what the overall purpose of the regulation is, or should be. It rarely goes beyond a

\textsuperscript{985} See 2.4 above  
\textsuperscript{986} See 2.4 above  
\textsuperscript{987} FSA, \textit{A new regulator for the new millennium}, January 2000.  
\textsuperscript{988} Klick, Kobayashi, Ribstein, “The Effect of Contract Regulation: The Case of Franchising”, George Mason Law & Economics Research Paper No. 07-03, 2\textsuperscript{nd} Annual Conference on Empirical legal Studies Paper, FSU College of Law, Law and Economics Paper No. 07/001. Based upon the impact of the Iowa Franchise Law of 1992, which is uniformly regarded as unfavourable to franchisors. In addition to preventing termination at will by the franchisor, the Iowa requires that franchisors allow franchisees a right to remedy any defect and restricts waiver and choice of law clauses.  
\textsuperscript{989} Financial Services Authority, an outline, 28 October 1997.  
\textsuperscript{990} One of the draft bills placed before the Belgian Chamber of Deputies, whilst advocating the regulation of franchising acknowledged that; “As in all commercial sectors, there are clearly franchisees who consider that they have suffered loss as a result of the agreements they have entered into. However ….. these franchisees are in the minority, as 70\% of franchisees are satisfied with their contracts. It is therefore necessary to place this information which is occasionally tainted with sensationalism in context. This does not mean however that those franchisees suffering loss do not merit protection. The matter should be treated in a way which does not adversely affect either the franchisors or the franchisees”. The Belgian House of Representatives, 30 Oct 2003, Article 16, Doc 51 9361/001.  
\textsuperscript{991} Lithuania and Estonia. But neither has imposed appropriate mandatory terms.
general feeling that franchisees are unsophisticated “consumers” who are often investing their life savings into complex businesses that may be run by unscrupulous business people with a great deal more experience and little regard for the franchisee’s welfare. The conclusion drawn is that they therefore deserve some kind of extra protection against being unfairly exploited.

As Terry comments,

“the world has embraced the US franchising concept but not the manner of its regulation”992.

This lack of clarity and homogeneity has created difficulties and complications with the regulation of franchising in the EU.

5.1 Defining Franchising

This section provides critical analysis towards achieving the third objective of the thesis.

Following the discussion in section 2.5.2 above, it is suggested that a definition of franchising should follow the Shared Marketing Plan approach and that franchising be established as a new “type agreement” by adopting an “Exchange of Benefits” approach, that affords franchisors a number of advantages in return for accepting a reasonable level of regulation.

5.1.1 The Need for a Definition

Establishing a working definition of franchising is an essential part of a Directive for at least four basic reasons993.

Firstly a clear definition helps would-be franchisees assess, with a greater level of confidence, whether a business proposition is all it appears to be i.e. a definition can become a benchmark for potential franchisees. Secondly, a precise definition makes it easier to understand the size and role of franchising in the EU by differentiating it from other types of third party relationships. Thirdly, a sharper definition makes it easier to identify those schemes that are either ill-conceived or fraudulent. Fourthly, a clear definition may help to ensure that any regulation is appropriately phrased.

However, although most of those considering the regulation of franchising generally agree that

“it is necessary to have a clear-cut definition of franchising”994,

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993 Op cit Felstead
994 Italian President Caponi, Corriere della Sera on December 9th, 1997.
this is not the unanimous view\textsuperscript{995}.

5.1.2  Definitions are Self-Serving

It is not surprising that all the definitions of franchising reflect the interests and concerns of the bodies or individuals providing them. Legislators are naturally trying to define a type of commercial behaviour that they wish to regulate. Trade bodies are trying to determine what types of business they wish to join them. Academics are more interested in the legal and economic dynamics at play than commercial reality. It is therefore only natural that the definitions emanating from such different sources often exhibit material differences to each other.

It must be borne in mind that individuals and organisations will produce a definition that best suits their own purpose. So, a trade association, an academic and a legislator will be seeking to achieve different ends by framing a definition of franchising. It is therefore perhaps inevitable that they will produce definition that differ from each other.

5.1.3  Questioning the Need for a Definition

Some, following the French and Belgian lead, question the value of any definition\textsuperscript{996}, as it

“is less important than a model or “ideal type” which will enable the area of economic activity with which we are concerned to be identified”\textsuperscript{997}.

Definitions can create problems of their own. Immediately a definition of franchising is adopted by the legislature in any jurisdiction, lawyers consider whether it is advantageous or disadvantageous for their clients to be deemed a franchise and then commence drafting their contracts and advising their clients to structure their businesses accordingly. In other words legal definitions can become the issue more than the business practices being controlled by them. Alluding to this problem one of the bills placed before the Belgian Chamber of Deputies stated\textsuperscript{998};

\textsuperscript{995} The French “Loi Doubin”, Law No. 89-1008 dated 31 December 1989 does not seek to define franchising.

\textsuperscript{996} Op cit Adams and Jones, p.23

\textsuperscript{997} They offer what they see as the three characteristics of franchising. These are “(1) relatively long term relational contracts (usually five years or more); (2) in which an independent undertaking carries out tasks which were, or might have been, carried out by the franchisor undertaking; (3) a relatively high degree of integration of the franchisee undertaking’s business systems and activities and those of the franchisor undertaking” (Ibid Adams and Jones, p.23).

\textsuperscript{998} The Belgian House of Representatives, Extraordinary Session, 8 October 2003; Introduction to Draft Parliamentary Bill Concerning pre-contract information in relation to contracts by which one person grants to another the right to carry on commercial activities (lodged by Mme Anne Brazing and MM. Serge Van Overt veldt and Philippe Collard).
“the problems encountered by a number of businesses do not arise in franchise networks strictly so called, but rather in commercial situations which are similar to franchise agreements (independent management agreements, sales concessions, know-how licences, commission agencies, commercial partnerships etc). One should therefore be aware that the regulations should apply also to these other distribution systems, which are not limited solely to franchise agreements. Otherwise the regulations would not have their desired effect. What would be the use of regulating solely franchise agreements when most contracts outwardly showing franchise characteristics, but which are not in fact franchise agreements, would not be subject to this regulatory regime? Unscrupulous franchisers would quickly be able to steer clear of franchise agreements by adopting formulas less all-embracing or advanced as the franchise, to the detriment of franchisees, in order to escape regulations which would otherwise defeat this objective. If a new law is to be introduced it must cover all types of agreement closely allied to franchise contracts”.

This seems to be the view of the French government as when it enacted the Loi Doubin to regulate franchising, it opted to avoid the need to define it and instead decided to merely describe the main characteristics of a business that has a network of third parties using the same brand999. The Belgian government subsequently opted for the same approach1000.

5.1.4 The Proposed Definition

Maintaining market confidence in franchising means that an appropriate definition of franchising is essential1001. This inevitably determines the scope and therefore the commercial impact of an EU franchise directive.

Although there is debate over whether or not it is worthwhile attempting to define franchising and if so how should it be done, it is suggested that in order to effectively regulate it, a “clear cut definition” of franchising1002 is imperative. The difficulty is how best to achieve this push for the black and white in a world of grey. A definition must facilitate the more effective regulation of franchising. The regulative approach proposed is one that not only regulates the actions of franchisors but also extends them certain commercial advantages. The definition must therefore have a qualitative threshold to it. A business can only be a franchise and therefore enjoy its privileges if it clears that threshold. This is dealt with in the definition by the requirement for a “track record”.

1000 Law of 19 December 2005 relative to pre-contractual information in the framework of agreements of commercial partnerships.
1001 Also see Chapter 2 p. 1 for other reasons to clearly define franchising.
1002 Italian President Caponi, addressing the Italian Parliament on 9 December 1997.
A shared marketing plan or prescribed system approach\textsuperscript{1003} which borrows from both the European Franchise Federation’s definition and the Italian franchise law is suggested as follows;

<table>
<thead>
<tr>
<th>“A Franchise exists where</th>
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<tbody>
<tr>
<td>(a) one party (the “Franchisor”) who owns or has the right to license other parties to operate a business format offering, supplying or distributing goods or services or both</td>
</tr>
<tr>
<td>(b) grants another party (a “Franchisee”)</td>
</tr>
<tr>
<td>(c) the right to carry on a business using that business format under a system or in accordance with a marketing plan substantially determined, controlled and/or suggested by the Franchisor or one of its associates or otherwise assisted by the franchisor or one of its associates (a “\textit{Shared Marketing Plan}”).</td>
</tr>
<tr>
<td>(d) The operation of the business must be substantially or materially associated with a brand owned, used or licensed by the Franchisor or an associate of the Franchisor.</td>
</tr>
<tr>
<td>(e) The Franchisee will pay monies to the Franchisor or its affiliate, by way of, for example only:</td>
</tr>
<tr>
<td>(i) an initial capital investment and/or</td>
</tr>
<tr>
<td>(ii) a payment for goods or services and/or</td>
</tr>
<tr>
<td>(iii) an ongoing or periodic fee of any discharge from and/or</td>
</tr>
<tr>
<td>(iv) a training fee and/or</td>
</tr>
<tr>
<td>(v) repayment for a lien made by the Franchisor.</td>
</tr>
<tr>
<td>(f) A business using the business format has been operated by the Franchisor or its affiliate for a period of 12 months.</td>
</tr>
<tr>
<td>(g) For the avoidance of doubt, a franchise does not include, motor vehicle dealerships, employee/employer relationship, agencies, landlord and tenants and co-operatives.”</td>
</tr>
<tr>
<td>(h) An affiliate is an entity in which the Franchisor has a controlling interest.</td>
</tr>
</tbody>
</table>

\textsuperscript{1003} See Chapter 2 pp. 24-27.
It is important to consider the main elements of this definition.

### 5.1.4.1 Shared Marketing Plan

Under this definition, a franchise does not have to expressly prescribe a Shared Marketing Plan

“Control reserved over terms of payment by customers, credit practices, warranties and representations in dealings between franchisees and their customers, suggest a uniform marketing plan”

as do

“provisions concerning collateral services, which may or may not be rendered, or prohibiting or limiting the sale of competitive or non-competitive goods”\(^{1004}\).

The key issue is the imposition of a duty to observe

“the licensor’s directions or obtaining the licensor’s approval with respect to selection of locations, the use of trade names, advertising, signs, sales pitches, and sources of supply, or concerning the appearance of the licensee’s business premises and the fixtures and equipment utilized therein, uniforms of employees, hours of operation, housekeeping, and similar decorations”\(^{1005}\).

“A marketing plan or system is “prescribed” where a specific sales program is outlined, suggested, recommended, or otherwise originated by the franchisor”\(^{1006}\).

So, a sales program may be “prescribed” by the franchisor where it supplies the franchisee with sales aids or props, such as demonstration kits, films, or detailed instructions for personal introduction and presentation of the product, possibly including the text of a sales pitch and especially where such a program is supported by training materials, courses, or seminars\(^{1007}\). This view of a prescribed plan is not unique to California\(^{1008}\).

It is preferable to adopt the broader definitions adopted by States such as Illinois, Rhode Island, Washington, and Wisconsin which take the view that the marketing plan or system does not have to be prescribed but it can merely be suggested in substantial part by a

\(^{1004}\) California Department of Corporations, Release 3-F (Revised) at B(2)(c) (June 22, 1994) (“CA Release 3-F”), reprinted at http://www.corp.ca.gov/Commissioner/Releases/3-F.asp.

\(^{1005}\) ibid.

\(^{1006}\) ibid.

\(^{1007}\) ibid.

franchisor\textsuperscript{1009}. This is because the benefits being offered to franchisees must not be offered too widely. They must be restricted to well structured businesses that are clearly providing a business format.

Whereas many jurisdictions require the payment of a franchise fee\textsuperscript{1010}, only some require a minimum payment\textsuperscript{1011}. It is proposed that there would be no minimum value of fees in the European law as it opens the door to the structuring of payments so as to avoid coming within the definition of a franchise.

5.1.4.2 Trademarks

The role of the trademarks also needs to be considered. There are a variety of approaches. For example, whereas California requires substantial association with the franchisor’s trademark\textsuperscript{1012}, New York does not require the use of a trademark at all. Rather, a business arrangement will constitute a franchise if either the franchisor offers a marketing plan or permits the sale of trademarked goods or services. In Hawaii, Minnesota, and South Dakota, it is sufficient for a franchisor to grant the franchisee the right to use the franchisor’s trademark\textsuperscript{1013}. As the brand is a fundamental element of a franchise, its use is specifically included in the proposed definition. The bigger issue is how the brand is used by the franchisee.

The US Federal Trade Commission (FTC) Franchise Rule, (which also adopts the shared marketing plan approach) uses the phrase “identified or associated with” the franchisor’s mark as do states such as California that require that the franchisee obtain the right to use the franchisor’s mark. For example, “a service-oriented franchise operated out of a home, as opposed to a storefront, might not have a sign with the franchisor’s logo, or unique uniforms associated with the franchisor. Although the franchisee’s “association” with the franchisor’s mark may be limited (such as the right to use the franchisor’s mark on business cards, advertising, and in yellow page listings), it is sufficient to trigger the Rule’s disclosure obligations: in such circumstances, the use of the franchisor’s trademark leads consumers to identify the business with the franchisor”\textsuperscript{1014}. States such as California, which uses the phrase “substantial association” with the mark, recognize that the grant of permission to use a

\textsuperscript{1012} California Department of Corporations, Release 3-F (Revised) ibid
\textsuperscript{1014} Code of Federal Regulations Rule 16 Part 436.2
franchisor’s trademark in the operation of a business would constitute “substantial association” with the mark.\footnote{See CA Release 3-F at 3 (“[I]f the franchisee is granted the right to use the franchisor’s symbol, that part of the franchise definition is satisfied even if the franchisee is not obligated to display the symbol.”).}

It is interesting to note that in its Staff Report, the FTC however rejected the need for association to be substantial on the basis that the need to show “substantial use” imposes a new and unnecessary burden of proof\footnote{Federal Trade Commission Disclosure Requirements and Prohibitions Concerning Franchising Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436) – Bureau of Consumer Protection August 2004 pp. 42.}. The proposed definition overcomes this by requiring that the business is substantially or materially associated with the brand.

**5.1.4.3 Minimum Standard**

The European Franchise Federation\footnote{www.eff-franchise.com} requires that franchisors

> “have operated a business concept with success, for a reasonable time and in at least one pilot unit before starting its franchise network”.

The Italian franchise regulation has expanded on that requirement and requires the franchisor to have tested the concept for at least one year before it is franchised.\footnote{Law of 6 May 2004, No. 129 Article 3.2.}

It originates from the non statutory requirement found in the Code of Ethics of the European Franchise Federation\footnote{EFF’s European Code of Ethics 19th September 2008.} (and in turn the Italian Franchise Association\footnote{Regulations of the Italian Franchise Association, effective January 1 1995, Article 2: “Prior to the establishment of its own franchise system, the franchisor shall have implemented its formula in the market for a minimum period of one year, with at least a pilot unit, if applicable”.}) for franchisors to have at least one-year’s experience of their business formula before embarking upon the roll out of their franchise\footnote{The original proposal (in the draft bill approved by the Senate on March, 25th 2003 was far more challenging than the provision finally incorporated in the franchise law. It provided for a two-year testing period carried out through at least two pilot units, located in different cities. The “Test Period” was deemed to be necessary because, “...cases of inexperience and improvisation may generate a serious litigation…” (Senator Gambini in the XIII Legislature ). However, there was a fear that the test period – at one point proposed to be 3 years – would severely compromise the commercial success of franchises as it would rob them of many of the advantages that being first to the market brings and so giving non franchised concepts an unfair commercial advantage. In the first draft it was expressly stated that it had to be piloted in the Italian market. This effectively created a barrier to freedom of trade within the EU so contravening a basic tenant of EU law. There was also concern that the provision would discourage foreign franchisors from entering the Italian market. These concerns were acknowledged and the current text of the law, provides that the “testing period” must be based upon the criteria of reasonableness and flexibility. Following the comments of the Commission for Constitutional Affairs (Remarks made on October 7th, 2003) that, “the present formulation of the law might involve an unjustified limitation of economic initiative” the meaning of “the market” was also amended to mean any market, be it in Italy, Europe or elsewhere in the world.}. No minimum period of time is stated for the testing period. All that is required is that the results are disclosed to potential franchisees in a full and unambiguous
manner. The only other jurisdictions in the world which have this requirement are China and Vietnam\textsuperscript{1022}.

Like China, Italy ultimately rejected the suggestion that the pilot should be in its domestic market, due to the commercial inappropriateness of such a provision. It effectively creates a barrier to entry into the market.

Subjecting new franchisees to the rigorous regulatory regime proposed by this thesis from day one has the appeal of being straightforward, but could create substantial barriers to new entrants who are franchising their businesses because, inter alia, they lack capital and/or management resource\textsuperscript{1023}. It is therefore proposed that before franchisors are required to take on the burden of complying with the proposed franchise regulation and can enjoy the consequential benefits they establish a “track record”. That is that they must have operated a business using the business format for twelve months or be operating, either by itself or through franchisees a total of four outlets. Forbidding a business to franchise out its business without complying with the regulation would be too arduous for new entrants. However, in practice, it is suspected that many new entrants will decide that it is more efficient to seek to comply from day one so as to avoid the duplication of effort involved in redrafting their documentation so soon after starting and in order to take advantage of the “Exchange of Benefits” offered to established franchisors.

Another advantage of the initial period is that it enables potential franchisees to have the opportunity to consider the achievements of a year’s trading and base its decision whether or not to buy the franchise partly upon that information.

Some commentators have suggested that before granting a franchise to a party within an EU member state a franchisor should operate a pilot operation in that member state for a 12 month period. The justification for this proposal is that without experience of a particular member state a franchisor cannot properly franchise in it, although it is not justified in any meaningful way. If this approach were adopted it would in effect freeze foreign franchisors

\textsuperscript{1022} In China Franchisors are required to establish and operate two company-owned units for more than one year before granting franchises to third parties (Article 7 of the Regulation on Administration of Commercial Franchises 2007). In the earlier regulation, the pilot had to be in China, but the current law removed this requirement, mirroring the debate in Italy as to where the pilot operation has to be. In Vietnam, pursuant to Article 2 of the Commercial Law of 2001, which came into force on 1 January 2006, a franchisor must be a lawfully established enterprise either in Vietnam or in a foreign country and a franchise can only be granted to a franchisee who has a Vietnamese business licence (Article 6 of Decree No 35/2006/ND-CP issued by the Government to regulate franchises). In addition, the franchise system must have been in operation for at least a year before a franchise can be granted. In the case of a sub-franchise granted to a Vietnamese master franchisee, the Vietnamese master franchisee must have operated the franchise business for at least a year before it can grant sub-franchises to unit franchisees (Article 5(1) of the Decree No 35/2006/ND-CP).

\textsuperscript{1023} See section 2.4 below. The so-called Agency Theory and Transaction Cost Theory, supported by empirical evidence obtained from the research done for this thesis.
out of smaller member states such as the Baltic States, the Czech Republic, Slovakia and Slovenia. For this reason it must be rejected. The experience of both Italy and China has been that such a parochial approach is unworkable on a national level. The diverse economic and cultural profile of the EU makes it worthless on an EU level.

Given the structures generally used for international franchising it would also seem to be inappropriate to require that testing be carried on in the EU. Such a requirement would probably make it very difficult for smaller non EU franchisors to enter the EU market. In order to comply with such a requirement smaller non EU franchisors would probably have to use joint venture structures. Whilst these are often used for more substantial businesses and by more sophisticated players, it is doubtful that they would be appropriate for smaller, less sophisticated and less well resourced franchisors. Further, with appropriate expert advice franchisors could work the structure to circumvent the main intent of the regulation by still placing the real burden of the EU pilot operation on the joint venture partner.

It is therefore recommended that in order to come within the definition of a franchise a business must have been operated for a 12 month period in any market, not necessarily one in the EU. This avoids burdening small start up businesses with too heavy a regulatory burden, so reducing barriers to entry. Such small businesses are unlikely to have a material adverse impact on the market. However, they should not be able to afford themselves of the benefits afforded to franchisors\footnote{Such as retail price control in the network and the ability to control a multi channel sales strategy}.

The definition of a franchise must focus on substance rather than form. Merely because a business relationship is called a “franchise,” does not mean it should be treated as one if the relationship does not satisfy the definition. “Misdescriptions” of a business relationship as a franchise should not bring it within the definition of a franchise. This definition aims at both describing the essential elements of the business relationship and “qualifying” each system on the basis of its track record to enjoy certain privileges extended to franchise systems.

5.1.5 Sub-conclusion

It is suggested that franchising be defined in accordance with the Marketing Plan approach that originated in the US and is found in various forms in six of the eight EU member states with franchise specific regulations. It focuses upon independence, economic interest, the brand, the business format, control and ongoing support. It also includes a qualitative threshold to ensure that the advantages of being a franchise are only available to businesses that have a track record and that start up franchises are not overwhelmed with regulatory requirements. A franchise that has not operated the business format for at least 12 months or
which is operating less than four outlets will not have to comply with the regulation and cannot enjoy the “Exchange of Benefits”.  

5.2 hochacentrating the Influence of Commercial Imperatives on the EU’s Legal Eco-Systems

This section provides critical analysis towards achieving the third objective of this thesis. Following the discussion in section 2.3 above about why people get involved in franchising, it is proposed that in order to enable franchisors and franchisees to access the economic drivers that attract them to franchising and reduce the risks involved, the regulatory environment must accentuate the influence of three distinct commercial imperatives on the legislative eco-systems. It must maintain market confidence in franchising as a way of expanding a business; maintain pre-contractual hygiene by increasing understanding of franchising amongst potential franchisees and ensure that they have access to information that allows them to make an informed decision; and impose a mandatory taxonomy of rights and obligations to protect the fundamental interests of both franchisors and franchisees. These commercial imperatives are not unique to franchising. They apply to many regulatory systems and are articulated well in the UK’s Financial Services and Market Act 2000. It is suggested that these three “commercial imperatives” should have a key influence on the way in which the regulatory environment for franchising in the EU is re-engineered.

5.2.1 Identifying the Commercial Imperatives

The first “commercial imperative” is the need to maintain market confidence in franchising and so ensure that it is used as an effective route to market by a wide spectrum of businesses across the single market. Unless franchising is regarded by companies as an attractive way of growing their business both domestically and across borders in the EU, it will never be able to help them expand their networks or make its full potential contribution to the growth of the single European market, which will suffer as a consequence. Market confidence is essential. Maintaining market confidence,

“involves preserving both actual stability …. and the reasonable expectation that it will remain stable”.  

1025 See 5.3 below
1026 These criteria are based on the Financial Services and Markets Act 2000 (FSMA) which suggests four objectives that apply equally to the regulation of other areas of commerce, including franchising. FSMA 2000 Part 1, Sections 2(1), 3, 4, 5 and 6. The fourth objective, prevention of crime, is not appropriate for franchising due to a comparatively low level of criminal activity in the franchise sector and the adequacy of existing criminal sanctions due to the relative lack of sophistication of crime involving franchising as compared to that involving financial services.
1027 FSMA 2000 Part (1) Sections 3, 4, 5 and 6
It is therefore essential that the re-engineering of the regulatory environment for franchising in the EU accentuates the influence of this factor on the various legal eco-systems.

The second “commercial imperative” is a matter of pre-contractual hygiene. Unless potential franchisees fully understand what they are getting into when they buy a franchise, (that it is not a guarantee of success which allows them to abdicate any responsibility for their own performance), there will always be an inappropriately high level of disputes between franchisors and their franchisees. Increasing understanding amongst potential franchisees means “promoting awareness of both the benefits and risks” associated with the commercial activity being regulated and, “the provision of appropriate information and advice”\(^{1029}\). This means that regulation has an educational role in improving general understanding of franchising amongst potential franchisees and ensuring that relevant information is made available to them in good time and in an appropriate form, so rectifying the severe imbalance of information between potential franchisees and franchisors. It is therefore essential that the re-engineering of the regulatory environment creates an educational infrastructure that ensures that potential franchisees have access to appropriate information and accentuates the influence of this factor on the EU’s legal eco-systems. It is also essential that potential franchisees are given full access to the information that will enable them to take an informed decision as to whether or not they should purchase a particular franchise.

The third “commercial imperative” is that the terms of the franchisor/franchisee relationship, as captured in the franchise agreement, must afford such protection to the parties that the economic drivers which attract them to franchising are supported and re-enforced and the consequential and inherent risks are reduced to an appropriate level. There should be a mandatory taxonomy for franchise agreements.

The appropriate level of protection afforded to franchisees and franchisors can be measured by reference to the differing degrees of risk involved for each party; the differing degrees of experience and expertise that the parties may have; and the general principle that individuals should take responsibility for their decisions\(^ {1030}\).

As a result, a franchise directive must aim to ensure that both parties receive clear and adequate information about each other and the risks involved. It must also recognise the parties’ responsibility for their own decisions, whilst aiming to ensure that they are not exposed to risks that they should not reasonably be expected to assume.

An effective franchise directive must therefore maintain market confidence in franchising, ensure pre-contractual hygiene and provide adequate protection to franchisors and

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\(^{1029}\) FSMA 2000, Section 4.

\(^{1030}\) FSMA 2000, Section 5(2).
franchisees. All this must be done in a manner that does not stifle innovation and competition.

5.2.2 The current impact of Commercial Imperatives

As is evident from the discussion in Chapter 3 above\textsuperscript{1031} the EU’s current regulatory environment does not focus upon accentuating the impact of these three Commercial Imperatives on its constituent legal eco-systems. None of the legal eco-systems endeavour to promote market confidence, educate potential franchisees, ensuring that they have an appropriate level of information to enable them to take an informed decision about their prospective purchase and provide adequate protection for both franchisors and franchisees on either an EU wide or national basis.

Whilst EU member state franchise laws all seek, on a member state basis, to reduce misconduct by franchisors and maintain market confidence by imposing a degree of stability in their individual national markets, the lack of uniformity of approach and content means that on an EU level they lead to instability. They all fail to protect the franchisor’s legitimate interests.

The Loi Doubin\textsuperscript{1032} requires the proprietor of a network in France working under a common brand to make pre-contractual disclosure 21 days before contract. However, it does nothing to try and ensure that this information is imparted in a manner that potential franchisees will easily understand or to try and ensure that they are educated about the need to take and follow advice about what is revealed by it. Nor does it identify franchising as a specific form of business and differentiate it from other forms of licensing, agency and distribution. It therefore does nothing to promote market confidence in it and encourage the use of franchising in preference to other forms of branded networks. As it deals only with disclosure it also fails to deal with the risks involved for both parties or support the commercial drivers that attract franchisors and franchisees to franchising.

German law does not categorise franchising as a “type agreement” and does nothing to promote it as a way of doing business. Likewise it does nothing to educate potential franchisees. It does seek to address the way in which the balance of the franchisor/franchisee relationship is reflected in the franchise agreement\textsuperscript{1033}, although this is from the perspective of there being an inherent imbalance of bargaining power between the parties and a need to

\textsuperscript{1031} See 3.18 above
\textsuperscript{1032} Commercial Code Article L.330-3 (Article 1 of the “Loi Doubin”, Law No. 89-1008 dated 31 December 1989).
\textsuperscript{1033} See 2.5 above
apply commercial agency, consumer, employment and other laws to redress the balance in favour of the franchisee. It therefore fails to deal with the commercial imperatives.

The “caveat emptor” approach of English law and a relative lack of relevant jurisprudence means that it fails to promote market confidence in franchising, does nothing to promote pre-contractual hygiene and is loathe to interfere in the detail of the commercial bargain struck by the parties.

None of the other member states have adequately tackled the commercial imperatives with their franchise focused laws either.\textsuperscript{1034}

The regulation of franchising in the other seven EU member states that have specific franchise laws also lacks any real harmonisation and so fails to promote confidence in franchising as a way of exploiting (and so expanding) the single market.

5.2.3 The impact of the Commercial Imperatives on proposals to re-engineer the EU’s regulatory environment?

Neither of the two main proposals to re-engineer the EU’s regulatory environment for franchising (the Amsterdam Team’s proposal for a Common Frame of Reference and UNIDROIT’s proposal for a model franchise law) focus on the three Commercial Imperatives.

Although the Study Group describes itself as being composed of experts who work

“with the benefit of and from the standpoint of current legal science”,\textsuperscript{1035}

\textsuperscript{1034} The Spanish law (Act 7/1996 and Royal Decree 2485/1998) provides for both disclosure and the registration of franchise documentation but does promote market confidence in franchising in any meaningful way. The registration requirement is an attempt to help educate potential franchisees but it fails in part due to its lack of effective implementation and in part to the inherent shortcomings of a registration system. The Spanish law fails to acknowledge the risks accepted by franchisors. The Italian law (Law of 6 May 2004, No. 129 Article 1.1) fails to promote market confidence in franchising and fails to recognise the risks accepted by franchisor or seek to educate potential franchisees. The Belgian (Law of Commercial Partnerships—enacted in 2005 and came into force on February 1 2006) law takes a very heavy handed and paternalistic approach to protecting franchisees but fails to maintain market confidence in franchising. It fails to recognise the risks accepted by franchisors or the principle that franchisees should be responsible for their own actions and no attempt is made to educate potential franchisees. The Swedish law (Franchise Disclosure Law No. 2006:484 – came into force on October 1, 2006) fails to effectively protect the interest of franchisors and franchisees and also fails to recognise the risks accepted by franchisors and promote franchising as a way of business. It also fails to educate potential franchisees about it. Although by adopting a franchise law the Romanian, Estonian and Lithuanian legislatures were in a limited way attempting to promote the use of franchising and educate potential franchisees about it, they have failed. The Estonian (Estonian Law of Obligations Act) and Lithuanian (Lithuanian Civil Code Articles 6.766 to 6.779) laws merely acknowledge the existence of franchising with rather turgid and ineffective provisions. They do not even provide for pre-contractual disclosure. The Romanian law (Ordinance no 52/1997 of 28 August 1997 on the law governing franchising, modified by Law 79/1998) fails to provide franchisees with adequate protection. None of these laws seek to protect the franchisor’s legitimate interests.

\textsuperscript{1035} The European Parliament (OJ C 158 (28.6.1989), resolution of 26th May 1989; OJ C 205 (25.7.1994), resolution of 6th May 1994) supports and some member states (The Speech by the Dutch Minister of Justice
It fails to address the first commercial imperative – maintaining market confidence - as it does not adequately capture franchising’s fundamental nature. It defines franchising as

“the rights granted by a party (the franchisor) authorising and requiring another party (the franchisee) in exchange of direct or indirect financial compensation to engage in the business of selling goods or services on its own behalf under a system designated by the franchisor…”.

There is no mention of the brand, the franchisor’s control of the franchise or the support provided to the franchisees by the franchisor, which sets franchising apart from mere distribution\(^{1036}\). Its view of franchising is rooted in the civil law view that it is not a “type agreement” and so should have the law of “type agreements” such as commercial agency and distribution applied to it by analogy\(^{1037}\). It therefore fails to produce recommendations that maintain market confidence in franchising and encourage its use. The Study Group’s lack of familiarity with the reality of franchising runs throughout the proposals and its failure to distinguish between franchising, agency and distribution undermines all of the Study Group’s recommendations.

The Study Group Chapter fails to address the second commercial imperative – pre-contractual hygiene (educating potential franchisees and ensuring that they are given appropriate

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\(^{1036}\) However, rather inconsistently, the later provisions do refer to the franchisor providing ongoing assistance to the franchisee. Article 3:101 Commercial Agency, Franchise And Distribution Amsterdam Group 8th Draft (21 May, 2003). See Appendix 10.

\(^{1037}\) Commercial Agency, Franchise And Distribution Amsterdam Group 8th Draft (21 May, 2003).
information) - because although it proposes a full set of rules for franchising, it makes no suggestion as to how potential franchisees can be educated into taking appropriate advice before they enter into a franchise agreement and use the information disclosed to them to make an informed decision as to whether they should enter into the franchise. Further, the rules proposed are both excessive and inappropriate. They fail to deliver an appropriate balance between the economic drivers that encourage the parties to become involved in franchising and the consequential inherent risks.

The chapter focuses upon the third commercial imperative, seeking to ensure that the franchisors’ and franchisees’ interests are protected. Although it proposes certain mandatory clauses that are reasonable and underpin some of the economic drivers of the relationship, it fails to appreciate where the balance between the interests of the franchisor and franchisee lies and so seeks to over protect the franchisee thereby eroding some of the economic drivers that attract franchisors to franchising.

It suggests that the franchisee should have a number of appropriate obligations imposed upon it. These include paying all monies due to the franchisor under the contract and informing the franchisor of any threat to its intellectual property rights. It also proposes that the franchisee must make reasonable efforts to operate the franchise business according to the business format of the franchisor, follow the franchisor’s reasonable instructions in relation with the business format and the maintenance of the reputation of the network and take reasonable care not to harm the franchise network. The franchisee must also allow the franchisor reasonable access to its premises so as to enable the franchisor to check that the franchisee is complying with the franchisor's business method and instructions and audit the franchisee’s accounting books. This recognition of at least some of the risks accepted by the franchisor is very positive. However, it fails to identify other important concerns identified earlier in this study such as non compete provisions and respect of the franchisor’s intellectual property.

\[1038\] Ibid Chapter 3.
\[1039\] Some of the provisions are reasonable, for example, if the franchisee is obliged or as a matter of practice required to purchase goods or services from the franchisor or a designated supplier, the franchisor must ensure that the goods or services ordered by the franchisee are supplied within a reasonable time, insofar as practicable provided that the order is reasonable (Article 3:204).
\[1040\] Article 3:301 Commercial Agency, Franchise And Distribution Amsterdam Team ibid.
\[1041\] Article 3:302 ibid.
\[1042\] Article 3:303 ibid.
\[1043\] Article 3:304 ibid.
Unfortunately the Study Group also seeks to impose provisions that are far too burdensome on the franchisor and which undermine the economic drivers\textsuperscript{1044} that attract franchisors to franchising.

On the positive side, the Study Group does impose certain obligations on the franchisor which re-enforce the commercial drivers that encourage franchisees to become involved in franchising. For example, it recommends that the franchisor must grant the franchisee a right to use the intellectual property rights to the extent necessary to operate the franchise business and make reasonable efforts to ensure the undisturbed and continuous use of the intellectual property rights,\textsuperscript{1045} and that throughout the duration of the contract, the franchisor must provide the franchisee with the know-how which is necessary to operate the franchise business\textsuperscript{1046}. It also states that the franchisor must provide the franchisee with on-going assistance in so far as it is necessary for the operation of the franchise business, without additional charge for the franchisee.

However, its lack of specificity potentially causes problems when it states that any further assistance reasonably requested by the franchisee must also be provided at a reasonable cost. The lack of detail as to what “further assistance” and “a reasonable cost” means will have a direct impact upon the commercial viability of the franchise for both the franchisor and the franchisee.\textsuperscript{1047} It is an open invitation for endless litigation and uncertainty.

Some of the obligations it proposes are far too wide and general. As a result they undermine the economic drivers that attract franchisors to franchising. For example, during the term of the contract the franchisor is required to provide the franchisee with information concerning a number of issues including market conditions, commercial results of the franchise network and characteristics of the goods and services\textsuperscript{1048}. It is not clear what is meant by “market conditions” or whether the market is local, regional or national market. It is totally impractical and indeed unnecessary to expect a franchisor based in one member state (or indeed outside the EU) to know anything about market conditions in another member state. Indeed, its ignorance of those market conditions may well be one of the reasons that it

\textsuperscript{1044} For example, it must warn the franchisee, within a reasonable time when it foresees or ought to foresee, that the franchisor's or designated supplier’s ability to make the supplies will be significantly less than the franchisee had reason to expect (Article 3:206). This obligation may be difficult to comply with in practice and clearly borrows for existing agency laws. The phrase “ought to foresee” places an arduous duty on the franchisor that is highly subjective and vague. It is unlikely to encourage companies to franchise their business for fear of continual and unjustified litigation with any disenchanted franchisees.

\textsuperscript{1045} Article 3:201 Commercial Agency, Franchise And Distribution Amsterdam Team ibid.

\textsuperscript{1046} Ibid, Article 3:202.

\textsuperscript{1047} Ibid, Article 3:203.

\textsuperscript{1048} Ibid, Article 3:205. The other issues prices and terms for the sale of goods or services, any recommended prices and terms for the resale of goods or services, relevant communication between the franchisor and customers in the territory, advertising campaigns are not problematic.
decided to grant a franchise there in the first place. It is also unclear what is meant by “commercial results”. It could mean sales figures, balance sheets or profit and loss accounts of the franchisor or all the franchisees on the network. Franchisees are unlikely to welcome having details of their individual businesses shared with other franchisees, who in some circumstances are their most immediate competitors but any lesser level of detail would probably not be of any real use or interest to other franchisees.

It also proposes that the franchisor is obliged to make reasonable efforts to promote and maintain the reputation of the franchise network and must design and co-ordinate the appropriate advertising campaigns aimed at the promotion of the franchise network without any additional charge. 1049 Yet again this provision is inappropriate. It suggests that the franchisees can abdicate responsibility for promoting their business to the franchisor. That is totally at odds with the whole essence of the franchisor/franchisee relationship.

Sadly, the Amsterdam Group’s proposals are a missed opportunity. Although some of them do accentuate the impact of the third commercial imperatives on the legal eco-systems they fail to appreciate where the balance of interests between franchisor and franchisee lies. Most of its proposals are little more than a distillation of existing European member state jurisprudence. There is no originality of thought. Just the regurgitation of ready made solutions to different problems. It therefore fails to address the Commercial Imperatives in any meaningful way and so, for example, it fails to either analyse the fundamental characteristics of franchising or consider empirical evidence and academic comment about it fails to understand even the basic differences between agency and distribution on the one hand and franchising on the other. This leads it to propose an indemnity for goodwill for the franchisee if the franchisor’s business volume has been increased by the franchisee, even when the contract was terminated for non-performance of one party. It also leads it to propose that the franchisor must repurchase the franchisee’s stock at the end of the contract1050.

1049 Ibid, Article 3:207.
The UNIDROIT Model Franchise disclosure law\textsuperscript{1051} is the other proposal to re-engineer the regulatory environment for franchising. It was issued in September 2002 and was supplemented by the second edition of its Guide to International Master Franchise Agreements which was issued in October 2007. UNIDROIT is an independent intergovernmental organisation. Its model law is meant to represent international best practice. It is therefore appropriate to consider whether it addresses the three commercial imperatives identified above and if so, who successful it is in doing so. The fact that the UNIDROIT Model law only deals with pre-contractual disclosure clearly means that it cannot deal with two of the three Commercial Imperatives. At best it can only deal with the second Commercial Imperative, pre-contractual hygiene, although even here it is lacking, as it proposes nothing to enable prospective franchisees to better understand any information disclosed to them about their potential purchase.

UNIDROIT’s model law does propose that certain relevant information is disclosed to potential franchisees. However, it fails to offer any new suggestions as to how to ensure that potential franchisees are informed of the nature of the relationship that they are about to enter into. It is no more than a distillation of what it deems to be best practice from existing franchise legislation around the world. Despite the input of practitioners (or perhaps because of it) the model is the sterile product of administrative endeavour. It lacks in the subtlety, originality and “context” necessary to effectively ensure that potential franchisees not only receive appropriate information but that it is delivered in a manner and style that the potential franchisee will be able to understand. It offers no proposal as to how the “Psychology of Failure” identified by the Australian authorities\textsuperscript{1052} can be overcome or how potential franchisees can be persuaded to take and follow advice given by appropriately qualified and experienced advisors. It offers no fresh insight into the issues to be regulated or how that regulation must be applied. There is nothing in it that cannot be found in existing franchise laws. It gives no analysis of the commercial imperatives at play in the franchising sector and how to maintain market confidence and encourage new entrants. In short it fails to meet the

\textsuperscript{1051} The International Institute for the Unification of Private Law (UNIDROIT) dismissed the suggestion of an International Convention on Franchising. An international code of ethics a model contract – Guide to International Master Franchising Arrangements (second edition) pp xxxiv – xxxv Guide to International Master Franchise Arrangements (second edition) UNIDROIT 2007 originally issued in September 2002 Franchise Arrangements (second edition) UNIDROIT 2007. See www.unidroit.org. It was set up in 1926 as an auxiliary organ of the League of Nations and following the demise of the League, was re-established in 1940 on the basis of a multilateral agreement, the UNIDROIT Statute. Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private and in particular commercial law as between States and groups of States. It endeavours to prepare model and where appropriate harmonise uniform rules of private law.

\textsuperscript{1052} The Franchise Council of Australia’s Submission to the Australian Federal Government Review dated August 2006
benchmarks that franchise regulations should aspire to. It is disappointing that so much collective endeavour has resulted in no original thought or proposals.

Instead it declares that the fundamental principle that needs to be addressed is whether potential franchisees are more likely to protect themselves against fraud if they have access to truthful, important information before they enter into the franchise agreement. That misses a fundamental point. Fraud is a criminal offence and should be regulated accordingly by the criminal law. Disclosure should be about ensuring that franchisees enter into their franchises giving full informed consent to their obligations they take on and they acknowledge that they are taking on real risks\(^{1053}\).

It is disappointing that it focuses upon fraud rather than the Commercial Imperatives. By identifying fraud as the priority they have to some extent proscribed the thrust of the model law and limited its potential use and impact\(^{1054}\).

The Model Law merely lists matters to be disclosed 14 days\(^{1055}\) before “completion” and makes the obvious, but valid, point that legislators must consider the financial burden that new legislation can place upon franchisors and franchisees and compare these to the benefits that will be derived from any new disclosure law\(^{1056}\).

It also provides for annual updating of the disclosure document linked to the franchisor’s financial year\(^{1057}\). It does not propose any set form for the disclosure document but requires that it be in a single document\(^{1058}\) receipt of which is acknowledged by the potential franchisee in writing\(^{1059}\).

It does, however, recognise the need to ensure that franchisees are not overwhelmed by unnecessary disclosure obligations and although the requirement for disclosure cannot be contracted out of\(^{1060}\), certain obvious exemptions to the need to issue a disclosure document are proposed. These are sales to those already involved in the franchise, franchisee sales, investments over a certain threshold, sales to potential franchisees of a certain minimum net worth, fractional franchises and renewals\(^{1061}\).


\(^{1054}\) See Chapter 14.

\(^{1055}\) UNIDROIT, *ibid*, Article 3(A).

\(^{1056}\) *ibid*, Preamble.

\(^{1057}\) *ibid*, Article 3 (B).

\(^{1058}\) *ibid*, Article 4.

\(^{1059}\) *ibid*, Article 7.

\(^{1060}\) *ibid*, Article 10.

\(^{1061}\) *ibid*, Article 5.
The uninspiring nature of the model law is attested to by the fact that it has been in existence for more than 9 years so far but has had no impact on the many franchise laws that have been adopted during that period\textsuperscript{1062}.

Neither the Study Group proposal nor the UNIDROIT model law seek to accentuate the impact of the three Commercial Imperatives on the legal eco-systems that comprise the regulatory environment for franchising in the EU.

5.2.4 **Sub-Conclusion**

In order to ensure that the EU regulatory environment is fit for purpose as regards franchising and so enables franchisors and franchisees to access the economic drivers that attract them to franchising whilst reducing the risks involved to a reasonable level, its legal ecosystems must accentuate the influence of three Commercial Imperatives. These are maintaining market confidence, ensuring precontractual hygiene and imposing mandatory terms onto the franchisor/franchisee relationship through the franchise agreement.

5.3 **Accentuating the Impact of the First Commercial Imperative – Maintaining Market Confidence**

This section provides critical analysis towards achieving the third objective of this thesis.

Further to the discussion in section 2.3, in order to maintain market confidence in franchising, a directive must promote franchising and the economic benefit that it can deliver both to the economy as a whole and to the companies that use it as part of their market strategy in particular. As the introduction to one of the draft bills placed before the Belgian Chamber of Deputies stated\textsuperscript{1063}, it is

\textsuperscript{1062} In Italy the model law was rejected out of hand by the Senate as a basis for their law because “it did not reflect Italy’s legal tradition or deal with the issues of most concern to them” (Emanuele Rossi, La Scala law office – Milan – EFN Annual Conference London 24 March 2006). In Sweden, the only jurisdiction that one is aware of having considered the Model Law (due in no small part due to the fact that the Unidroit officer heading the project was Swedish), it was rejected as being inappropriate.\textsuperscript{1062} In 2004 the Swedish Ministry of Justice analysed the Unidroit Model Law and considered whether or not statutory provisions on franchising should be adopted in Sweden (Departementsserien Ds 2004:55). A survey was conducted among 60 franchise systems of varying size and within different business sectors (in total 550 questionnaires were distributed, of which 310 were replied to) as part of the study. It discussed termination, disputes and pre-contractual disclosure and concluded that there was no need to improve the position of franchisees in terms of statutory rules on termination of franchise agreements. The appropriateness of Arbitration clauses was also considered and the suggestion that they be prohibited in franchise agreements was dismissed. These conclusions were based on the notion that franchisees are legal entities with the ability to negotiate terms and as such should take commercial responsibility for their decision. The Study concluded that a Swedish law based on the Unidroit Model Law would not be appropriate, because it would not accord with “the Swedish model” (Departementsserien Ds 2004:55 page 150).

\textsuperscript{1063} The Belgian House of Representatives, 30 October 2003.
“essential……. not to interrupt …….the development …. of a commercial formula which having been successfully used in the American market has spread to Europe where there are more than 5,000 franchisors and almost 200,000 franchisees generating a turnover of 166 billion euros and employing some 1,500,000 personnel.”

Franchising can make the single market a reality not only for large corporates with the capital and man power to set up in other member states, but also for smaller enterprises that have traditionally done business only in their own national markets.

It is suggested that a directive must not only expressly state that it believes that franchising is a legitimate and respectable form of commerce that adds and has the potential to add further to the successful development of the Single Market by empowering SMEs and others to expand their businesses across national boundaries. It must proactively encourage companies to use franchising as part of their market strategy. Conflicting and confusing regulations impede the efficient functioning of the market and discourage entrepreneurship and commerce. Maintaining market confidence in franchising, involves preserving stability in franchising and the reasonable expectation that it will remain stable on an EU level\textsuperscript{1064}. In order to do this, it is suggested that a new dynamic needs to be imposed on the various legal eco-systems. One which can be called an “Exchange of Benefits” approach.

The challenge of regulation is met by the EU’s current legal eco-systems, the CFR and the UNIDROIT Model Law in an almost one dimensional manner. They all focus on penalising non-compliant franchisors by way of civil and/or criminal penalties imposed through either governmental or private legal action\textsuperscript{1065}. The EU’s legal eco-systems do not seek to encourage franchising by offering franchisors appropriate commercial benefits in return for complying with certain appropriate requirements or recognise the risks faced by franchisors. As a result not only do the EU’s current legal eco-systems fail to accentuate the impact of the need to increase market confidence, but being a franchisor has become synonymous with accepting extra legal, administrative and financial burden.

They have failed to understand the nature of those involved in franchising. Not all franchisors are successful and wealthy multi-national corporations like, for example, McDonalds or Wyndham. The majority are far more modest organisations\textsuperscript{1066}. Many are SMEs that are using franchising as a way of enabling themselves to compete meaningfully on

\textsuperscript{1064} FSMA, ibid Chapter 1, para. 2.
\textsuperscript{1065} See Chapters 10, 11, 12, 15 and 17 above.
\textsuperscript{1066} See 2.1
the European stage. The equation which helps them to decide whether or not to franchise their business is delicately balanced. By granting franchises, franchisors are exposing themselves to potential abuse by franchisees. In order to be encouraged to franchise their business, companies must be able to see tangible benefits beyond the economic drivers already identified.

An Exchange of Benefits approach is proposed as an effective way of accentuating the impact of the need for increased market confidence in franchising on the legal eco-systems.

A regulatory environment that not only controls the behaviour of franchisors but also protects them from abuse by franchisees will encourage businesses to take advantage of the single market and potentially transform the regulatory environment in the eyes of franchisors from a costly administrative, financial and legal burden to one which, in return for a reasonable investment, offers substantial financial, commercial and legal benefit. By adopting this “exchange of benefits” approach, regulators will potentially reverse the focus of the debate about what amounts to a franchise. Rather than businesses seeking to find ways of escaping from being classified as a franchise, they may endeavour to come within the definition. Disputes over whether or not a business amounts to a franchise would no longer be characterised by businesses trying to prove that they are not a franchise. They would also include cases where businesses were seeking to prove the opposite.

In order for businesses to be able to enjoy these benefits they must come within the definition of a franchise, detailed above. It is suggested that the benefits extended to franchisors should be such as re-enforce the economic drivers that attract them to franchising and reduce the consequential inherent risks to an appropriate level. It is therefore proposed that the benefits offered include requiring franchisees to make pre-contractual disclosure to franchisors (at the franchisor’s request), focusing the regulation only where it is needed and reducing the disadvantages that franchisors suffer compared to corporate chains.

5.3.1 The Benefits Extended to Franchisors

The following section provides critical analysis towards achieving the third objective of this thesis.

It is suggested that in order to increase market confidence in franchising and encourage companies to become franchisors, disclosure should not be just a one way process. The degree of risk involved for both franchisors and franchisees must be reflected in the pre-

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1067 The BFA has 236 full and provisional members of which only around 10 are substantial corporates e.g. McDonalds and the Halifax.
contractual disclosure requirements of an EU franchise directive. Not only should franchisors have an obligation to give pre-contractual disclosure, but they should also have the right to require that franchisees provide them with pre-contractual disclosure too. This will help ensure that the risks to franchisors are taken into account and so encourage more companies to franchise their businesses. Effective disclosure by potential franchisees, should the franchisor require it, helps to ensure that inappropriately qualified individuals are less likely to be placed in a position in which they damage themselves, the franchisor and other franchisees. It also protects franchisors from being “duped” by prospective franchisors with inappropriate criminal, financial, business or personal backgrounds. The franchisor’s risk profile is correspondingly reduced.

This will not of course prevent franchisors recruiting poor quality franchisees. It will however help to make it less of a surprise to them when a franchisee turns out to be inappropriate and so ensure that they are more clearly responsible for a poor recruitment. If a franchisee mis-states its circumstances, the blame for the problems should be more equitably shared between the franchisee and the franchisor and so reduce the ability of undeserving franchisees to blame their franchisor for all their problems."^^\textsuperscript{1068}.

\^\textsuperscript{1068} Curiously, only the Vietnamese franchise regulation requires pre-contractual disclosure by potential franchisees, but unfortunately this is an extremely recent law and so offers no guidance as to its effectiveness. The original Chinese franchise regulation also required it, but this was dropped when the second regulation was adopted. No reason was given for its exclusion.
Franchisors should be given the right, but not the obligation, to require that at least 10 working days before entering into any agreement which obliges or potentially obliges a Franchisor to grant a potential franchisee a franchise, the potential franchisee must provide the franchisor with the following information about itself and its spouse/partner, if any or if it is a limited liability company its shareholders and officers:

1. Full name and address including e-mail address and telephone number.
2. Details of education and employment.
3. Details of business experience including directorships and any direct or indirect shareholdings in privately held companies.
4. Personal bankruptcy history.
5. Details of the insolvency of any company in which he/she was a director or shareholder.
6. Details of family situation including details of any divorce, child maintenance and other such court orders and arrangements, a signed statement from the prospective franchisee’s spouse/partner that they fully support the prospective franchisees application.
7. Personal medical history and that of their spouse/partner and children.
8. Criminal record and that of their spouse/partner.
9. Details of any judgment against it.
10. Copy of driving licence and passport.
11. Banker’s reference
12. Details of personal assets and those of spouse/partner including details of status of current home and any charges on those assets.
The consequences of a potential franchisee failing to supply all such information to any franchisor that has requested it, would be to give the franchisor the right to terminate the franchise agreement on the basis of defective consent within twelve (12) months of the failure coming to the franchisor’s attention or within two (2) years of the franchisee signing the franchise agreement, whichever is the earliest.

A franchisee that has made any material or substantial wrongful or lack of disclosure will be deprived of any right to claim damages or other remedy from the franchisor unless the franchisor is shown to have intentionally and materially breached the terms of the franchise agreement or intentionally and materially made wrongful or incomplete pre-contractual disclosure to the franchisee.

This should avoid any franchisee being inequitably denied justice due to technical non-compliance and prevent the franchisor from using a franchisee’s failures to excuse its own deliberately inappropriate behaviour.

It is the obligation of any franchisor to ensure that it is aware of and complies with relevant laws that impose obligations upon it. However, one cannot expect potential franchisees to be aware of any such obligations that are placed upon it as a result of it deciding to become a franchisee. Therefore, if a franchisor decides to take advantage of its right to require pre-contractual disclosure by a potential franchisee, the burden of ensuring that the potential franchisee knows of its obligation must lie with the franchisor.

The franchisor must provide the potential franchisee with a written statement informing him/her that it wishes to exercise its right to require disclosure in plain language. This must be delivered to the potential franchisee at least 14 days prior to the date on which the potential franchisee must make the disclosure.

It must also be accompanied by a form, in plain language and in a Question and Answer format, setting out exactly what information is required in order to comply with the obligation, so that the franchisee need only complete the form.

It would be difficult, and indeed pointless, to oblige all potential franchisees to make pre-contractual disclosure regardless of the franchisor’s desire for it. The franchisor should therefore have the right to require potential franchisees to make full pre-contractual disclosure and be able to rely upon the veracity of such disclosure if it is made. The Franchisor may at its own option decide that it does not need written pre-contractual disclosure from a potential franchisee.

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1069 This reflects the court’s approach to non-disclosure by franchisors under both the French and Spanish disclosure laws and German law. See 3.3 below
franchisee. It may for some other reason fail to obtain such disclosure from a potential franchisee. In either such case the franchisor will lose its right of redress outlined above.

As stated above, if a franchisor wishes to take advantage of its right to pre-contractual disclosure by a potential franchisee, it must deliver a notice to the potential franchisee stating that that is the case and clearly explaining the consequences of it not doing so. This notice should also be stated clearly on the cover sheet of the franchise agreement.

Both notices of the potential franchisee’s pre-contractual disclosure obligations should be in prominent and easily legible form and read as follows;

“This is a very important notice.
You must read it carefully and do as it says before you enter into any agreement with us.

It requires you to give us certain information about you and your spouse/partner/shareholders/officers (if applicable).

You must give this information to us at least 14 days before you sign any agreement which entitles you to the franchise.

You can give us this information by accurately completing the attached questionnaire. Alternatively, if you choose to do so, you can give it in any other written form.

If you do not give us all this information, or if any of the information that you give us is false, incorrect or incomplete, you may lose your right to the franchise and some of your other important legal rights may be severely restricted”.

5.3.2 Focusing Regulation where it is needed

This provides critical analysis towards the third objective of this thesis.

It is proposed that the pre-contractual disclosure obligation of franchisors proposed below should not apply to all franchise sales. The proposed EU franchise directive must encourage the use of franchising by taking into account its commercial realities. The size, commercial

1070 Chapter 5.4.3 below
experience and sophistication of some franchisees will mean that they do not require the same level of protection as the majority of franchisees. The role a franchise will play in the overall business interests of some franchisees and the size of the investment being made in the franchise (be it very substantial or minimal) will also have an impact upon whether or not additional protection should be made available to franchisees.

Substantial businesses that take on a franchise as an “add-on” to an existing business and other sophisticated individuals making substantial capital investments are dealing with franchisors on a more even footing and have sufficient commercial experience to mean that they do not need the same level of protection as the more usual type of franchisee. They can rely upon the usual contractual remedies available to businesses. Likewise a small investment by a franchisee may not justify imposing the same administrative burden as a more substantial one.

Franchisors should only be required to make pre-contractual disclosure when it is appropriate and not in the case of fractional franchisees, de minimis franchisees, sophisticated franchisees, large investors, large franchisees and insiders.

5.3.2.1 Excluding Fractional and De Minimis Franchises

Fractional franchises are those that are taken on by an existing business which is seeking to expand its product line through taking a franchise.

If (1) the franchisee or its principals have more than two years of experience in the same line of business or is otherwise already familiar with the products and services to be sold through the franchise; and (2) the parties reasonably expect that the franchisee’s sales from the new line of business will not exceed 20% of its total sales.\footnote{In the original SBP, the Commission reasoned, with respect to fractional franchisees, that pre-sale disclosure is unwarranted where the prospective franchisee already is familiar with the products and services to be sold through the franchise and where the prospective franchisee faces a minimal investment risk. Original SBP, 43 FR at 59707.} It is proposed that any disclosure requirement be excluded.\footnote{Section 436.1(g) of the US’s updated FTC Rule takes this approach.}

A de minimis exemption will ensure that the directive focuses upon those franchisees who have made a personally significant monetary investment and who cannot extricate themselves from the relationship if it becomes burdensome without suffering a financial setback\footnote{In the US franchise sales under US$500; are exempted from the pre-contractual disclosure requirement. See 16 CFR 436.2(a)(3)(iii).}. The threshold will exclude transactions where the prospective franchisee is at risk of losing an
amount of money too small to justify imposition of the expense and burden of preparing a disclosure document upon sellers. The threshold proposed is €1,000.

**It is proposed that any franchisee investing €1,000 or less in a franchise should not be entitled to a disclosure document.**

### 5.3.2.2 Excluding Sophisticated Franchisees

Franchising often involves heavily-negotiated, multi-million pound deals between franchisors and highly sophisticated individuals and corporate franchisees with highly competent lawyers. In the course of such deals, prospective franchisees often demand and receive material information from the franchisor that equals or exceeds the disclosures required by the Rule. Such business arrangements do not require the same level of protection as those with similar investors.

There are three types of sophisticated investors and those that make a large franchise investment, large franchisees and inside investors.

In the USA, large franchise investments are defined as franchises where the initial investment is at least US$1 million. The basis for a large investment exemption is not that “sophisticated” investors do not need pre-sale disclosure, but that they will demand and obtain material information with which to make an investment decision regardless of the application of any law. Where prospective franchisees are likely to demand and obtain pre-sale material information regardless of external prompting or compulsion, then there is no case for legislative intervention.

Such an exemption must, of course, be limited. To ensure that the exemption is not too wide, the US FTC Rule sets forth additional safeguards beyond the mere financial threshold.

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1074 See FTC Staff Report. Gust Rosenfeld, at 7; J&G, at 7; Marriott, at 2-4; Starwood, at 2-3; 7-Eleven, NPR 10, at 2; NFC, NPR 12, at 17; IFA, NPR 22, at 7; AFC, NPR 30, at 2-3; Marriott, NPR 35, at 6. See also Kaufmann, ANPR, 18Sept.97 Tr., at 165; Wieczorek, id., at 187-88; Tifford, id., at 194 (noting that the Rule imposes unnecessary costs on sophisticated franchisees and adds unwarranted delay in the high-paced negotiation process, where parties often are anxious to cement their deals quickly to beat out the competition).

1075 E.g. hotel franchises such as those offered by Wyndham, Marriott, Intercontinental and the like can require investments of US$10 million and more. Large retail franchises such as that offered by Hamleys require a similar level of investment.

1076 See the FTC Rule Section 436.8(a)(5)(i) which has such an exemption for franchise sales over US$1 million exclusive of unimproved land and franchisor financing.

1077 At least two US states provide some form of exemption for transactions involving large initial investments. Illinois permits a franchisor to apply for an exemption from both registration and disclosure where the investment for a single franchise unit exceeds $1 million. Maryland exempts franchises that require an initial investment of $750,000 or more from registration, but not from disclosure.

1078 FTC Rule, Section 436.8(a)(5)(i).

1079 These safeguards were included in the proposed version of this provision. Franchise NPR, 64 FR at 57321 and 57345.
First, funds obtained from the franchisor (or an affiliate) cannot be counted toward the $1 million initial investment threshold. Second, the prospective franchisee must sign an acknowledgment that the franchise sale is exempt from the Franchise Rule because the prospective franchisee will be making an initial investment over the threshold.

Although franchisors may find a large initial investment exemption appealing, wealth or the ability to make a large franchise investment does not necessarily equate with business sophistication. The franchisees’ business background is arguably more relevant.

A large investment exemption would not consider the source of the prospective franchisee’s funds, which could be raised through a secured loan, pension fund and so on.

“The fact that a franchisee may be ready to invest a highly leveraged franchise investment does not prove that such a person is so sophisticated that a disclosure document would be of no benefit.”

However, on balance it appears that a large investment exemption is warranted and that the size of prospective franchisees investment is one measure of its sophistication.

It is reasonable to conclude that investment level is a straightforward and unambiguous indication of sophistication. Franchisors need a clear objective standard that will indicate when and under what circumstances the sophisticated investor exemption will apply. An exemption based upon the specific business experience of each individual prospective franchisee would be burdensome to administer. Franchisors would not be able to take advantage of the exemption unless they first verified each prospective franchisee’s business background. Similarly, without verification, law enforcers would not be able to discern whether any specific franchise relationship was covered by the directive. This approach could create a regulatory nightmare for both franchisors and franchise law enforcers.

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1080 Section 436.8(a)(5)(i).
1081 Section 436.8(a)(5)(i).
1082 E.g., PMRW, NPR 4, at 3; Wendy’s, NPR 5, at 2; McDonalds, NPR 7, at 2; H&H, NPR 9, at 4; Baer, NPR 11, at 16; NFC, NPR 12, at 20. Marriott, for example, stated that not only are sophisticated franchisees able to protect their own interests, but the self-interest of others involved in the project, such as bankers, is sufficient to protect those interests as well. Marriott, NPR 35, at 6. See, e.g., Baer, NPR 11, at 16; Gurnick, NPR 21, at 3; J&G, NPR 32, at 3.
1083 Stadfeld, NPR 23, at 8; Karp, NPR 24, at 6.
1084 Karp, at 7; Karp, NPR 24, at 6-7. See also Stadfeld, NPR 23, at 7-8 (“Being wealthy should not be a basis for being screwed.”).
1085 Karp, ibid, at 8.
1086 This view was supported by the Automobile Importers of America submission to the FTC, which observed that “Prospective motor vehicle dealers make extraordinarily large investments. As a practical matter, investments of this size and scope involve relatively knowledgeable investors or the use of independent business advisors, and an extended period of negotiation. The record is consistent with the conclusion that the transactions negotiated by such knowledgeable investors over time and with the aid of business advisors produce the pre-sale information disclosure necessary to ensure that investment decisions are the product of an informed assessment of the potential risks and benefits of the proposed investment.” 45 FR 51763-64 (Aug. 5, 1980).
A large investment exemption offers tangible benefits to franchisors such as those operating a hotel business where the typical franchise investment is likely to exceed the large investment exemption’s monetary threshold will provide regulatory relief in those instances. A large franchise investment exemption, however, will provide only limited relief for franchisors that sell franchises both above and below the threshold. In such instances, the franchisor must prepare disclosure documents in order to sell at levels below the threshold.

Obviously deciding what the financial threshold should be is vital. In the USA the FTC concluded that a $1 million threshold strikes the right balance between providing relief for sophisticated investors and protecting consumers.

Interestingly, during its review of the FTC Rule no consensus emerged on the appropriate investment threshold for the large investment exemption. Several commenters supported a $1.5 million threshold, whilst others urged a higher threshold so as not to place too many transactions outside the Rule’s protection. Others, such as McDonald’s suggested that the threshold should be lower. The IFA proposed a $1 million threshold, excluding land. It observed that a 1997 update to the Profile of Franchising identified 52 franchise companies offering franchises with an initial investment exceeding $1 million, excluding land. This equates to 4.4% or less of all franchise systems. Thus, at a $1 million threshold for the exemption, more than 95% of all franchise systems would remain within the ambit of the Rule. Some commentators recommended an even lower threshold.

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1087 E.g., Baer, NPR 11, at 16; Gurnick, NPR 21, at 3; Marriott, NPR 35, at 6.
1088 NASAA recommended a $3 million threshold. NASAA, NPR 17, at 12. Seth Stadfeld added that it is not difficult to invest $1.5 million when there is a down payment plus financing of a substantial portion of the investment. “Indeed, because they are taking on larger obligations, there is all the more reason and urgency why they should get the material, factual and contractual information that is otherwise available under the Rule.” Stadfeld, NPR 23, at 8. See also NFA, NPR 27, at 3.
1089 For example, McDonald’s suggested that the threshold should be set at $1 million. “In our considerable experience, individuals purchasing franchises involving a $1 million investment have a clear understanding of the terms and conditions of the business arrangements and have obtained professional financial and/or legal advice before entering into the franchise agreement.” McDonald’s, NPR 7, at 2. See also 7-Eleven, NPR 10, at 3; NCF, NPR 12, at 20; BI, NPR 28, at 13. Wendy’s suggested that the threshold be lowered, but did not offer any specific amount. Wendy’s, NPR 5, at 2.
1090 As discussed below, IFA initially stated that “real estate” should be excluded in calculating the large investment threshold. IFA, NPR 22, at 7. In its Staff Report comment, however, the IFA clarified that by “real estate,” it means raw, unimproved land. See IFA, at 3.
1091 IFA, NPR 22, at 7.
1092 The Staff Report recommended a $1 million threshold for the exemption, excluding land and franchisor financing, as discussed below. Staff Report, at 240.
1093 PMR&W, NPR 4, at 3 (suggesting a $500,000 threshold). See also Cendant, ANPR 140, at 4 (suggesting a $750,000 threshold); H&H, NPR 9, at 4 (advocating a lowered threshold, but not specifying an amount); Duvall & Mandel, ANPR 114, at 21 (suggesting a $250,000 threshold provided there is a showing that the purchaser, alone or with counsel, can understand the merits and risks of the investment). The Commission rejects this approach as unworkable, because it would require franchisors to make subjective judgments about each purchaser’s business acumen.
The Commission gave particular weight to the statements offered by franchisors such as McDonald’s and Marriott that, in their experience, a $1 million investment is likely to involve sophisticated investors\textsuperscript{1094}. A review of franchise investment fees in the UK\textsuperscript{1095} suggests that a large investment threshold of €500,000 be adopted in the EU Franchise Regulation. The average up front fee in the UK charged is £45,400\textsuperscript{1096}.

Excluding franchisor financing adds a measure of protection to the prospective franchisee because traditional lenders are very likely to require a due diligence investigation of the offering, whereas the franchisor or its affiliate likely would not\textsuperscript{1097}.

Although there is a risk that excluding financing might discourage franchisors from offering financing to prospects not to do so could tempt a franchisor to increase the cost of the initial investment to qualify for the large investment exemption, while simultaneously offering to finance the deal itself, all without proper pre-sale disclosures.

It is therefore appropriate for the exemption to be dependent upon the franchisee having been given notice of the fact that the franchisor is exempt from the disclosure requirement.

\begin{shaded}
It is proposed that franchisees who invest €500,000 or more (excluding funds obtained from the franchisor or its affiliates) in a franchise and have signed an acknowledgement that the sale is exempt from the disclosure requirement because the initial investment is over the threshold, should be exempted from the disclosure requirement
\end{shaded}

Large entities negotiating franchise deals – such as airports, hospitals, and universities – do not need the protection afforded by the regulation\textsuperscript{1098 1099}.

\textsuperscript{1094} The Commission has a history of considering and granting petitions for exemption to the Franchise Rule under section 18(g) of the FTC Act. In numerous exemption petition proceedings, the Commission has considered the size of investment as an indicium of sophistication. E.g., Paccar, Inc., 68 FR 67442 (Dec. 2, 2003); Rolls-Royce Corp., 68 FR 67443 (Dec. 2, 2003); Austin Rover Cars of North America, 52 FR 6612 (Mar. 4, 1987); Volkswagen of America, Inc., 49 FR 13677 (Apr. 6, 1984); Automobile Importers of America, Inc., 45 FR 51783 (Aug. 5, 1980). Based upon this experience in analyzing various franchise systems, the Commission believes that a large investment typically entails a sophisticated purchaser: “As a practical matter, investments of this size and scope typically involve knowledgeable investors, the use of independent business and legal advisors, and an extended period of negotiation that generates the exchange of information necessary to ensure that investment decisions are the product of an informed assessment of the potential risks and benefits.” Mercedes-Benz of North America, Inc., 57 FR 1745 (Jan. 15, 1992) (granting petition for exemption).

\textsuperscript{1095} A review of the 44 franchisees advertised in Franchise World Feb/March 2009 Nos. 169 suggests a range of investment levels from £4,000 to £260,000

\textsuperscript{1096} BFA/Nat West Survey page 36.

\textsuperscript{1097} Section 436.8(5)(i) of the FTC Rule does not count monies that are obtained through franchisor (or affiliate) financing toward the large initial investment exemption’s $1 million threshold.

\textsuperscript{1098} Section 436.8(a)(5)(ii) of the FTC Rule exempts sales to entities who have been in any business for at least five years and have a net worth of at least $5 million.

\textsuperscript{1099} Net worth of an entity can readily be determined from the entity’s balance sheet or other financial information, typically submitted as part the application process.
The US FTC concluded that both $5 million net worth and five years experience are necessary to ensure that the Rule continues to protect businesses with limited experience, limited assets, and, by inference, limited prior success.

As larger companies often have complex corporate group structures, it is appropriate for a franchisor to consider the prior experience and net worth of the franchisee’s affiliates and parents when determining whether the franchisee qualifies as a “large franchisee”.

It is recommended that the EU Franchise directive adopts a large franchisee exemption with a threshold of €5 million and a requirement for 5 years experience.

Where a company wishes to sell a franchise to experienced company personnel with substantial direct management experience of the business, it would be overly burdensome to force the company to have to deliver a disclosure document to them as the only beneficiaries of the disclosures are already knowledgeable individuals.

The exemption should be company-specific. A manager of one franchised company should not be deemed to be sophisticated for all franchise sales.

It is proposed that a manager or other officer seeking to purchase a franchise of a particular company that the individual in question has worked in the franchisor for two years or more.

5.3.3 Reducing the Disadvantages Franchisors Suffer Compared to Corporate Chains

This provides critical analysis towards the third objective of this thesis.

Franchised businesses are disadvantaged when compared to corporate chains by the franchisor’s inability to impose uniform retail prices and restrict the franchisees’ use of the internet.

Most franchisors would struggle to expand their businesses through conventional corporate means. Indeed, access to working capital and better motivated people are why many franchisors in the UK, Germany, Franchise and Spain franchise their business\(^\text{1100}\). The average cost of launching a franchise in the UK is £170,000\(^\text{1101}\) so the financial threshold for

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\(^{1100}\) See Appendix 3. In the Survey of Franchisors 72% of UK respondents, 72% of German respondents, 64% of French respondents and 52% of Spanish respondents stated that access to Capital was a very significant reason why they franchised their business and 24% in the UK, 16% in Germany, 1% in France and 16% in Spain stated that it was a significant reason. 72% of UK respondents, 60% of German respondents, 60% of French respondents and 32% of Spanish respondents stated that access to better motivated people was a significant reason why they franchised their business. Whilst 88% in the UK, 96% in Germany, 88% in France and 96% in Spain saw franchising as being able to help them expand their business more quickly.

\(^{1101}\) BFA/Nat West Survey 2007, p. 40.
entry is fairly low. They are very much at a disadvantage when compared to well capitalized and resourced corporate chains.

Uniform pricing is a key element in ensuring the brand integrity of any business and so essential to allow franchise chains to compete effectively with corporate chains. The majority of franchisors surveyed believe that they are disadvantaged compared to non franchised businesses as regards their ability to set prices in all of their outlets\textsuperscript{1102}. The presence of uniform prices across the network acts as a key attraction for potential new franchisees\textsuperscript{1103}. Research suggests that a majority of potential franchisees\textsuperscript{1104} consider that one of the attractions of buying a franchise is that the franchisor has the appropriate experience and expertise to enable it to know the most appropriate price point for the goods/product and that when they buy a franchise they will not want other members of the franchise network undercutting them on price\textsuperscript{1105}. The reasons given for this are the prevention of intra brand competition based on price\textsuperscript{1106} and the fact that price differentials would damage their brand and confuse the customers\textsuperscript{1107}.

Research suggests that franchisors believe that franchised businesses are disadvantaged as compared to non-franchised businesses with regard to their access to a “multi channel sales strategy”\textsuperscript{1108} due to their inability to set prices in all their outlets and to control the franchisee’s use of the internet\textsuperscript{1109}.

The development and execution of an appropriate multi channel sales strategy that involves the appropriate use of the worldwide web is essential to most businesses. Current EU law does not merely fail to encourage companies to use franchising as part of its corporate strategy, in some ways it positively discourages its use. EU anti trust law discriminates against franchising by denying it rights enjoyed by corporate chains in respect of both retail prices and use of the internet. Given that most franchisors are small or medium sized businesses\textsuperscript{1110} and that franchising greatly increases the chances of individuals with little or

\textsuperscript{1102} Appendix 3. 76% in the UK, 72% in Germany, 76% in France and 72% in Spain
\textsuperscript{1103} OECD, Competition Policy and Vertical Restraints: Franchising Agreement.
\textsuperscript{1104} Appendix 2. 80% of the sample interviewed in the UK, 75% in France and 58% in Spain.
\textsuperscript{1105} Appendix 2. 23.2% of the UK sample, 35% of the French and 58% of the Spanish sample.
\textsuperscript{1106} Appendix 2. 93.32% of the UK sample, 87.5% of the French sample and 68% of the Spanish sample.
\textsuperscript{1107} Delloites LLP & Retail (2007) First Cross Channel Think Tank Focuses on Future of Retail Industry
\textsuperscript{1108} Appendix 3. 56% in UK, 56% in Germany; 16% in France and 64% in Spain thought that franchised businesses are disadvantaged as compared to non-franchised business in respect of their ability to control the franchisees use of the internet 32% in the UK, 18% in Germany, 60% in France and 32% in Spain disagreed with this whilst 16% in the UK, 36% in Germany, 24% in France and 6.4% in Spain did not know.
\textsuperscript{1110} See Chapter 2 p. 34.
no prior experience of business being successful. This amounts to institutionalised
discrimination against small businesses. This discrimination is clearly anti-competitive.

| It is proposed that franchisors be allowed to set retail prices for its franchisees and
dictate the network’s multi channel sales strategy. |

5.3.3.1 Pricing

As detailed in Chapter 3 above resale price maintenance is a hard core restriction under
the Vertical Restraints Block Exemption and was ruled against in both the Pronuptia and
Yves Rocher cases. They are considered to be “per se” anti-competitive by the EU
authorities. As a result, vertically integrated corporate chains have a monopoly on the ability
to deliver a price promise, so disadvantaging both franchisors and the consumer. The
OECD however believes that resale price maintenance by franchisors can be pro-
competitive. The US Supreme Court takes a similar view.

| It is suggested that the vertical restraints block exemption be amended to expressly
state that franchisors may set retail prices for their franchisees where it promotes
efficiency by improving vertical co-ordination between franchisor and franchisees,
particularly where there is substantial inter brand competition. |

5.3.3.2 Multi Channel Sale’s Strategy

The growing importance of a multi channel sales strategy, particularly on line sales and other
commercial use of the internet, is clear. Here again, whilst large corporates have freedom to
adopt whatever strategy they deem appropriate, franchisors are substantially limited in their
commercial options by EU competition law – which provides that every franchisee must be
free to use the Internet to advertise and sell products. The Commission’s apparent inability to
understand the dynamic and interactive nature of the worldwide web means that it is using an
outmoded approach to try to regulate the latest developments in electronic commerce.

The EU Commission considers that the use of the internet is a passive form of promoting
sales in the same way as advertising in the local press. It considers that the fact that it may
have effects outside one’s own territory or customer group results merely from its distribution
and accessibility. It is considered to be passive selling and any restriction on it is “per se” anti
competitive. Insofar as a web site is not specifically targeted at reaching customers primarily
inside the territory or customer group exclusively allocated to another distributor, for instance
with the use of banners or links in pages of providers specifically available to these

1112 Section 3.8.3.2
1113 ibid
1114 Leegin Creative Leather Products Inc v PSKS Inc ibid
exclusively allocated customers, the website is not considered to be a form of active selling. Unsolicited e-mails sent to individual customers or specific customer groups are also considered to be active selling.

By seeing the internet as a passive medium comparable to a journal or newspaper the importance of multi-channel sales strategies is totally missed. Over the past five years the retail market has changed substantially. For example, the percentage of UK retail sales made over the internet as a percentage of total retail sales has increased from 2.9% in November 2006 to 3.7% in January 2009.\textsuperscript{1115} The non-geographical nature of the worldwide web, and practices such as wordstuffing, seeding, using materials that drive traffic to websites, the subtle use of meta tabs and other such practices mean that search engines will pick up sites wherever they are. Websites are not an inert medium. The issues caused for franchise networks because of this restriction and its extra-territorial nature are problematic for franchisors. They erode the exclusivity that franchisees often gave and so discourage some potential franchisees from entering into franchise agreements.

The franchisor’s ability to control the quality of its franchisees’ websites is not enough to enable franchised chains to compete on equal terms with corporate chains in a multi-channel environment. A less dogmatic approach by the EU Commission would be appropriate. As the OECD observed\textsuperscript{1116} territorial restrictions can have pro-competitive effects by limiting intra-brand competition and increasing franchisees’ expected profits, thereby increasing the incentive for franchisees to invest in specific skills and effectively enter a market. Franchisors currently tend to use the internet to exclude and compete with their own franchisees because (amongst other things) they are unable to structure an overall internet strategy for the franchise network.

It is proposed that franchisors be given a greater level of flexibility and control over internet strategy so that they can add greater value to both the franchisee’s business and their own by being more proactive in the use of the internet to increase operational efficiencies and communication.

This collaborative approach to emerging technologies will strengthen the franchisor/franchisee relationship, rather than weaken it, as it currently tends to do so\textsuperscript{1117}. It is therefore recommended that, to borrow the words of the OECD, that the Commission should

\textsuperscript{1115} Retail Sales Business Monitor (SDM28), Office of National Statistics.
\textsuperscript{1116} OECD, Competition Policy and Vertical Restraints: Franchising Agreements, p. 196.
“allow franchises to use either price or non-price vertical restraints in situations where the franchise faces strong market competition and collusion”.

5.3.4 Sub-Conclusion

It is proposed that the EU Franchise Directive actively promotes franchising and accentuates the impact of the need to increase market confidence on the EU legal eco-systems. It should do this by enabling franchisors to require pre-contractual disclosure by franchisees, focusing regulation only where it is required (by excluding fractional franchisees, de minimis franchisees, sophisticated investors, large investors, large franchisees and insiders) and allowing franchisees to compete on a level playing field with corporate chains. It should establish this partly by allowing franchisors to set the prices of their franchisees and restrict franchisee sales over the internet. These provisions will accentuate the impact of the need for increased market confidence in franchising on the EU’s legal eco-system.

5.4 Accentuating the Impact of the Second Commercial Imperative - Pre-Contractual Hygiene

This section provides critical analysis to achieve the third objective of this thesis.

Further to the discussion in section 2.4, ensuring pre-contractual hygiene is essential. It is suggested that this means ensuring that potential franchisees access appropriate information and are equipped to interpret it in an appropriate manner. In order to be able to decide whether or not to buy a particular franchise potential franchisees must have access to certain basic information. However, no matter how well drafted a disclosure law is, the practical issues that arise on a day to day basis can dilute its potential impact. Regardless of how complete any disclosure law is, at the end of the day its effectiveness does depend to a large extent upon prospective franchisees being appropriately educated and looking after their own interests. No disclosure law can, or indeed should, allow franchisees to abdicate responsibility for their own actions.

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1118 Failing a wholesale change in the EU’s approach to competition law, Finland has found a way forward on this issue that may suggest a viable compromise. The EU authorities may be willing to accept this more readily than a more fundamental reappraisal of their “per se” approach. The Finnish Competition Authority issued an exemption on price cooperation by businesses while implementing a campaign of offers intended for consumers. (Exemption No. 187/67/2003, dated 14.03.2003) This exemption was valid until 28 February 2008. There is currently no intention to issue a new exemption. (Petri Rinkinen, Franchising Legislation in Finland, www.franchising.fi/ukindex.html). The effect of the exemption is that price campaigns within a chain are made possible as long as the campaign does not take place for a period of more than two months. In addition, the vendor must maintain the right to sell the product or service at an even lower price at any time (Petri Rinkinen, Franchising Legislation in Finland, www.franchising.fi/ukindex.html).
Potential franchisees must be able to understand what the information disclosed to them by the franchisor means and take appropriate legal and financial advice. The way to ensure this is to make it very clear what information is required, establish a set form of disclosure document which requires the use of plain language and provide for appropriate penalties to be imposed upon those franchisors who do not comply with the pre-contractual disclosure requirement.

However unless potential franchisees understand the need to take professional advice upon their proposed investment and act upon it, disclosure will have only a limited impact.

Potential franchisees must be educated into taking and following appropriate advice on their proposed purchase.

5.4.1 Educating Potential Franchisees

This provides critical analysis to the third objective of this thesis.

It is suggested that an EU Franchise Directive must provide that potential franchisees are educated about franchising and their responsibilities if they wish to become involved in it.

In its submissions to the Federal Government Review the Franchise Council of Australia (FCA) identified the lack of education and the apparent unwillingness of potential franchisees to look after their own best interests as a substantial weakness in the Australian system of disclosure,

“those involved in franchising and perhaps human nature in general”.

It criticises potential franchisees for not reading the documentation or conducting appropriate due diligence before committing to a franchise. It noted that some of the problems involving disgruntled franchisees brought to its attention may have been avoided if the prospective franchisee had a clearer understanding of the significant risks that were involved in becoming a franchisee. Significant risks may include decisions made by third parties relevant to the business (such as landlords, franchisor and franchisee associates), earnings projections, changing competition, franchisor rights to unilaterally amend the franchise agreement, franchisee rights and obligations on termination or expiration of the franchise agreement, economic cycles, legislative change, franchisor solvency, franchisor rights to unilaterally

1119 The Franchise Counsel of Australia’s submission to the Australian Federal Government Review dated 15 August 2006.
1120 Ibid.
1121 Stephen Giles, Director of the Franchise Council of Australia, interview with author (11 October 2009.)
terminate the franchise agreement and a decision by the prospective franchisee not to take advice before entering into a franchise agreement.

This tendency of franchisees to refuse to take advice and carry out proper due diligence is a real problem because it means that they do not understand the business, the costs involved, the time and effort required, the impact upon their lives and family, their exposure to risk, or the need to follow the franchise system.

It would also seem to be a problem in the UK, Spain and France. Only 56.25% of potential franchisees surveyed in the UK, 36.66% in France and 22% in Spain stated that they intended to pay for both legal and financial advice on a franchise before legally committing themselves to it1122. Franchisors recognise this “human” failure in potential franchisees1123.

One option would be to legally require potential franchisees to take appropriate advice. However the difficulties in enforcing such a requirement would be substantial. At the end of the day it would probably only increase the cost and bureaucracy without having any real positive impact1124.

A lack of pre-entry education of franchisees is the real problem, as is the “psychology of failure” which encourages failed franchisees to blame others for their failure and the willingness of the media to take pot shots at franchisors. This view that education is a key factor in the success of regulation is shared not only by the FCA but also the BFA and other franchising associations1125, franchisors and legal practitioners who specialise in franchising – “The education of people who are contemplating a franchise is fundamental to franchising’s ultimate success and that is why the BFA gives it so much priority through our website, exhibitions, publications and various seminars1126.

1122 Appendix 2 - Survey of potential franchisees.
1123 Peter Neighbour, Franchise Director at LighterLife, 20 February 2008 stated in an interview conducted for this thesis “Some franchisees are simply unwilling to take responsibility for their own decisions. They seem to be totally ignorant of the fact that a franchise is not a 100% guarantee of commercial success regardless of what they do. Whatever you tell them seems to go in one ear and out the other. They see professional advice as an unnecessary luxury. They recklessly jump into an investment with boundless, naïve enthusiasm and then blame anything less than 100% success on the franchisor. The problem for franchisors is that it is not always easy to screen these types out of the recruitment process” (Appendix 6 - Steve Mills, CEO of MRI). “It will make very little difference what disclosure laws are adopted unless you find a way of making potential franchisees take a real interest in the information they are given and use it as the basis of the decision whether or not they sign up.”
1124 Peter Neighbour, Franchise Director at LighterLife, 20 February 2008 stated that “It is not a bad idea in principle but it would be a bloody nightmare to enforce and the real risk is that it would just put people off franchising altogether.”.
1126 Interview with Brian Smart, Director General of the BFA, 18 September 2008.
The importance of education was explained by one staff member of the US Fair Trade Commission\textsuperscript{1127} as follows

“How do you tell a guy who bought into a franchise as a 35 year old father of 2 young children that after 20 years of hard work just at the time that he is having to put his children through college, and with another 5 years of his home loan to pay off, he suddenly no longer has a business? How do you tell him at that time that he should have read the disclosure documents more carefully? That is why education is so important.”

5.4.1.1 Delivery of Education to Potential Franchisees

Education is important, but how should it be delivered? Due to a variety of factors including their knowledge of franchising, existing infrastructures, (in some EU member states) and vested interest in making franchising a success, it is suggested that national franchise associations should be empowered by each EU member state government to ensure that potential franchisees are consistently and persistently offered appropriate education about the franchising facts of life and so increase the likelihood of them understanding what they are entering into and the due diligence they should undertake before becoming committed to a franchise. Where there is no national franchise association, the government should mandate its creation and membership of the European Franchise Federation (EFF).

The EFF has some 30 years experience of seeking to educate the public about franchising and create an appropriate self regulatory environment. Its failure to adequately do so is due more to the enormity of the task and its lack of any legal “locus standii” than its knowledge or intent.

By relieving the EFF and its member associations of the task of attempting to self regulate franchising in Europe, an EU Franchise Directive would allow the EFF and its members to focus on educating the public and provide it with a legal mandate to do so. This would give it a greater chance of success and allow the EFF and its members to deliver real benefit to franchising, franchisors, franchisees and the public.

\begin{quote}
It is proposed that each national franchise association be recognised as a legally acknowledged source of best practice in franchising and membership of it as an indication (but not a guarantee) that a franchisor has met certain minimum criteria as regards best practice. They should be charged with educating the public as to the benefits and risks of franchising. They should not however be charged with or be
\end{quote}

\textsuperscript{1127} Interview with Craig Tregellis, senior administrator of the FTC, ABA Franchise Symposium October 2008.
allowed to become involved with the regulation of franchising.

It would be appropriate for the national franchise associations to meet certain basic minimum standards before they are entrusted with this task (such as being a not for profit organisation and being a member of the European Franchise Federation).

5.4.1.2 A Minimal Level of Education for Potential Franchisees

It is suggested that potential franchisees need to be educated in the basic facts of franchising. These facts are:

1. The need for franchisees to work hard and for long hours. This is a clear and obvious factor of success in any business

2. The need for franchisees to follow the franchise system. The whole reason for buying a franchise rather than starting a business from scratch is that the franchisor has, through its own experience, identified how the business should be run.

3. The risk of failure and what this could mean in terms of both financial and personal terms. Failure is inevitably a risk in running one’s own business. It is fundamentally different from employment.

4. The importance of taking expert legal and financial advice from acknowledged experts before being legally committed to a franchise. In order to make an informed decision, advice is essential.

The national franchise associations should be obliged to create an educational pack for potential franchisees spelling out the franchising “facts of life”. An EU contribution to the funding of the national franchise associations would be appropriate.

It is recommended that the national franchise associations not only make publications and seminars freely available but also prepare an education pack that would include an audio visual presentation (by way of DVD, podcast or other digital media). All potential franchisees should be directed to this pack by franchisors.

In the UK, the internet is the way that the majority of franchisees find out about specific franchises1128. It is likely that it plays an important role in other EU member states too, so the educational pack should be available from the web. As 41% of all franchisors responding to the BFA/Nat West 2007 survey stated how important the BFA website is to recruitment, it is in an ideal position to ensure that potential franchisees receive these educational packs1129.

1128 BFA/Nat West Survey 2007 p 32.
1129 ibid p 17.
Again, it is likely that the website of national franchise associations in other EU member states has or in due course will have a similar impact on franchise recruitment.

The EU Franchise Directive should require all potential franchisees to provide written confirmation that they have watched an audio visual presentation and completed a short Question and Answer “test”, filed with the franchisor, to confirm that they have understood its contents.

This will not totally eliminate the problem of franchisees not understanding what they are getting into, of course, but it should reduce it. Some are cynical of what impact such a system will have. Octavia Morley, CEO of LighterLife, for example believes that,

“…..it will not make a scrap of difference. Potential franchisees are focused totally upon the excitement of having their own business. We (LighterLife) have a rigorous process to try and make sure that no one enters our franchise with any misconceptions as to what being in business for yourself as one of our franchisees means – but we still fail to get that message across to some of our franchisees. The problem is that many potential franchisees are extremely naïve and point blank refuse to take in anything that might dampen their enthusiasm to become a franchisee.”

Whether or not such cynicism is justified, it is suggested that an ongoing educational programme targeted at potential franchisees is appropriate, as part of a larger package of reform. It will certainly do no harm and it is suggested is likely to help ensure that potential franchisees take a more responsible approach when purchasing a franchise.

5.4.2 Ensuring Quality Advice for Potential Franchisees

This provides critical analysis to the third objective of this thesis.

It is suggested that a key element of education is ensuring that franchisees take advice from advisers with an appropriate level of experience. The FCA noted that in Australia the advice given to potential franchisees can vary and franchisees may rely on advice which is not adequate. There is no evidence to suggest that it is any different in the EU. This is another opportunity for the national franchise associations to play an active role in the regulation of franchising. By allowing affiliate membership of national franchise associations

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1130 Interview with Octavia Morley, CEO, LighterLife (20 February 2008) – See Appendix 6.
1132 The authors’ personal experience as a franchise lawyer acting for franchisors is that many potential franchisees do not take legal advice and of those that do, many use solicitors with little or no experience or knowledge of franchising. Indeed, he has even known for a potential franchisee to take advice from a personal injury lawyer, who offered to give the advice free of charge in return for the potential franchisee agreeing not to file a professional negligence case against him, in respect of a failed claim concerning injuries incurred in a motor vehicle accident.
(as the BFA already do) for professional advisers such as lawyers and accountants with relevant experience, a reservoir of more suitably experienced professional advisers will be created. Obviously it is important that such affiliate status is open to all advisers with relevant experience and that the definition of relevant experience be clear and unambiguous.

Relevant experience should be defined as having undertaken and successfully completed a short self study programme on the commercial aspects of franchising set by the national franchise association. It would not be appropriate for them to seek to test the technical knowledge of the relevant areas of law or financial accounting.

Many franchisors feel that prospective franchisees do not read the pre-contractual disclosure documentation given to them\textsuperscript{1133}. Empirical research in the UK, France and Spain suggests that that this feeling is correct\textsuperscript{1134}. Only 56.25\% of potential franchisees surveyed in the UK, 36.66\% of those surveyed in France and 22\% of those surveyed in Spain said that they intended to pay for both legal and financial advice on the franchise before committing themselves to it. It would be possible to legally require potential franchisees to read the disclosure document but it is doubtful that this would have any meaningful impact.

\begin{quote}
It is proposed that if a franchisee is required to invest a sum greater than €20,000, legal and financial advice from advisers affiliated to the national franchise associations should be mandatory. There should be a certificate from the potential franchisee’s legal and financial advisors stating that the potential franchisee has taken appropriate advice from them and that they have completed the self study module. Potential franchisees should also certify that they understand that they are taking a substantial risk if they do not follow appropriate advice and accept that they may be responsible for any loss they suffer as a result of not taking such advice.
\end{quote}

As detailed above, the problem is that not all national franchise associations are as well developed as the BFA or the FFF and so such a scheme is unlikely to be effective on a practical level in all EU member states in the immediate future. It will therefore be appropriate for national governments to provide support and encouragement to the less developed national franchise associations. Indeed, the establishment of more effective national franchise associations in those EU member states should be a key part of the “regulatory package”.

\textsuperscript{1133} Appendix 2 – 52\% of franchisors in the UK and Germany, 40\% in France and 36\% in Spain believe that franchisees do not read extensive documentation on the franchise.
\textsuperscript{1134} Appendix 2 - survey of potential franchisees.
5.4.3 Pre-Contractual Disclosure

This section provides critical analysis to the third objective of this thesis.

It is suggested that franchisors should be obliged to deliver standard form pre-contractual disclosure to potential franchisees 15 working days before execution of any agreement which commits the potential franchisee to take up the franchise or payment of any fees in connection with the franchise sale. It should deliver details of the identity and experience of the franchisor, the target market and the franchise network, the terms of the franchise agreement and any earning claims. There should be a five working day cooling off period. Failure to comply should enable both the franchisee and national regulatory authorities take action.

The challenge for legislators considering pre-contractual disclosure by franchisors is to secure optimal impact for minimal effort. This can be achieved, at least in part, by focusing on the two key factors of pre-contractual disclosure. Timing of the disclosure and the quality of the information disclosed. Beyond certain basic facts, it is suggested that the amount of information disclosed can be largely irrelevant. Indeed, above a certain threshold there is an inversely proportionate relationship between the amount of information disclosed and its effectiveness. The greater the volume of information given, the less likely it is that franchisees will analyse it. In this sense “less” is “more”. This was certainly the conclusion of the government review of the Australian Franchising Code in 2006\textsuperscript{1135}, which was launched due to an increase of complaints of more than 100% over a period of 5 years ending June 2006\textsuperscript{1136}.

An obligation of pre-contractual disclosure is not universally considered to be appropriate\textsuperscript{1137}. It is considered by some that if a person who has invested in the search for information is forced to give it away to the co-contracting party, he will have an incentive to reduce (or curtail entirely) his production of such information in the future\textsuperscript{1138}. The law should maximise the production of socially useful information by allowing those who discover it to benefit from it\textsuperscript{1139}. A conceptual distinction is made between information which has been gained “with investment” and that which has been “casually obtained”; although in practice this

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{1136} The ACCC reported 252 complaints related to disclosing issues during the period.
\item \textsuperscript{1138} Op cit Kronman, T, 1978
\end{itemize}
\end{footnotesize}
becomes a difficult distinction to make. In terms of franchisors it would suggest that information about the franchised business, which has been obtained without investment should be disclosed but information about the target market\textsuperscript{1140} should not.

Another approach to identifying what should be disclosed and what should not is advanced by Cooter and Ullen\textsuperscript{1141}. They distinguish between information that can be used to increase wealth and redistributive facts, that is information that creates a bargaining advantage, that can be used to redistribute wealth in favour of the knowledgeable party but that does not lead to the creation of new wealth. The conclusion is that economic efficiency requires that wealth creating facts should be disclosed but redistributive ones should not. Cooter and Ullen also identify a third type of fact, so called destructive facts, information, that if not disclosed will harm someone’s property or person. In franchising detail about the targeted marked should be disclosed by the franchisor to its potential franchisees. Likewise facts about franchisee failure and disputes. However, information about the franchisor’s margins on products and general profitability should not be disclosed to potential franchisees.

Both of these arguments are based upon the economic efficiency of disclosure but, in the case of franchising, come to different conclusions.

Perhaps the reality is that economic efficiency is better measured by having regard as what facts, if disclosed to the potential franchisee by the franchisor, are most likely to avoid the disputes that are occasioned by a mismatch of expectations between the parties.

Prospective franchisees are often relatively unsophisticated in terms of business. They lack the relevant education to be able to process, analyse and draw appropriate conclusions from large amounts of financial and other information. They are also often loathe to spend money on legal and financial advice at a time when they feel that they need to inject all the financial resources they have into their new business\textsuperscript{1142}. This

\begin{quote}
“weakness of those involved in franchising and perhaps human nature in general\textsuperscript{1143} underlines the reality that no matter how complete any pre-contractual disclosure law is, no matter how potential franchisees are educated about franchising and pushed to take appropriate advice, at the end of the day its effectiveness does depend upon the information disclosed being relevant and easy to understand. It also depends upon it being disclosed at an appropriate time during the “recruitment” or sales process.
\end{quote}

\textsuperscript{1140} As required by the French and Belgian Franchise focused Laws.


\textsuperscript{1142} Appendix 2. Only 55\% of potential franchisees in the UK, 36.66\% in France and 22\% in Spain intended to pay for both legal and financial advice before committing themselves to a franchise.

\textsuperscript{1143} FCA submission – 15 August 2006.
5.4.3.1 Can pre-contractual disclosure help provide adequate protection?

One of the biggest causes of disputes between franchisors and their franchisees is a “mismatch of expectation” caused by inadequate communication between them as to what they are looking for from the relationship. Pre-contractual disclosure seeks to prevent this mismatch by ensuring that franchisees have all relevant information about the franchise before they commit themselves to it.

If they have been appropriately educated they can then assess the likelihood of their expectation being met by the franchisor. Effective disclosure by the franchisor helps appropriately educated potential franchisees to more fully understand the franchise relationship that they are entering, as well as the legal and financial commitments they are undertaking. This reduces conflict in franchise systems.

As the then Chairman of the BFA said:

“Complete transparency during the recruitment process can help avoid most of the problems that franchisors encounter with their franchisees”.

This view seems to be supported by many of the franchisors surveyed for this thesis. A majority believe that appropriate regulation of the pre-contractual process would substantially reduce the amount of franchise disputes.

Analysis of a number of franchise disputes in the UK similarly supports the view. It shows that 85% of the sample considered involved allegations of misrepresentation by the franchisee. None of the sample issued pre-contractual disclosure documents to their potential franchisees.

5.4.3.2 The US Experience of Pre-contractual Disclosure

The US has the most comprehensive and complex pre-contractual disclosure requirements in the world. It is suggested that its experience supports the view that mandatory set form pre-
contractual disclosure can increase the protection afforded to potential franchisees to an appropriate level. It also suggests issues that it should be taken into account when considering the EU’s legal eco-system and its impact on franchising.

Pre-contractual disclosure is regulated at both federal and state level in the US. Predictably these laws are not identical, making life somewhat complex for franchisors.

The FTC Rule 436 (the “Amended Rule”)\footnote{Which came into effect in October, 1979, as amended in January 2007 and implemented July 1 2007 with interim provisions until July 1 2008. Federal Register Vol 72, No. 61, 15444-15563 March 30, 2007.} aims inter alia to prevent the misrepresentation of material facts and ensure the presentation of material facts as a franchisor offers franchises to prospective franchisees. Franchisors are required to deliver a disclosure document at least 14 days before the franchisee signs a contract with the franchisor or pays any money whichever occurs earlier. The Federal Trade Commission is responsible for enforcing the Amended Rule\footnote{Section 5 of the FTC Act 1914 as amended.}.

The Amended Rule provides that the franchise agreement and all related agreements (i.e. supply contracts, leases and security agreements) must be delivered to the prospective franchisee in final form, ready for execution, at least 7 days prior to the date on which they are to be executed\footnote{FTC Rule at 436.1(g).}.

The timings of the disclosure varies and under some state laws disclosure has to take place earlier than under the Amended Rule, i.e. at the first personal meeting\footnote{Maryland, Michigan, New York, Rhode Island and Washington.}. This causes unnecessary complexity on a practical level and so the North American Securities Administrations Association is recommending that these states adopt the FTC rules 14 day requirement in order to simplify matters\footnote{Per Fox Rothschild Newstand Elizabeth Sigety August 2009.}.

The offering circular must have a cover page bearing language specified by the Amended Rule\footnote{FTC Rule at 436.11(g).} and a table of contents\footnote{ibid at 436.4.}. It must contain comments that either positively or negatively respond to each disclosure question required to be answered under the Amended FTC Rule. The offering circular may take one of two forms. The first is prescribed by the Amended Rule. The second format is the Uniform Franchise Disclosure Document (the “UFDD”\footnote{Formerly known as the “Uniform Franchise Offering Circular” or “UFDD” (UFDD/UFOC) which has been amended to comply with the Amended FTC Rule.}) as developed by the North American Securities Administrators Association. The
two formats cannot be combined, but following the amendment of the FTC Rule, the differences between the two are now relatively minor.

The Amended Rule format is often shorter and more easily prepared than one following the UFDD format. However, it is accepted in only 42 states\textsuperscript{1157}. The UFDD format is accepted in all 50 states and complies with the requirements of those states with franchise disclosure laws.

Both forms of disclosure are similar to each other. The Amended FTC Rule format and the UFDD both include 21 different items of information. In fact the 21 different items (plus the franchise contract and the receipt) are identical. However, the level of disclosure required differs in respect of certain items. This disharmony makes the disclosure process far more complex than it need be. The UFDD complies with the Amended Rule but the laws and regulations of each state must be consulted in order to ensure compliance with its individual registration and disclosure provisions. This caused a great deal of debate and discussion amongst the US franchise bar during 2007 and 2008. It clearly demonstrates the importance of an integrated and straightforward approach to the regulation of franchising in the EU.

Disclosure under the Amended Rule is not necessary in certain circumstances\textsuperscript{1158}.

The Federal Trade Commission has the sole authority to bring actions to enforce the law and disclosure rule and there is no express or implied private right of action under the Amended Rule although parties with an interest in the consumer redress aspects of FTC suits have been allowed\textsuperscript{1159} to intervene in the FTC action for the limited purpose of addressing those issues.

Both civil and criminal penalties may be imposed for violation of the Amended Rule or of the franchise disclosure rule. The Commission may mitigate civil damages in view of the financial condition of the defendant.

The corporate veil of a Franchisor breaching the disclosure rule can be pierced, rendering individual officers and directors of the entity liable\textsuperscript{1160}.

\textsuperscript{1157} The eight states in which the FTC format has not been accepted for use each require a franchisor to register a franchise offering before beginning sales efforts in the state. They are California, Indiana, Maryland, Minnesota, Rhode Island, South Dakota, Virginia and Washington. Eight other states also have registration or specific disclosure requirements. They are Hawaii, Illinois, Michigan, New York, North Dakota, Oregon and Wisconsin. Texas has a Business Opportunity Law which applies to franchise arrangements. However the Act specifically excludes any arrangement which is defined as a “franchise” under the FTC Rule if the franchisor complies with the disclosure requirements and prohibitions of the FTC Rule in its operations in the State of Texas and the Secretary of the State has been notified before the offer or the sale of a franchise, §41.004(b)(8).

\textsuperscript{1158} FTC Rule at 436.8. See Appendix 10.

\textsuperscript{1159} E.g. FTC v. American Legal Distributors, Inc., 1989-2, Trade Cases, 68,867.

\textsuperscript{1160} FTC v. Jordan Ashley, Inc., 93 2257-Civ-Nesbitt (S.D. Fla.) three greeting card display rack franchisors, and their three principal officers, were liable for various misrepresentations violating the FTC
State disclosure/registration laws generally provide civil remedies and criminal penalties for violations. The civil remedies include rescission and the recovery of legal fees and other costs. A number of states, such as Florida, have laws focused on misrepresentation in the sale of franchises. This makes it unlawful when selling or establishing a franchise to “intentionally misrepresent the prospects or chances for success of a proposed or existing franchise, the known required total investment for a franchise and efforts to sell or establish more franchises than is reasonable to expect the market or market area for the particular franchise to sustain”

In some jurisdictions, fraud or gross misrepresentation may lead to the award of punitive damages.

Rescission is another possible remedy although failure to comply with a disclosure/registration law does not, in itself, void the agreement. It provides a party with the opportunity to rescind or seek damages. In some states, such as Wisconsin, rescission is the exclusive remedy for disclosure violations. In contrast, in California actions to remedy violations such as failure to register are in contract only and not for rescission; only wilful violations give rise to rescission rights under the California statute.

The need for a specific franchise law has been discussed in great detail for many years in the USA culminating in the publication in August 2004 of a Federal Trade Commission (FTC) Report and the adoption of an amended FTC Rule in 2007. Part of this process involved the preparation of an FTC Staff Report. A large number of franchisors and professional

Act. The liability was extendable to the officers upon demonstration that they had control over the wrongful acts and had some knowledge of the misrepresentations.

1161 The Florida Business Opportunity Act, Florida Statutes s 559.802.
1162 Cox v. Doctor’s Associates, Inc., 245 Ill. App. 3d 186, a terminated fast food franchisee recovered $1 million in punitive damages for overtly fraudulent oral and printed misrepresentations that amounted to an independent tort.
1163 Lulling v. Barnaby’s Family Inns, Inc., 449 F. Supp. 1353 E.D. (Wisc.1980), a franchisee that rejected rescission on advice of counsel was, in effect, subjected to a take-nothing judgment that allowed the Franchisor to gain possession plus damages and costs.
1165 Since 1995 the FTC has considered amending its rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures” (the “Franchise Rule”). This process began with a regulatory review in 1995 which was followed by the publication of an Advanced Notice of Proposed Rulemaking (“ANPR”) in 1997 and a Notice of Proposed Rulemaking (“NPR”) in 1999. As part of these and the FTC Staff Report there were numerous public workshops held by the FTC and some 281 submissions were received by the FTC from interested parties.
1166 Disclosure Requirements and Prohibitions Concerning Franchising- Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 CFR Part 436) – Bureau of Consumer Protection August 2004 (“the FTC Staff Report”) – The report, as required by Section 1.13(f) of the Commission’s Rules of Practice, contains the staff’s analysis of the rule amendment record and its recommendations as to the form of the final revised Franchise Rule. The Report has not yet been reviewed or adopted by the Commission. The Commission’s final determination in this matter will be based upon the record taken as a whole, including the Report and comments on the Report received during the 75-day period after the report is placed on the public record.
advisers, (many of them lawyers practising exclusively in the field of franchising,) made lengthy submissions about the need for franchise specific regulations. Many of them made it clear that pre-sale disclosure “helps franchisees more fully understand the franchise relationship that they are entering as well as the legal and financial commitments they are undertaking thereby reducing conflicts in franchise systems and potential litigation costs.” The vast majority of these not only supported the need for pre-contractual disclosure but also felt it to be “a cost effective way to provide material information to prospective franchisees so they can assess the costs, benefits and potential financial risks involved in entering into a franchise relationship.”

It was seen as enabling prospective franchisees to “investigate the franchise offering by providing information that is not available, such as the franchisor’s litigation history and franchisee failure rates.” Some commentators expressed the view that repeal of the US Franchise Rule would increase a franchisor’s costs and compliance burdens by opening the door for individual states to enact franchise disclosure laws that may be inconsistent, making it difficult for franchisors to conduct business on a national basis. A uniform pre-sale disclosure rule enables prospective franchisees to comparison shop for the best franchise offering and so reduces future disputes. In short, the FTC concluded that “free and informed consumer choice is the best regulator of the market.”

5.4.3.3 The Australian Experience of Pre-Contractual Disclosure

Australia has a highly developed franchise disclosure law. It is suggested that its experience supports the view that mandatory pre-contractual disclosure helps to ensure that the protection is extended to an appropriate level. It also suggests issues that should be taken into account when considering the EU’s legal eco-system’s impact on franchising.

1167 The FTC Staff Report III A pp 6. These included major franchisors such as Cendant, a publicly traded company that owns several franchise systems such as Howard Johnson, Ramada, Century 21, Coldwell Banker, ERA and Avis-Rent-a-Car, Re/Max, Snap-on-Tools, Little Ceasars, The Southland Corporation (7-11) Pepsico Restaurants (Pizza Hut, Taco Bell, KFC), Papa John’s Pizza, Forte Hotels and Medicap Pharmacies.
1168 The FTC Staff Report III A p. 6 and H&H, ANPR 28, at 2.
1171 The FTC Staff Report III A p 6; e.g. Marks ANPR 19 Sept 97 Tr, at 8-9, 29 and Wieczorek, Rule Review Comments (RR), Sept 95 Tr, at 62-63.
1172 E.g., WA Securities, ANPR 117; Shay, RR, Sept.95 Tr., at 104.
1173 Kaufmann, ANPR 33, at 3.
1174 The FTC Staff Report III A pp 11.
The Australian Franchise Code, prescribed by Section 51AE (which prohibits unconscionable behaviour) of the Trade Practices Act (TPA), focuses on creating an environment where a prospective franchisee can make an informed business decision whether to enter into a franchise agreement. Its provisions include comprehensive disclosure obligations on the part of a franchisor that intends to enter into, extend or renew a franchise agreement covered by the Code. A franchisor must provide to a prospective franchisee at least 14 days prior to signing a franchise agreement a detailed disclosure document. It must also provide a copy of the Code and a copy of the franchise agreement. The disclosure document requires the franchisor to provide approximately 250 items of information listed under 23 categories. The information required to be disclosed includes details of the franchisor, the business experience of those involved, litigation history, existing franchisee contact particulars, and information concerning intellectual property ownership, any territorial or supply restrictions, marketing or other cooperative funds, range of costs and payments relevant to the franchise and the franchisor’s financial position.

Section 51AC of the TPA, which prohibits unconscionable conduct, gives legal teeth to the Franchising Code of Conduct. Non compliance with the Code amounts to unconscionable behaviour and leads to prescribed remedies. This is clean and simple and avoids any confusion in Australia.

Other relevant provisions of the Code are a 7 day cooling off period for franchisees; requirement that the franchisor obtain from the prospective franchisee signed statements before entering into a franchise agreement confirmation that the franchisee has been given legal, business and accounting advice, or has been told to obtain that advice but has decided not to; and a requirement that the franchisor to provide financial statements for any marketing or other cooperative funds to which franchisees have made financial contributions.

The recruitment of franchisees is also regulated by section 52 of the TPA which prohibits misleading or deceptive conduct and is a comprehensive provision of wide impact. Franchisors are frequently the subject of claims based on misleading or deceptive conduct in the context of franchisee recruitment particularly as regards projected turnover and profitability. Section 52 applies the equivalent of a more general duty of good faith in pre-contractual negotiations to prevent prospective and actual franchisees from being misled or

1175 Clause 6 of Franchising Code of Conduct.
1176 Clause 13 of Franchising Code of Conduct.
1177 Franchisors should also be aware of the prohibitions against:
   • offering gifts, prizes or other free items with no intention of actually providing them, or with no intention of providing them as described (section 54).
   • bait advertising, which is advertising a product or service at a lower than normal price, where the product is unavailable at that price, or available only in limited quantities (section 56); and
   • advertising partial prices (section 53C).
deceived by the conduct in question. However, it does not go so far as the German concept of “culpa in contrahendo” to impose a duty of care to disclose. A failure to observe the standard of conduct required by section 52 has its consequences under Part VI of the TPA (enforcement and remedies), including both remedies available at common law (such as injunctions and damages) and other compensatory remedies under section 87 which apply when loss or damage is likely to be suffered by a franchisee (e.g., orders declaring the franchise agreement void or varied, for specific performance of the franchise agreement, accounting for profits made by the franchisor, payment of other compensation, or refunds or returns of property).

The ACCC take the view that advertisements must tell the full story and create an accurate impression. Phrases such as “conditions apply”, “to approved applicants” and “special offer” have been scrutinised to ensure that conditions or fine print terms were consistent with the thrust of the advertisement. It is important that the fine print is consistent with the impression created by the advertisement.

Section 61 TPA also impacts upon the recruitment of franchisees in that whilst it prohibits pyramid selling, the section is drafted broadly enough that it has the potential to catch multi-level product distribution agreements.

Any individual who suffers loss or damage as a consequence of a breach of section 51AD may seek injunctions under section 80 of the TPA; seek remedial orders under section 87 of the TPA; and/or recover damages under section 82 of the TPA. There are no criminal sanctions for a breach of section 51AD. The court may grant an injunction to the ACCC or any other person on such terms as it deems appropriate if a person has engaged in, or proposes to engage in, conduct that contravenes the Code.

A person who suffers loss or damage by the conduct of another person that was done in contravention of the Code, may recover the amount of the loss or damage by action against that other person or any person involved in the contravention. The ACCC cannot bring an action for damages under section 82 on its own behalf, as it is not a person who suffers loss and damage by reason of a contravention of the TPA. Actions for damages pursuant to section 82, for breach of section 51AD must be brought within six years of the date on which the applicant suffered loss or damage.

A breach of the TPA could have very serious consequences for a franchise system. Breaches of the anti-competitive conduct provisions attract fines of up to $10 million per offence for corporations and $500,000 per offence for those individuals involved in committing the breach. Breaches of the consumer protection provisions such as unconscionable behaviour may attract fines of up to $1.1 million per offence for corporations, and $220,000 per offence.
for individuals\textsuperscript{1178}. The courts can set aside or vary contracts and make other orders affecting the franchise relationship. Negative publicity and corrective advertising have a significant effect on brands, image and reputation. Such penalties are particularly significant in the franchising sector where a strong brand image is essential.

Since the introduction of the Code, the ACCC has commenced and successfully concluded litigation in 15 cases\textsuperscript{1179}. All cases were found to be in breach of the TPA and the Code, and a variety of remedies were ordered by the courts including injunctions, court orders and the implementation of a trade practices compliance program.

Of these 15 cases, 14 involved a failure by the franchisor to fully comply with the disclosure provisions of the Code. Most cases involved situations where the franchisor did not provide disclosure documents to potential franchisees or, if the disclosure documents were provided, they were misleading or inadequate. Some of these cases also involved franchise systems that wrongly represented themselves as distributorships or licence agreements, to avoid the stringent requirements of the Code.

The Code seems to have increased compliance costs for franchisors but has generally been well received. It has also provided an opportunity for those franchisors who comply with the Code and give full disclosure, as a mechanism to avoid or reduce likely claims by franchisees. Compliance with the Code reduces the opportunities for the application of section 51AC.

The government is proposing further amendments to the Code including, enhancing the ACCC’s powers to conduct random audits of franchisors, enabling the ACCC to alert the public of franchisor’s misconduct by issuing public warnings and permitting the ACCC to seek redress on behalf of franchisees where large numbers of franchisees have been affected by the franchisor’s non-compliance\textsuperscript{1180}. In addition, the government is proposing to include a list of examples of specific behaviour in the Code that constitute inappropriate behaviour. These may include: unforeseen capital expenditure, unilateral contract variation; attribution of legal costs; confidentiality agreements; franchisor initiated charges to franchise agreements when a franchisee is trying to sell the business\textsuperscript{1181}.

\textsuperscript{1178} Government’s response to the Report into the Franchising Code of Conduct by the Parliamentary Joint Committee on Corporations and Financial Services, the Trade Practices Amendment (Australian Consumer Law) Bill 2009.


In Australia, pre-contractual disclosure is credited with reducing the number of disputes between franchisors and franchisees. This is in no small part due to the fact that failure to comply with the disclosure process in both these jurisdictions is subject to significant legal sanctions which the authorities are ready, able and willing to apply. The Australian experience suggests that “prevention” in the form of legally prescribed disclosure can reduce the need for or at least lessen the drastic measures required for a “cure” in the form of the imposition of penalties.1182

5.4.3.4 The French Experience of Pre-Contractual Disclosure

The provisions of the Loi Doubin are detailed above1183. Its failure to define franchising the requirement of exclusivity or quasi-exclusivity in order for it to apply and its failure to require disclosure of the details of all ongoing fees that must be paid seem to have reduced the potential impact of the law, and so are not approaches that should be incorporated into an EU franchise directive.

5.4.3.5 What Should be Disclosed to Potential Franchisees?

Disclosure must help potential franchisees assess the potential benefits of taking a franchise1184 and reduce, but not remove entirely the consequential inherent risks involved1185.

Current requirements in EU member states, the USA and Australia are helpful in determining exactly what should be incorporated in the franchisor’s pre-contractual disclosure document to ensure that it helps to provide adequate protection for franchisees.

Common themes emerge when considering the six European disclosure regulations and the US and Australian franchise regulations. However, the European laws are generally less formulaic and are somewhat narrower in their scope. Some of these differences, such as that concerning the involvement of public figures in the franchise in the USA are due to cultural and commercial differences and so can be ignored. Others, such as exclusivity, reflect the differences in both the saturation/maturity of the markets and the propensity for litigation in each jurisdiction.

It is suggested that disclosure should comprise information about the identity and experience of the Franchisor; the franchise network; the terms of the franchise agreement and any earning claims made.

1182 See 4.6 above
1183 See 3.3 above
1184 See 2.3 above
1185 See 2.4 above
These are all straight forward matters of fact which potential franchisees clearly require and which the franchisor can easily provide and are reflected to some extent in the proposals of both the Amsterdam Team\textsuperscript{1186} and the UNIDROIT Model law\textsuperscript{1187}. However, it is the quality and relevance of the information and the way in which it is communicated rather than the mere type and quantity of the information that is important. “More is sometimes less” and as one experienced in-house US franchise lawyer has commented,

“The American UFDD goes far too far, obscuring important and relevant information with masses of less important detail”\textsuperscript{1188}.

Details of the identity and experience of the franchise and its directors should include the franchisor’s litigation history over the previous 36 months and the bankruptcy history of the franchisor and its directors and substantial shareholders (holding over 25% of the issued shares).

Details of the franchise network should include details of the franchise network in the target market (or, if there are none, an analogous market), including the contact details of existing franchisees and any franchisees that have failed in the previous 12 months.

There are significant differences between the different EU member states. The proposed obligation should be restricted to knowledge that the Franchisor actually has and will not include information that it ought to have.

A summary of the terms of the franchise agreement should be detailed in the disclosure document. These are;

- the Initial and Ongoing Fees,
- Intellectual Property,
- Franchise Territory,
- Supply of Goods and Services,
- Marketing and other co-operative funds,
- any financing arrangements provided by the franchisor,
- the Franchisor’s Obligations,

\textsuperscript{1186} Article 3:102 Commercial Agency, Franchise and Distribution Amsterdam Team 8th Draft (21 May, 2003).
\textsuperscript{1187} Ibid
\textsuperscript{1188} Interview with Christopher Nowak, Vice President and General Counsel, Wyndham Worldwide Corporation (10 March 2006).
Prospective franchisees want to know their likely level of earnings in the franchise and so this should be covered by the disclosure document. However, a prescriptive approach to what should be disclosed to potential franchisees about their likely earnings (as is found in the US), is not recommended.

It is proposed that the Italian approach to earning claims of “loyalty, fairness and good faith”\textsuperscript{1189} be adopted.

This is because artful draftsmen can get around detailed provisions so giving misleading information that complies with the law whilst this general approach makes it more difficult to evade and more adaptable to local conditions.

5.4.3.6 Inappropriate Disclosure

It is suggested that it is not appropriate to disclose the characteristics of the franchisor’s relevant know-how to potential franchisees.

Although the Amsterdam Team recommend this, to do so would compromise the franchisor’s trade secrets and so discourage companies from becoming franchisors\textsuperscript{1190}.

The Franchisor should not be under an obligation to deliver to the potential franchisee details about the market conditions.

This is contrary to the Study Group’s recommendation (and the provision of the French and Belgian disclosure laws).

However to require the franchisors to do so removes from the franchisee responsibility for its own commercial decisions and so encourages the unsuitable individuals and nurtures the blame culture condemned by the Australian government\textsuperscript{1191}.

\textsuperscript{1189} Law of 6 May 2004, No. 129 Article 6.1.
5.4.3.7 Renewal

There is a reasonable case for suggesting that on the renewal of a franchise agreement the incumbent franchisee has sufficient information about the franchised business to make any disclosure document a meaningless and unnecessary administrative burden for the franchisor. This is particularly so for mature systems that are no longer actively recruiting new franchisees.

However, the counter argument is, on balance, more persuasive. The renewal of a franchise is an important commercial event which requires the franchisee and the franchisor to carefully consider their options. In order to do this both need accurate and up to date information.

The franchise network will have developed during the term of the expiring franchise agreement and the new franchise agreement may differ from the original agreement in important ways.

The franchisee’s circumstances may have also changed and the franchisor should be given formal notice of these.

It is proposed that the EU franchise directive provide that on each renewal of a franchise agreement the franchisor and the franchisee must comply with the pre-contractual disclosure obligations as if they did not have an existing franchisor/franchisee relationship.

5.4.3.8 The Timing of Disclosure

Timing of disclosure is important. The franchisee must have sufficient time to properly consider it but too long a period risks it becoming out of date and unduly slowing down the commercial process.

Delivery of the disclosure document to the prospective franchisee should be 15 working days before the execution of any agreement which commits the prospective franchisee to take up the franchise or payment of any fees in connection with the franchise sale.

This follows the Swedish example\(^\text{1192}\) and is similar to the approach taken by both the US’s FTC Rules\(^\text{1193}\) and the Australian Franchise Code\(^\text{1194}\).

\(^{1191}\) See 5.4.1 above

\(^{1192}\) The Swedish law requires a reasonable period of no less than 14 days.

\(^{1193}\) See 16 CFR 436.1(g), 436.2(a), and 436.2(c).

\(^{1194}\) See 4.6.2 above
5.4.3.9 **Who Should it be Delivered to?**

The disclosure document must be delivered to a “prospective franchisee”. A prospective franchisee any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.

This follows the US lead\textsuperscript{1195}. Representatives of a prospective corporate franchisee must be permitted to accept delivery of the disclosure document on the prospective franchisee’s behalf. The requirement that the parties must

“discuss the possible establishment of a franchise relationship,”

makes it clear that for an individual to become a “prospective franchisee” he or she must communicate with the franchisor about a franchise offering. Merely perusing a franchisor’s website alone, for example, will not turn an ordinary internet surfer into a prospective franchisee.

5.4.3.10 **What Constitutes Delivery of the Disclosure Document?**

It is important to avoid confusion over whether or not the disclosure document has been delivered.

It is suggested that the Directive should lay down a clear and unambiguous definition of what amounts to delivery to the prospective franchisee.

Evidence that the duty of disclosure has been complied with is important in order to prevent any future dispute as to compliance. This issue is dealt with in both the US\textsuperscript{1196} and Australian\textsuperscript{1197} legislation.

With the increasing use of email and other forms of electronic communication, the Directive must also deal with issue of electronic disclosure. There are three key issues that need to be considered as regards this\textsuperscript{1198}.

The first issue to be addressed is whether the electronic disclosure document has to be exactly the same as the hard copy document. Enhancements such as audio, video, pop-ups and

\textsuperscript{1195} Section 436.1(r) of the FTC Rule. The term “franchise seller” is used in lieu of “franchisor, or franchise broker, or any representative, agent, or employee thereof.” See section 436.1(i).

\textsuperscript{1196} In the USA Item 23 of the UFDD requires that the last page of the offering circular must be a detachable document acknowledging receipt of the offering circular by the prospective Franchisee. The prospective Franchisee signs the receipt and returns it to the Franchisor. The Franchisor is also required to furnish the franchise agreement containing all material terms at least five business days before signing.

\textsuperscript{1197} According to the Australian Franchise Code of Conduct, the last page of the disclosure document must contain “a statement to the effect that the prospective franchisee may keep the disclosure document”, and “a form on which the prospective franchisee can acknowledge receipt of the disclosure document” (The Code, Annexure 1, item 23).

\textsuperscript{1198} Plave, LJN’s Franchising Business & Law Alert, April 2007, Vol. 13, No. 7, pp. 1, 1, 2, 4.
external links to websites could erode the integrity of the disclosure document so are best avoided although limited electronic enhancements, such as scroll bars, search features and internal links to facilitate franchisee navigation of the document are appropriate.

Secondly, there are a multitude of options available to the franchisor: e.g., e-mail, a password protected Internet site or CD-ROM although e-mail is likely to be the favoured option due to cost efficiency and ease of use. To ensure that a franchise prospect realises that alternative disclosure formats are available, the franchisor should add information to the cover page of the disclosure document indicating that such alternative formats are available.

Thirdly, the greater ease of using electronic disclosure potentially increases the administrative burden of recording who was served with the disclosure document and when. The US requirement for the delivery of disclosure documents to be acknowledged by the recipient\textsuperscript{1199} has lead to detailed provisions as to how this must be effected if disclosure is made electronically\textsuperscript{1200}.

\begin{quote}
It is proposed that receipt of the disclosed document can be acknowledged by any affirmative action by the recipient to authenticate his/her identify and confirm receipt. This could include, for example, a handwritten signature, an electronic signature, passwords or a security code. The fast changing nature of electronic commerce means that this general statement is more appropriate than detailed and specific provisions that are likely to become out of date in a short period of time.
\end{quote}

5.4.3.11 \textit{What documents should be given to the potential franchisees}

\begin{quote}
It is proposed that the disclosure document should be accompanied by a copy of the franchise agreement in the form in which it is to be executed.
\end{quote}

The franchisor should also provide the prospective franchisee with all other documents required by the franchise agreement to be signed, in the form each is intended to be executed. Whilst this may seem all very obvious and straight forward, in practice complications can arise\textsuperscript{1201}.

The prospective franchisees should receive the franchise agreement in the form in which it is intended to be executed at the same time as they receive the disclosure document. However in practice all documents may not be available in their final form at that time\textsuperscript{1202}.

\textsuperscript{1199} Statement of Basis and Purpose, Section II.B.2.b, 72 Fed. Reg at 15469. See Appendix 10.
\textsuperscript{1200} Section 436.1(4) Statement of Purpose, Section III, A21, 72 Fed Reg at 15467 FTC FAQs Question 15.
\textsuperscript{1201} See the Italian franchise law in section 4.5 above.
\textsuperscript{1202} A similar provision found in the Australian Franchising Code of Conduct, Part 2, Division 2.1, section 6C and Annexure 1, section 18.
Research in Australia suggests that despite the requirements of the Code, the final form of such documents is sometimes not provided until after the franchise agreement is signed and their existence is only alluded to briefly during preliminary meetings or brushed off as not being of any significance.

The Loi Doubin, requires that potential franchisee must be provided with all information which is indispensable for the franchisee to contract with full knowledge of the facts.

It is suggested that if there is any material difference between the summary of any such document and the one presented to the franchisee for execution, it should entitle the franchisee to withdraw from the franchise without penalty and cost.

Clearly a franchisor may have difficulty providing all documents required to be signed by the franchisor to the prospective franchisee 15 working days before the franchise agreement is expected to be signed. If the documents are available, they should be provided at least 15 working days before the franchise agreement is expected to be signed. A latest draft of documents not available in final form at that time must be provided. When the final draft is ready, a red lined copy illustrating any changes should be provided. This must be at least 5 working days before executing the Franchise Agreement and other relevant documents. If necessary, the execution of documents must be delayed to ensure that there are 5 working days between delivery of the final document and execution.

5.4.3.12 The Accuracy of the Information being Disclosed

It is important that the standard of the franchisor’s liability for drafting the disclosure document is established. If the information disclosed is inaccurate the disclosure process is pointless. The simplest solution would be to place the Franchisor under a strict liability to ensure the accuracy of the information it supplies. However,

“as anyone who has drafted a (US) Offering Circular can testify, there is no certainty as to the nature of the information that has to be included in the various disclosure sections of the Offering Circular and reasonable persons often differ in good faith as to what has to be disclosed.”

1204 It requires the franchisor to provide a summary of any requirements under the franchise agreement for the franchisee to enter into other agreements as a result of signing the franchise agreement. These include leases and sub-leases for premises, chattel leases or hire purchase agreements, guarantees, mortgage security deposits, confidentiality agreements and agreements not to carry out business in the area for a time after the franchise agreement is terminated. Federal Trade Commission Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures (FTC Rule) §436.
1205 Commercial Court of Creteil, 9 May 2000, L’Off De la. fr No. 30 p. 94.
1206 FTC Staff Report Baer, NPR 11, at 10.
The Directive should follow the French and Spanish approach to accuracy of disclosure and focus upon the subjective test of defective consent rather than a technical failure to comply with the technical requirement of disclosure.\textsuperscript{1207}

It is therefore proposed that even if disclosed information is inaccurate it will be immaterial if the inaccuracy has not led to defective consent being given by the franchisee and that it is a violation for a franchisor to fail to use best endeavours to ensure the accuracy of the disclosed information.

Liability for inaccurate disclosure that lead to defective consent should attach not only to the franchisor, but also to any individual working for or with the franchisor who can be shown to have been responsible for the disclosure of the inaccurate information, who knew (or should have known) the legal or commercial significance of those facts, and was in a position to influence the outcome of the matter.

A secretary could “know” that incorrect financial performance data was routinely provided to buyers, but neither knew the significance of doing so nor was in a position to stop the practice. Failure to comply should lead to the imposition of a fine by the authorities and liability in damages if despite consent being valid the franchisee is disadvantaged in some tangible way.

In the interests of clarity and practicality it is also appropriate to impose an obligation upon the Franchisor to update the disclosure document on a regular basis.

It is suggested that the Australian approach be adopted by the EU Franchise Directive and that the Disclosure Document be updated within 6 months of the end of each financial year.

A shorter period might create too much compliance urgency for franchisors without adequate resources to comply.

5.4.3.13 \textit{Language}

The different languages of the 27 member states can create complications with precontractual disclosure.

\textsuperscript{1207} See 3.3 above
It is proposed that the disclosure document should be in the plain language(s) of the member state in which the franchisee will be operating its business or, in member states in which there is more than one official language, the official language which the franchisee designates as its preference.

For example, a franchisee in Belgium could require the disclosure document to be Flemish, French or German.

Plain language should be defined as “the organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information, where possible.

It avoids legal jargon, highly technical business terms, and multiple negatives”\(^{1208}\).

5.4.3.14 Risk Statement

Potential franchisees need to be reminded in clear and unambiguous terms that buying a franchise can be a risky business. There is no guaranteed return on their income and they may lose everything they invest. The proposals regarding educating potential franchisees made above\(^ {1209}\) should be re-enforced by a Risk Statement on the disclosure document.

If prospective franchisees are made aware of these significant risks then they should be better informed in making their decision about entering a franchise agreement and will be better equipped to manage the risks.

The US approach is to ensure that franchisors

“present all material facts accurately, clearly, concisely, and legibly”\(^ {1210}\).

There are no such requirements in the EU member states.

It would be appropriate to place on the front of the disclosure document a clear and unequivocal risk statement.

\(^{1208}\) This definition is based upon the definition of “plain English” used in Part 436 of the final amended FTC Rule, Section 436.1(o).

\(^{1209}\) See 5.4.1 above

\(^{1210}\) See UFOC Guidelines, General Instruction 150. The phrase “plain English” is defined separately in section 436.1(o), consistent with the UFOC Guidelines.
A Risk Statement which identifies known significant risks that could have a material impact on the franchisee should be placed on the front of the disclosure document. It should read as follows;

“Investing in a franchise can be a risky business. There is no guarantee that your franchise will be a success. You could lose your investment. In order to succeed you will have to work long and hard. It is not a road to instant success and riches. You must think about it carefully before you enter into the franchise agreement. Some of the information you need in order to make an informed decision” is contained in this disclosure document. Take your time, read all documents carefully, talk to other franchisees and assess your own financial resources and capabilities to deal with requirements of the franchised business. You should also make your own enquiries, get independent legal, accounting and business advice, prepare a business plan and projections for profit and cash flow and consider educational course, particularly if you have not operated a business before”.

It is also recommended that the front of each franchise agreement be endorsed with the following statement:

“This franchise will not provide a guaranteed income to you. In entering into this franchise you are accepting the risk that you may lose your investment. If you get into financial trouble whilst operating your franchised business your franchisor has no obligation to rescue you. It is therefore essential that before entering this franchise you take legal and financial advice from professionals with a proven track record of advising prospective franchisees on their intended investment and that you follow their advice. You must also carefully read the disclosure document. It contain important information that you must read before entering into the franchise agreement. Remember, if your franchised business fails depending upon your circumstances you could end up losing your home and becoming bankrupt.”

5.4.3.15 Cooling Off Period

A number of jurisdictions with franchise focused laws impose a “cooling off” period on the parties after the execution of the franchise agreement, ranging from 5 to 30 days\textsuperscript{1211}.

\textsuperscript{1211} Mexico - Decree No 35/2006/ND-CP, article 142 of Mexico’s Industrial Property Law. Malaysia - The Franchise Act 1998 Part III Section 18 (2)(h) and 18(4). Taiwan - Article 5 of the Standards Governing Disclosure of information by Franchisors by the Fair Trade Commission
In Germany BGB 507 imposing a cooling off period in certain circumstances\textsuperscript{1212} as does Austria\textsuperscript{1213} and the UK\textsuperscript{1214}.

This extra time for a franchisee to reflect upon their decision is a small investment in helping to ensure that franchisees are really committed to making the franchised business a success. It is an investment in favour of franchisor and franchisee alike.

\begin{quote}
It is therefore proposed that a period of five working days following the day on which the franchise agreement is executed by both parties the franchisee has the right to withdraw by written notice, without penalty
\end{quote}

5.4.3.16 \textbf{Foreign Franchisors}

Should an EU disclosure law impact only on franchisors based in the EU or should it also have jurisdiction over those based outside of the EU but granting franchises into member states?

The answer to the question about the effect of the franchisor's location may seem an obvious one. However, until a recent change of law, Australia exempted foreign franchisors from the need to provide disclosure to an Australian Franchisee so long as the franchisor was resident outside of Australia and only granted one franchise or master franchise to be operated in Australia\textsuperscript{1215}. The main reason for this exemption seems to have been to ensure that there was nothing that discouraged foreign franchisors entering into the geographically remote and demographically small Australian market. However, it seems that this concern was misplaced and the AFC’s recommendation\textsuperscript{1216} that this exemption be dropped has recently been accepted by the Australian government.

If one views individual member states as separate markets then some of the smaller markets such as the Baltic States, Slovenia and Slovakia may merit such treatment. They are demographically small and are noticeably more remote than the western and central member states. Perhaps a US franchisor would appreciate an exemption that removed its obligation to make disclosure to, say, a Latvian franchisee.

However, given the size and wealth of the EU as a whole, the justification for such an exemption for foreign franchises entering an EU member state could not be that it is necessary in order to encourage new franchises to enter the EU. One could argue that foreign concepts entering an EU member state for the first time are entirely untested in the target EU

\textsuperscript{1212} See Section 3.5 above
\textsuperscript{1213} Ibid
\textsuperscript{1214} Ibid
\textsuperscript{1215} Section 5 of the Australian Franchise Code of Conduct.
market, and therefore do not have that much information about the target market to disclose. There is, of course, some merit in that argument, but it is not sufficiently persuasive. There is a good deal of important non-market specific information that needs to be disclosed to potential franchisees, in addition to which, as one franchise executive stated,

“whilst for some businesses the details of the business outside of the target member state might well be irrelevant and possibly confusing, for many including our business such disclosure is extremely useful and important to potential franchisees.”

All franchisors should give some form of disclosure. Although, a franchisor with no experience of the market in a particular member state should not be under any obligation to furnish potential franchise information about that member state.

“To expect a franchisor to have a real detailed knowledge of foreign jurisdictions in which it has no operational experience is nonsensical and dangerous. Often it is the franchisors’ very lack of such knowledge that leads it to franchise in a foreign jurisdictions in the first place.”

Such requirements can create barriers to successful cross border franchising and show a real lack of understanding of what master franchisees and developers are expected to bring to the party.

However such a franchisor must make some type of disclosure about the business and about how it has fared in at least one market. A Master Franchisee who tries to establish a franchise system in an EU member state from scratch would be compromised by a lack of knowledge of how the system has performed in other markets. A potential franchisee needs the protection afforded to it by formal disclosure and the location of the franchisor is irrelevant. Although a system’s performance in foreign markets and other member states may be totally different to its potential performance in a particular member state, so long as such information is furnished to the potential franchisee with an appropriate health warning clearly stating that it is for a different market and that it may perform very differently in the franchisee’s market, it can be useful.

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1217 Interview with Christopher Nowak, Vice President and General Counsel, Wyndham Worldwide Corporation (10 March 2006).
1218 Interview with Jane Colton, Vice President & Legal Counsel, Vanguard Rental GMbH (1 June 2006)
It is therefore proposed that:

(1) A franchisor granting a franchise to a party in a member state in which it is not based (the target member state) should disclose details of its franchise in the target member state.

(2) If a franchisor does not have outlets in the target market it should disclose details of its business in another member state.

(3) If the franchisor does not have any outlets in the whole of the EU, it should disclose details of its franchise in the country in which it is based or another country which it can reasonably justify as being appropriate ("the analogous market").

The disclosure requirement will not apply to Franchisors based in the EU granting franchises to potential franchisees who are based outside of the EU.

When a franchisor is disclosing details of outlets in a market other than the target member state, it must clearly state that this is the case and that performance in a different market is not necessarily a reliable guide to performance in the target market due to economic, cultural and commercial differences and that the potential franchisee should therefore treat them with caution.

5.4.3.17 Regular Review of the Law

It is proposed that the EU Directive be reviewed every five (5) years to ensure that the contents of the Disclosure Document continue to be relevant to the market.

It is important that the required contents of the disclosure document and indeed other aspects of it are not fossilised, but are regularly updated to reflect the concerns of the market and so ensure that it continues to meet the benchmarks of good regulation.

Such reviews have recently been conducted on an ad hoc basis in both Australia and the USA. The disclosure provisions of the Australian Franchising Code were reviewed on behalf of government in 2006\textsuperscript{1219} due to a marked increase of complaints (more than 100% increase) on

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\textsuperscript{1219} Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon. Fran Bailey M.P., Minister of Small Business and Tourism – October 2006 – Secretariat Office of Small Business. The Review, completed on 31 October, was conducted by a committee chaired by Mr Graeme Matthews, National Managing Partner, KPMG Middle Market Advisory, supported by a secretariat from the Office of Small Business and a team from the law firm Corrs Chambers Westgarth.
the 5 year period to June 2006\textsuperscript{1220}. The US Federal and State franchise laws are being continually re-assessed and amended\textsuperscript{1221}.

It is therefore suggested that

“the format of the statutory disclosure document should be reviewed every 10 years or so to ensure that as franchising develops along with the sophistication of potential franchisees it also changes to ensure that the disclosures are relevant and useful”.

\textbf{5.4.3.18 The consequences of inadequate disclosure}

A disclosure law is meaningless unless the consequences of non compliance are such as to deter franchisors from failing to give full disclosure and afford sufficient remedy to the wronged party. The wronged franchisee always has a right of redress against a franchisor who has made wrongful or inadequate disclosure. However, in some jurisdictions the government agencies have an independent right of action\textsuperscript{1222}. Failure to make adequate disclosure under disclosure laws\textsuperscript{1223} is generally sanctioned by nullity/recision of the franchise agreement\textsuperscript{1224};

\textsuperscript{1220} The ACCC reported 252 complaints related to disclosure issues in the five year period – Review of the Disclosure Provisions of the Franchising Code of Conduct – Report to the Hon Fran Bailey M.P. etc.

\textsuperscript{1221} For example: (1) in the last 20 years, Congressman LaFalce has twice proposed stricter federal regulation, (2) the FTC has twice reviewed its FTC Rules as part of the process that ultimately led to the recent changes, (3) states such as Iowa have adopted new franchise laws, (4) the Supreme Court has relaxed the law on price control in the Leegin case, (5) innumerable states have amended their existing franchise laws.

\textsuperscript{1222} In Spain for example, both private parties and the Ministry of Economy and Finance may bring legal action for violation of the disclosure requirements before the administrative courts. In addition, franchisee can file a request to the government to commence action against a franchisor. The Government does not have to do this, but if failure to bring action results in damages to the franchisee, the franchisee may have a claim against the government. In the USA, the FTC itself can bring a civil action for rescission of contract (FTC Act s.19 (15 U.S.C. s57b)). The Australian Competition and Consumer Commission (ACCC) also has power to act against offending franchisors. It can bring actions in relation to a violation of the Franchising Code of Conduct or of Section 52 of the TPA. It can order the contract fully or partly void and can refuse to enforce all or any provisions of the franchise agreement.

\textsuperscript{1223} USA: Federal Trade Commission Act;


\textsuperscript{1224} Nullity/recision of the franchise agreement is a formalistic approach to non compliance aimed at ensuring that franchisors comply with the disclosure law, sometimes regardless of proportionality. All jurisdictions except Sweden recognise the right for individual franchisees to rescind agreements but not all give the regulatory authorities the same rights. Misrepresentation under English and Irish law can render the agreement void “ab initio”. Although the Loi Doubin is silent as to the consequences of inadequate or wrongful disclosure, failure to comply can give rise to a retroactive cancellation (Cass. Com., 10 February 1998, Bull. Civ.IV No. 71 recently confirmed by Cass. Com., 7 July 2004, No.02-15950). However, in recent years French courts have only voided or cancelled a franchise agreement if the franchisor’s failure to disclose has meant that the franchisee’s consent was vitiated (Cass. Com., 10 February 1998, Bull., Civ IV No. 71, recently confirmed by Cass. Com., 7 July 2004, No. 02-15950). Article 1304 of the French Civil Code imposes a time bar of 5 years from the time that the franchisee on any action for rescission of contract. Inadequate or incorrect disclosure may give rise to the nullity of the franchise agreement in Spain.
prohibition of further franchising by the franchisor\textsuperscript{1225}; cease and desist orders and injunctive relief\textsuperscript{1226}, financial penalties\textsuperscript{1227}, damages\textsuperscript{1228}, and criminal sanctions\textsuperscript{1229}.

Some Spanish courts have declared several franchise agreements to be null and void due to a lack of compliance with disclosure requirements, whereas other courts have deemed the failure to comply with disclosure obligations a mere administrative default. If the misrepresentation has been minor, the Spanish courts will award the franchisee an extraordinary right to terminate the agreement rather than to declare it null and void from the beginning. Failure to disclose may lead the Italian courts to rescind the agreement or declare it null and void. Article 5 of the Belgian franchise law provides that failure to provide the disclosure document enables the franchisee to seek a declaration that the franchise agreement is null and void within two years following the execution of the contract.

\textsuperscript{1225} In some jurisdictions if a franchisor is a serial offender and is regularly breaching the disclosure obligations the authorities have the right, in the public interest, to disqualify it from granting further franchises. In the UK the Companies Investigation Branch of the Insolvency Service can petition the High Court to place franchisors who misrepresent their businesses to potential franchisees into liquidation (In November 2008 the Queensbury and Richmond vending franchises were placed into liquidation as a result of the CIB’s investigation showing that their recruitment literature contained untested claims about what franchisees could earn; Franchise World, Dec/Jan 2009, p. 6).

\textsuperscript{1226} In a number of jurisdictions, the courts can make orders for specific performance in addition to fines and awarding damages. However in Sweden this is the only order that the Market Court can make (Lag (2006:484) om franchisegivares informationsskyldighet). As the right to recission or damages may not always be immediate enough to provide a franchisee with adequate remedy both the wronged franchisee and the regulatory authority are often able to apply for injunctive relief. For example, in both the USA and Australia, cease and desist orders can be issued by the regulatory authorities and obtained from the courts on application by the franchisee.

\textsuperscript{1227} Financial penalties rather than damages can also be imposed by the regulatory authorities in the USA, Australia and certain EU member states. In the USA, monetary penalties of up to US$10,000 a day for each violation can be imposed (§5 of the FTC Act (U.S.C. §45)); whilst in New South Wales payment of money is a possible remedy under section 106 of the Industrial Relations Act 1996 (New South Wales). Article 2 of the Loi Doubin provides for specific fines for failure to comply with disclosure obligations (€1,500 for a single violation and €3,000 for repeat violation) even when lack of intent, whilst the Spanish government can impose fines of up to €3,000 for the first offences, up to €15,000 for repeated violations and if turnover of the Franchisor is over €600,000 fines of up to €600,000.

\textsuperscript{1228} Failure to comply with the disclosure obligation usually also gives the franchisee the right to damages. For example, in the UK and Ireland the franchisee can affirm the contract and opt for damages instead of recission. In the USA, franchisees can bring common law action for damages (even penal damages) against franchisors, but may not be able to obtain recission or legal fees. The Australian courts will grant damages. Remedies for contravention of the Code or the unconscionable conduct provisions in section 51 AC of the TPA may be brought by the ACCC or by a person who suffers loss or damage as a result of conduct. Even if there has been no breach of the code, the conduct of a franchisor may contravene section 52 of the TPA which prohibits a corporation from engaging in conduct that is misleading or deceptive or is likely to mislead or deceive. Franchisees have evoked this to recover losses from failed franchised businesses on the grounds of misrepresentations during the sales process (Silver Fox Company PTY Limited v Lenards PTY Limited [2005] FCAFC 131 (19 July 2005); Cut Price Deli Pty Ltd v Jacques(1994) 49 FCR 397; 126 ALR 413; (1994) ATPR 46-128). The general limitation period is six years from the date on which the cause of the action accrued. Damages can be claimed under Article 1382 of the French Civil Code (law of tort); but the French courts will only award them in cases of fraud or gross negligence. There are no punitive damages. Actions for damages under tort liability are time-barred after five years from the time that the damage occurred. There is no contractual claim. In Italy, damages can be awarded if there is a direct relation between any loss suffered and the Franchisor’s failure to disclose. In Romania, civil damages can be claimed for both actual loss and anticipated loss. The time bar for such claims is three years.

\textsuperscript{1229} Some jurisdictions also impose criminal sanctions on franchisors for inaccurate disclosure in some circumstances. In France, criminal penalties can be imposed if fraud, false advertising or abuse of power are involved. Article 515 of the Italian Criminal Code provides for a criminal penalty up to two years of imprisonment or up to €2,065.83 in case of fraud. In Romania, intentional misrepresentation can result in criminal charges.
These sanctions are imposed either by individual franchisees exercising their rights in the courts or by the regulatory authorities who either have a right to take court action against the franchisor or impose an administrative penalty.

The Amsterdam Group’s recommendation for a model Civil Code was that if failure to make “full and proper disclosure” leads to a “fundamental mistake” the franchisee is entitled to damages unless the franchisor had reason to believe that the information was adequate and it was given in reasonable time. It is uncertain what “full and proper” disclosure, a “fundamental mistake”, “adequate information” and “reasonable time” are. Such details are of fundamental importance and their absence renders the proposal both meaningless and dangerous. Such an approach is unlikely to encourage either new franchisors or franchisees.

Failure to comply with the disclosure obligation which leads to defective consent being given should enable both the franchisee and the appropriate regulatory authority (e.g. the Department of Trade and Industry in the UK) to rescind the franchise and related agreements or, in the case of the franchisee, to affirm the agreement and sue for damages instead, subject to certain chronological limitations. The franchisee’s right to withdraw from a contractual relationship into which it has been wrongfully enticed is clearly of fundamental importance, although there comes a point at which it must be deemed to have affirmed the relationship. The right to walk away from the franchise due to inadequate disclosure cannot continue in perpetuity.

Empirical research suggests that franchisees’ allegations of misrepresentation by the franchisor are not restricted to those franchisees who have entered into the franchise agreement within the past two years. Allegations are raised by franchisees who have been in the franchise system for more than two years.

It is suggested that the right to walk away or claim damages due to inadequate disclosure should be restricted so that it must be exercised by the franchisee (or the government authorised) within 12 months of the franchisee becoming aware of the failure or 24 months of the date of the franchise agreement, whichever is the later. If the agreement continues after this time the franchisee, will be deemed to have affirmed the franchise agreement and so lose both its right to terminate the agreement and the right to sue for damages (as would the government agency). If the franchisee

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1231 Article 4:117 (2) and (3) Commercial Agency, Franchise And Distribution Amsterdam Team 8th Draft (21 May, 2003).
1232 Appendix 8.
1233 Article 5 of the Belgian law provides similar limitations – As does Section 339 Ptk of the Hungarian Civil Code.
The cut off is necessary to ensure that the franchisor can enjoy a degree of certainty and avoid having to work with the franchisee under the burden of uncertainty for a prolonged period of time.

Member state regulatory authorities should have the right to require a franchisor to desist from making wrongful or inadequate disclosure if there is found to be an established pattern of such behaviour. Failure to comply with the prohibition should lead to the imposition of substantial fines on the franchisor and the disqualification of its directors as directors of a company for up to 5 years.

Penalties for non disclosure should also be imposed on franchisees. Franchisors should also have the right (but not obligation) to require potential franchisees to give them precontractual disclosure.

Failure by a franchisee to comply with a franchisor’s request for disclosure by the franchisee will result in the franchisor having the right to terminate the franchise agreement within 12 months of the failure coming to the franchisor’s attention or within two years of the franchisee signing the franchise agreement, whichever is the earlier. The franchisee will also be deprived of any right to claim damages or other remedy unless the franchisor has intentionally and materially either breached the franchise agreement or made wrongful or incomplete disclosure to the franchisee.

5.4.4 Prohibition on Misleading or Deceptive Behaviour

This provides critical analysis to the third objective of this thesis.

Following the discussion at 3.6 above, it is suggested that in addition to set form precontractual disclosure, there should also be a pre-contractual duty on the franchisor not to do anything which is misleading and deceptive. However, franchisees and potential franchisees are not consumers and should not be allowed to enjoy any consumer rights vis a vis their relationship with franchisors.

In Germany the pre-contractual duty to make full disclosure (culpa in contrahendo) seeks to ensure that potential franchisees are able to make a decision to enter the franchise based on all relevant facts. In the UK it has been suggested that there is a pre-contractual duty of care.

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1234 BGB 242. Ibid pp.[103]
owed by the franchisor to the franchisee which means that pre-contractual representations are actionable in tort as well as contract. In Australia there is a similar approach taken under the Trade Practices Act (TPA).

A pre-contractual duty to disclose similar to that found in the Australian TPA would comprise two parts. Firstly, it would impose an obligation to comply with the pre-contractual disclosure required by the EU Franchise Directive. Secondly, it would prohibit all conduct constituting pre-contractual disclosure that could objectively be considered to be misleading and deceptive. The Directive will need to give details of what amounts to misleading and deceptive behaviour. The term “misleading” is mentioned in many EU directives and is defined in two ways. These lead one to understand the term to mean “anything which contains false information and is therefore untruthful or which in any way (including its presentation), deceives or is likely to deceive a person, even if the information is in part factually correct”. The term “deceptive” is mentioned but is not defined in a number of Directives.

Misleading and deceptive behaviour would include a franchisor’s statement, (whether made publicly or in private negotiations by the franchisor), which although literally true, misleads or deceives or is likely to mislead or deceive. Even reasonable and honest conduct by a franchisor could be misleading or deceptive conduct in certain circumstances.

Although a franchisor must be permitted to bargain “hard”, silence by a franchisor may, in

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1236 In Directive 2006/114/EC of the European Parliament and of the Council of 12 December 2006 concerning misleading and comparative advertising has defined “misleading advertising” means any advertising which in any way, including its presentation, deceives or is likely to deceive the persons to whom it is addressed or whom it reaches and which, by reason of its deceptive nature, is likely to affect their economic behaviour or which, for those reasons, injures or is likely to injure a competitor” or Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council (“Unfair Commercial Practices Directive”) has defined... 


1238 *Bevanere Pty Ltd v Lubidineuse* (1985) 7 FCR 325.

1239 *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216.

all of the circumstances constituted by its acts, omissions and representations, constitute
cold to mislead or deceive a franchisee. Representations and opinions by a
franchisor, as to future matters, could be misleading unless the franchisor can prove that it
had reasonable grounds for making the representation.

Such a “duty to disclose”, obliging all parties to act in an objectively reasonable manner when
making the relevant pre-contractual disclosure would be practical and would work to further
ensure that each party receives all the information it needs during the pre-contractual phase to
make a decision whether or not to join the franchise/grant a franchise. It would amount to
what some commentators call “good faith purchase”. However it would preserve the
required degree of certainty by falling short of the amorphous duty of a good faith that
regulates the ability of the parties to treat with third parties during their negotiations and
allows the courts to imply collateral terms as they deem fit.

Failure to comply with the pre-contractual disclosure requirements would only amount to
misleading and deceptive behaviour if the franchisor would have made a different decision
had it been complied with, so following the French and Spanish approach to disclosure of
relying upon the need for defective consent rather than a failure to comply with a technical
requirement. It is also similar to the English law concept of misrepresentation.

Negotiating parties will always have adversarial interests. Each party is interested in making a
profit and to get “the best deal possible”. However, there can be little objection to them
having to behave in an objectively reasonable manner when making their pre-contractual
disclosures to each other. They would not be under any other pre-contractual duty of good
faith that restricts their ability to deal with other parties, as is the case in Germany. Breach of
the pre-contractual disclosure requirement would give rise to the remedies detailed above.

This will homogenise the pre-contractual disclosure obligations of franchisors in the EU in an
appropriate manner delivering a high degree of certainty but avoiding some of the difficulties
found under German law.

A pre-contractual duty that both focuses upon the disclosure made by the parties and prohibits
misleading and deceptive conduct, as articulated above, will serve to maintain market
confidence in franchising.

452.
1242 Farnsworth, “Good Faith Performance and Reasonableness under the Uniform Commercial Code”,
1243 See 3.8 above
It is therefore proposed that any pre-contractual duty of care or consumer right currently imposed by member state law be disapplied to franchising and replaced with the following provisions in the franchise directive;

(1) The proposed parties to a franchise agreement and related documentation must comply with the duty of the pre-contractual disclosure expressly provided for in this Directive. Failure to do so will be deemed to be unconscionable behaviour.

(2) In addition to this all parties must refrain from any misleading or deceptive conduct when making any pre-contractual disclosure. This will include, but is not limited to, making statements which, although literally true misleads or deceives or is likely to mislead or deceive.

(3) If the misleading or deceptive behaviour leads to defective consent by the franchisee the courts will be able to make orders preventing such misleading or deceptive behaviour and preventing the franchisor from enjoying the benefits acquired by such behaviour being set aside or varying the franchise agreement or related documents and awarding damages. When considering what remedy to apply the court shall give priority to the best interests of the franchise network as a whole. The parties involved and the regulatory authorities may apply for such remedies.

5.4.5 Registration of Franchise Documentation

This provides critical analysis to the third objective of this thesis.

Another way of trying to ensure that potential franchisees have access to relevant information when deciding whether or not to invest in a franchise and enable them to compare what they are being offered with other franchises is to require all franchisors to place key information on a public register. In order for the information to be placed on the register it must be approved by the administrators who administer the register. The idea is that this not only enables potential franchisees to “comparison shop” but ensures that all franchisors meet certain minimum levels as regards their offerings. It is suggested that such an approach is inappropriate as it is unwieldy and cost ineffective.

The aim of those jurisdictions that require the registration of documentation at a public registry is to ensure that it is reviewed and approved before the franchisor begins offering franchises in that jurisdiction. The general rationale is that “prevention is better than cure”. The registration authority provides a minimum quality assurance by only registering
documents that comply with the law. However this creates substantial challenges for both franchisors and the administrators who run the registry.

It is suggested that registration is not an appropriate way to accentuate the impact of the second commercial imperative on the EU’s legal eco-system, and should therefore not be required by the Directive.

In the USA, 15 states require advance registration. 13 of these states require that the Disclosure Document and contractual documents be submitted for review and approval before franchises can be offered in those states. The documents have to be modified in slightly different way for each state. This obviously creates a great deal of administrative compliance work for franchisors, and results in not insubstantial costs being incurred.

It also results in delay. Franchises cannot lawfully be granted in registration states until the franchisor has complied with the registration requirements. Failure to do so can result in administrative proceedings, public or private civil actions, or even criminal prosecution. Waiting periods of up to 30 days are something imposed in order to give the regulators the opportunity to review the documents filed. The cost and delay is not confined to when the franchise is launched as many states require franchisors to renew a registration or file a report, annually.

The consequence of non-compliance can be severe. Officials in some states have the authority, without a prior hearing, to order a halt to franchise sales if there has been a failure to register successfully. Failure to comply with such an order can amount to a criminal offence. In other states, any violation of the registration laws is a criminal offence, regardless of whether there is a stop order in effect.

Each state offers exemptions to franchisors but there is no homogenous approach. The various registration regimes are all implemented by well financed and heavily resourced state administrative regimes.

1244 These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Texas, Virginia, Washington and Wisconsin. Oregon has specific disclosure requirements but does not require registration. Michigan does not require prior submission and approval of the franchise offering documents. Michigan and Texas do not require this.


1246 ibid.

1247 ibid.

1248 ibid.

1249 ibid.

1250 ibid.

1251 Franchise offerings can be exempt from the registration requirements of state laws based on characteristics of the franchisor, the franchisee, or the offering. These exemptions can be conferred by statute, by regulation, or by a state regulator and must be considered in light of a state’s registration requirements. One state might declare an offering to be exempt from registration while another simply does
Registration is a pre-emptive attempt to ensure that franchisors comply with their various legal requirements as regards disclosure and other franchise specific requirements laid down by the relevant state law. This means that the state administrative agencies review the franchisor’s application to register the franchise, the proposed disclosure statement, financial statements, the franchise’s advertising materials, information about the persons who will engage in the sale of the franchise, the franchise agreement and all other agreements that the franchisee must sign to acquire the franchise.

The purpose of the state review of the application is to determine whether the franchisor has complied with all legal requirements; whether all documents contain all of the required information in a understandable form; whether advertising materials contain any prohibited claims or representations, whether the franchise is fraudulent, deceptive, unfair or inequitable and whether the franchisor has sufficient financial resources to fulfil its obligations. The most common problems encountered by the registration authorities are incomplete financial statements, deficient disclosure documents, inconsistent advertisements, illegal activities, outdated information in disclosure, other State specific issues, financial assurance documentation, revenue disclosure, rebate/supplier payments, expense estimates, and assistance with the advertising fund, site selection and training. Most of the agencies also have the power to suspend or revoke any registration.

Australia does not have a registration system, but there is some support for such a system by those who believe that if a franchisee enters into a franchise agreement due to misleading material, “the only recourse it has is to law and, by the time a franchisee is in a position where it needs recourse to law, it usually has no money [to fund a legal action].” The Franchise Council of Australia recently recommended that the Australian Competition and Consumer Commission (ACCC) be empowered to administer a mandatory franchisor registration system requiring annual filing of the most current disclosure material and other prescribed information. However, the Government declined to follow their suggestion on the grounds of cost and practicality. This underscores the problems inherent in any attempt to establish a registration system for franchising, namely the compliance burden placed on franchisors (which would be significant); the difficulties the authorities would have in ensuring the enforcement of registration requirements; and the potential for fraudulent practices by franchisors.

not include it within those transactions that must be registered. For example, Illinois excludes from the definition of a franchise a transaction requiring the payment of a fee of less than $500, while Michigan defines the arrangement as a franchise but exempts it from registration. Registration exemptions based on the net worth of the franchisor or the franchisor’s holding company are perhaps the most important and exist in nine states (California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, South Dakota and Washington). The experience of the franchisor and the sophistication of the prospective franchisee might also qualify an offering for an exemption.


quality or substance of the documents lodged; the potential liability of the authorities if they were seen to endorse and provide credibility to registered franchisors and lodged disclosure documents; and the fact that it would increase the regulatory burden on business.

The only mandatory registration regime in the EU is found in Spain1254. Once an Agreement is executed, the Franchisor must register it1255. However, it has not been successful, despite recent attempts to re-invigorate it1256. The new law introduces the concept of an “Established Franchisor”1257. This is an attempt to distinguish between established franchisors with a track record of demonstrable success and newcomers. Franchisors who have a minimum of 4 establishments, two of which must be exploited directly by the Franchisor and who have been operating the franchise network for a period of at least 2 years qualify for the status of “Established Franchisor”.

1254 (Royal Decree 2485/1998 Articles 5 to 10). Franchisors must register with the Autonomous Government in the territory where they are headquartered. Franchisors intending to do business in more than one Autonomous Region must be included in the federal Register under the Directorate General for Domestic Trade of the Ministry of Economy and Finance (Royal Decree 2485/1998 Articles 5). The Federal Register includes franchisors registered by the Autonomous Governments (.Royal Decree 2485/1998 Article 6) Applications for inclusion in the Federal Register must be made by the Autonomous Governments where the franchisor is headquartered. In Lithuania there is an obligation to register, but it can be contracted out of the franchise agreement must be in writing, and must be registered in the Register of Legal Entities of the Republic of Lithuania to be enforceable against third parties (Lithuanian Civil Code Article 6.767(1)). If the franchisor is not Lithuanian, the franchise agreement must be registered by the franchisee. This obligation could in theory be contracted out of by the parties, but it would render the agreement legally unenforceable. The practical impact of this is that the franchise agreement must always be registered. The information required to obtain registration with the Franchisor’s Registry includes (Echarri. A, 2006, “New Regulations on the Spanish Franchisor’s Registry”, International Journal of Franchising law, Volume 4, Issue 3, p 3: the franchisor’s details such as company name, registered office, details of registration with the Spanish Commercial Registry, taxpayer or business identification number; details of the intellectual property rights included in the franchise and a certificate verifying ownership; a description of the franchised business, including the number of franchises in the network and the number of units, indicating whether they are directly operated by the franchisor or franchised, the time period for which the franchisor has been in the franchising business and the name of the franchisees which have left the franchise network within the last two years; if the franchisor is a master franchisee, the name, registered address, legal status, and duration of an agreement for franchisees that have the power to grant sub franchises as well as the master franchise agreement itself (Royal Decree 2485/1998 Article 7); In the event that the franchisor is registered through a representative, proof of its authority. Foreign franchisors must submit the original and translated copies of the relevant documents (Royal Decree 419/2006 Article 7(f)). In addition, there are some details which can voluntarily be filed with the Registry for information purposes only, such as (Royal Decree 419/2006 Article 11): A quality standards certificate evidencing compliance with quality standards; Adherence to an alternative dispute resolution system; Adherence to any franchising codes of conduct; Adherence to consumer arbitration systems or other ADR procedure in regard to consumer complaints; Other information of general interest 1255 Royal Decree 2485/1998.

1256 The first 8 years of the Spanish law were confused, with the authorities and franchisors alike being uncertain as to where the documents should be registered. As a result, there was a very low level of compliance with, and no enforcement of, the law. To try and remedy this, Royal Decree No 419/2006 was enacted on 27 April 2006. It has not changed the registration system as such but seeks to improve it. The new law obliges registered Franchisors to file a report at the beginning of each calendar year even if the data registered remain unchanged (the new sections 3 and 4 of Article 8)

1257 Article 12
Failure to comply with the registration obligation can result in the following imposition of a fine of between 3,000 up to 15,000 Euros subject to a maximum amount not exceeding the total invoicing of the Franchisor.

The history of the registration of franchise agreements in the EU has not been distinguished by notable success. In Spain franchisors are required to register the franchise agreement and certain relevant information with the relevant authorities\textsuperscript{1258} and file an annual update\textsuperscript{1259}. Failure to comply can result in the imposition of a fine. The purpose is to help maintain a certain level of quality amongst franchisors. This has not been achieved.

The registration of franchise agreements in Spain has not been a success. There appears to be no qualitative or other analysis of the documentation and it has become nothing more than a “tick the box” administrative task. Registration, has become the hallmark of respectability, but without any qualitative consideration of the documentation registered, this has obvious and dangerous implications. The introduction of the concept of an “Established Franchisor”\textsuperscript{1260} is a weak attempt to try to remedy this fault by distinguishing between newly established franchisors and those with a track record (regardless of how good that record is). So far it shows little sign of making any impact.

One therefore concludes that a registration requirement places a substantial administrative burden (and possibly a substantial cost) on the regulator. It imposes an equally great administrative on the franchisor, which has to constantly update the registration to keep it current and so avoid being penalised. This burden would be increased further by the large number of languages used in the EU Any registry would have to be on a member state basis due to the linguistic differences between member states. It would create financial and technical barriers to the establishment of a true single market within the EU.

The cost effectiveness of a registration system is an issue that cannot be ignored. To set up the necessary regulatory framework, train the regulators, keep them updated on all relevant changes, and expect them to regularly audit the registered documents is a substantial and expensive undertaking. Given the size and scale of franchising in the EU, it seems to be an unwieldy and disproportionate response to the issues involved. The contrast between the Californian registration requirements and Spain’s feeble attempt to it could not be greater. Neither could the budget of the two system. The Californian registration system serves to show that a registration law requires the creation of a substantial administrative infrastructure which in turn demands a substantial financial investment. It proved to be impossible to obtain

\textsuperscript{1258} Article 62(2) of Act 7/1996
\textsuperscript{1259} Royal Decree No 419/2006 (new sections 3 and 4 of Article 8).
\textsuperscript{1260} ibid (New Article 12).
any estimate of the Spanish budget for its registration system other than “probably not a great
deal”\textsuperscript{1261}. In California the registration of franchising is dealt with by the Department of Corporations, which publishes its annual expenditure. In 2008-09 the Department’s total expenditure was US$40,161,000. This deals with many more areas than just franchising. The cost directly attributable to franchising alone in 2008-09 was US$1,456,000\textsuperscript{1262}. However, this excludes all of the indirect costs involved, such as accommodation, infrastructure, technology support and so on.

The Department estimates that it processes up to 600 franchise registrations and renewals each year. There is a charge US$675 for an application for registration and US$450 for a renewal. If there were 600 applications for registration in one year that would amount to US$405,000 in fees for applications. If all of these were renewals it would be US$270,000.

The professional costs of compliance with the Californian registration requirement are estimated\textsuperscript{1263} at around US$1,500 for the initial filing and US$400 for renewals.

These costs are for a state with a population of approximately 36,500,000\textsuperscript{1264} the working language of which is English. The EU has a population of approximately 500,000,000 and 23 official languages\textsuperscript{1265}. The likely cost of a pan EU registration system is therefore substantial and unlikely to be proportionate to any benefit it might provide. At Californian type rates, the professional legal costs of filing a franchise in 27 EU member states could be around US$40,500 or €28,196 with US$10,800 or €7,518 annual renewal fees\textsuperscript{1266}. The administrative filing cost in 27 EU member states at Californian levels would be US$18,225 or €12,688 with annual renewal costs of US$12,150 or €8,459\textsuperscript{1267}. Such professional and administrative filing costs would be a real barrier to franchising between EU member states.

Although appropriately resourced and well implemented registration may maintain market confidence in franchising, it is unlikely to encourage companies to use franchising as part of their corporate growth strategy as it will inevitably result in increased costs and bureaucracy.

\begin{itemize}
\item \textsuperscript{1261} Joana Banda, Jimenez de Parga law offices, Barcelona “Franchising in Spain” at EfN Annual Convention 2006.
\item \textsuperscript{1262} Interview with Tim Lebas, Corporation Deputy Commissioner in charge of franchise registration, Californian Department of Corporations, (telephone interview, March 2009).
\item \textsuperscript{1263} An estimate supplied by leading franchise lawyer, Ken Costello, partner in the LA office at the Bryan Cave law firm.
\item \textsuperscript{1264} US Census Bureau 2007 estimate blocks http://quickfacts.census.gov/qfd/states/06000.html
\item \textsuperscript{1265} http://ec.europa.eu/education/languages/languages-of-europe/index_en.html
\item \textsuperscript{1266} At 6 January 2010 exchange rate.
\item \textsuperscript{1267} At 6 January 2010 exchange rate.
\end{itemize}
5.4.6 **Sub-Conclusion**

It is suggested that in order to help ensure pre-contractual hygiene potential franchisees must be given access to appropriate information and equipped to interpret it in an appropriate manner.

This means that potential franchisees must be educated out of the ‘psychology of failure’ that encourages failed franchisees to blame others for their own failures. They must understand what they are committing themselves to when they buy a franchise and the need to take and follow appropriate expert professional advice. It is proposed that advisors are required to take short on-line franchise education courses if they are to advise potential franchisees and that potential franchisees investing more than US$20,000 must produce a certificate from their advisers to prove that they have taken such advice. National franchise associations can play an important part in educating potential franchisees about the facts of life of franchising – they have to work hard, follow the format, risk failure and take and follow expert advice from appropriately experienced professionals.

Pre-contractual disclosure should be given in a set form 15 working days before execution or payment, covering details of the identity and experience of the franchisor, the franchise network, the terms of the franchise agreement and any earning claims. It should be in plain language and contain an appropriate risk statement. A copy of the franchise agreement in the form in which it is to be executed should accompany the disclosure document. There should also be a five day cooling off period after execution. Failure to comply with the disclosure requirements should lead to the right for the franchisee and government authorities to terminate or claim damages within 12 months of the franchisee becoming aware of it or 24 months of the date of execution, whichever is the later if it resulted in defective consent having been given. Electronic disclosure should be permitted. There should be personal liability for any individual responsible for the disclosure document being inaccurate. Those disclosure obligations should apply to foreign franchisors with no presence in the relevant member state who should be under an obligation to disclose relevant information about analogous markets.

There should be a regular review of the law every 5 years. Failure to comply with the disclosure requirements, if it leads to defective consent, should enable both the franchisee and the appropriate regulatory authority to rescind the franchise and related agreements or claim damages. The claim must be made within 12 months of the franchisee becoming aware of the failure or 24 months of it taking place, whichever is the latest. The regulatory authorities should be able to impose penalties including disqualification.
Misleading and deceptive behaviour should be prohibited. Such behaviour comprises failing to comply with the pre-contractual disclosure obligations and making any statement which although literally true, misleads or deceives is or likely to mislead or deceive.

It is suggested that registration of documentation on a public register is not appropriate due not only to the practical difficulties it would give rise to in the 27 EU member states, but also due to the cost effectiveness of it and the law likelihood of it making any tangible contribution to accentuating the impact of the second commercial imperative on the EU’s legal eco-systems.

5.5 Accentuating the Impact of the Third Commercial Imperative – A Mandatory Taxonomy

This section provides critical analysis towards achieving the third objective of this thesis.

Further to the discussion in sections 2.5 and 3.3, it is suggested that accentuating the impact of the need for adequate protection on the EU’s legal eco-systems is most effectively achieved by imposing mandatory terms upon the franchise agreement and a prohibition of unconscionable behaviour.

The risks that both the Franchisor and Franchisee are exposed to are detailed in Chapter 2 above. Franchise agreements seek to address these risks but the sample examined above suggests that they do not always deliver sufficient protection. The EU’s legal eco-systems need to compensate for this failure. In doing so they need to balance the risks that both parties face with the general principle of independence that both parties are responsible for their own decisions. Franchisees cannot abdicate their responsibility for their own decisions. A franchise is not a guarantee of success. Good regulation provides adequate not total protection.

It is suggested that in order to achieve an appropriate balance in the franchisor/franchisee relationship it is necessary to re-engineer the EU’s legal eco-systems so that the regulatory environment ensures that all franchise agreements contain certain minimum terms which re-enforce the economic drivers that encourage both franchisors and franchisees to become involved in franchising and reduce the inherent consequential risks to both parties to an appropriate level.

As evidenced by the sample franchise agreements, a fairly standard architecture has evolved for franchise agreements. They define the rights granted, the term and renewal, the

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1268 See 2.4.2 above
1269 See 2.5.4 above
1270 See 2.5 above
1271 See 3.4 above
obligations of the parties, confidentiality, non-compete clauses, impose targets, regulate termination, stipulate the ownership of goodwill and set out the franchisee’s right to sell its business. However, this architecture fails to fully re-enforce the economic drivers that encourage franchisees to become involved in franchising. It also fails to reduce the inherent consequential risks to which the franchisees are exposed\textsuperscript{1272}.

The legal eco-systems of EU member states do not improve matters. They create a regulatory environment for franchise agreements which reduces their ability to re-enforce the economic drivers which encourage franchisors to become involved in franchising and fails to reduce the inherent consequential risks to which franchisors are exposed\textsuperscript{1273}. It is therefore suggested that franchise agreements should incorporate mandatory clauses that impose certain obligations upon franchisors and franchisees and grant them certain rights so that the franchisor/franchisee relationship is one which will continue to attract franchisors and franchisees and reduce the consequential inherent risks to an appropriate level. However, that alone will not be sufficient. The franchisor/franchisee relationship is a dynamic one. It changes over time, which means that the contractual terms of the relationship may become dated, irrelevant or even oppressive. A more flexible tool which takes account of the changing nature of the franchise relationship is also needed to ensure that the re-engineering of the legal eco-system is successful. A prohibition of unconscionable behaviour is therefore proposed.

5.5.1 The US Experience

Although at federal level in the USA, there are no franchise specific relationship laws. Twenty states – plus the District of Columbia, Puerto Rico, and the Virgin Islands – have enacted laws of general application that govern franchise relationships and terminations\textsuperscript{1274}. They aim to prevent franchisees being abused by franchisors by preventing discrimination, franchisor competition, market encroachment and dilution, or change of competitive circumstances. They also regulate terminations, cancellations and non-renewals. Some relationship/termination laws also govern alterations in franchise relationships. For example, in Indiana\textsuperscript{1275}, it is unlawful for a franchise agreement to provide for or allow substantial modification of the franchise agreement by the franchisor without written consent of the franchisee. Many relationship/termination laws, require franchisors to be “fair,” “just,” and act with “good cause,” or in “good faith” when terminating a franchise or not renewing.

\textsuperscript{1272} See 3.5 above
\textsuperscript{1273} See 3.8 above
\textsuperscript{1274} See Appendix 10.
\textsuperscript{1275} Section 1 of the Indiana Deceptive Franchise Practices Law.
However, despite vigorous lobbying by franchisees and their advisors there is no regulation of the ongoing franchise relationship at a federal level\textsuperscript{1276}. Although the FTC Staff Report\textsuperscript{1277} concluded that

“There is little doubt that some franchisees are dissatisfied with their franchise purchase\textsuperscript{1278},

it felt unable to identify how much that dissatisfaction was due to the franchisor and how much was due to

“other factors, such as downturns in the economy or shifting consumer preferences”.

It therefore concluded that “substantive franchise rulemaking is unwarranted\textsuperscript{1279}.

### 5.5.2 The Australian Experience

The Australian approach to regulating the ongoing relationship contrasts to that found in the USA and relies more upon prohibition of unconscionable behaviour and misleading and deceptive conduct.

The Australian common law duty of good faith is apparently in a state of some confusion with different states taking different views. There is doubt as to whether a duty of good faith is a broad duty implied into all commercial contracts as held by the\textit{Burger King v Hungry Jack} decision in the New South Wales Court of Appeal\textsuperscript{1280}, or is implied only where the facts and circumstances of a particular case warrant it, so supporting contractual certainty, as held in\textit{Esso Australia Resources Pty v Southern Pacific Petroleum NL} in the Victorian Supreme

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\textsuperscript{1276} US franchisees and their advisers commenting on the proposed changes for the FTC Rule suggested that “the greatest problem in franchising today” is “post-sale abusive franchise relationships”. They urged that the Rule be amended so as to “prohibit post-contract covenants not to compete (e.g. Brown, ANPR 4, at 3; AFA, APNR 62, at 3; Slimak, ANPR 130; Leap, ANPR at 1-2; Vidulich, ANPR, 22Aug97 Tr, at 21.), encroachment of franchisees’ market territory (Brown, ANPR 4, at 2; Donafin, ANPR 14; AFA, ANPR 62, at 1; Buckley, ANPR 97; Zarco & Pardo, ANPR 134, at 2.), and restrictions on the sources of products or services (e.g. Brown, ANPR 4, at 2; Weaver, ANPR 17, Colenda, ANPR 71; Haines, ANPR 100, at 3; Chiodo, ANPR, 21Nov 97 TR, at 293-94), among other practices” (The FTC Staff Report III A p.7). They also recommended that the Commission prohibit the inclusion into franchise agreements of mandatory arbitration, jurisdiction and choice of law provisions that either impede a franchisee from bringing suit or favour the franchisor (the FTC Staff Report III A p.7 Brown, ANPR 4, at 3; Bell, ANPR 30; D. Iuliano, ANPR 56; AFA, ANPR 62, at 3; Johnson ANPR 67.

\textsuperscript{1277} The FTC Staff Report III A p. 7.

\textsuperscript{1278} ibid p. 8.

\textsuperscript{1279} ibid p. 10. This position is supported by a staff review of post-sale franchise relationship issues, as reflected in the Commission’s complaint database – the Consumer Information System (“CIS”) During the period 1993 through June 1999, franchisees raised post-sale relationship issues involving 110 companies. The FTC Staff Report concludes that this means that about 95% of the approximately 2,50036 franchise systems operating in North America at that time did not generate even a single relationship complaint to the Commission. Moreover, the vast majority of companies that were the subject of a complaint generated only one complaint, See Bond’s Franchise Guide (11th ed. 1998) at 9, 25 (estimating there are 2,500 American and Canadian franchisors). Currently, Bond’s maintains a database of 2,500 North American franchisors, and its Franchise Guide (13th ed. 2001) provides information on approximately 2,150 of those systems, that in its view, are actively engaged in franchising.

\textsuperscript{1280} (2001) NSWCA 187
Court. In contrast to the common law position however there is absolute clarity under the
Trade Practice Act, which prohibits unconscionable conduct under section 51 and misleading
and deceptive conduct under section 52.

Section 51AC prevents a range of abusive conduct including charging excessive prices for
good supplied to franchisees; secret rebates and commissions from suppliers, encroachment
on the franchisees geographical trading area and failing to provide adequate service and
support to franchisees.

Unconscionability of conduct has to be judged by reference to 7 factors which include
the relative bargaining position of the parties, the reasonableness of the conditions protecting
the franchisors, the franchisees ability to understand the documents, undue influence,
alternative suppliers, discrimination and the amount of negotiation that took place.

The most instructive case concerning unconscionable behaviour under Section 51AC is
ACCC v Simply No Knead. In this case the company had a number of franchisees to
which it supplied training and materials for baking bread and related products in the home.
Sandberg J found that the franchisor’s behaviour had disclosed “an overwhelming case of
unreasonable, unfair, bullying and thuggish behaviour” against five franchisees. The
franchisor’s conduct included refusing to deliver products to franchisees, refusing to negotiate
with franchisees and discuss matters of concern to them; deleting franchisee’s telephone
numbers from the Telephone Directory Assistance Service without their knowledge or
consent; producing and distributing advertising and promotional material for its products in
the territories of the franchisees and refusing to provide current disclosure documents in
response to written requests.

1281 [2005] VSCA 228 This case rejects the concept of a blanket duty of good faith in favour of contractual
certainty. However, the relevance of the common law duty of good faith, no matter how confused it is, has
been reinforced by the government’s current proposals to insert a new provision in the Franchise Code
stating that nothing in the Code limits any common law requirements of good faith in relation to the
franchise agreement. Additional Information on Franchising Code and Unconscionable Conduct Reforms
November 2009 at http://minister,

1282 Giles, Redfern & Terry – Franchising Law and Practice, Lexis Nexis, para 11.0200. Others include
fraud and misrepresentation in inducing the contract; unjust terms in the contract; bad faith in the operation
of the contract; discrimination in terms of trading between company owned outlets and franchised outlets;
failure to address lack of viability of franchise outlets; making substantial increases to renewal fees;
unwillingness to discuss and negotiate problems using advertising levies for other purposes; intimidation
and victimisation of franchisees; and unfair terminations.

1283 TPA Section 51AC

1284 The provision excludes from its ambit listed public companies and the acquisition of goods and services
of no more than Aus $ 3 million.

1285 ACCC v Simply No Knead (Franchising) Pty Ltd & Cameron Bates (2000) ATPR. 104 FCR 253
None of the cases so far suggest, as feared by some[^1286], that the courts have taken an overly lenient approach to finding unconscionable behaviour based solely upon a disparity of bargaining power in franchising. Reflecting the common law’s distrust of a general concept of good faith[^1287] there were concerns that equitable notions of unconscionability would pose a real threat to the doctrine of freedom of contract[^1288] and bring uncertainty to commercial transactions by either enabling[^1289] or even requiring the courts to make value judgments and expand the notion far beyond the equitable notion as set out in section 51AA[^1290]. However so far this does not seem to have happened.

Section 51AC (along with section 51AD and the Franchising Code of Conduct) amounts to a legislative attempt to re-engineer the regulatory environment for franchising by accentuating the impact of the economic drivers that encourage franchisees to become involved in franchising[^1291].

5.5.3 Protecting the Franchisor’s Interests

The franchisor’s interests are best protected by re-enforcing the economic drivers that attract them to franchising and reducing the inherent consequential risk that they expose themselves to.

As detailed in Chapter 3 above franchise agreements generally endeavour to re-enforce these economic drivers and reduce the inherent consequential risk to a reasonable level.

However, some of the legal eco-systems that comprise the EU’s regulatory environment tend to limit the franchise agreements’ ability to reduce the risks[^1292]. Commercial agency law, employment law and consumer law in some member states inhibit the ability of the franchisor to prevent “free riding” by terminating erstwhile franchisees[^1293]. The duty of good faith can also reduce the franchisor’s ability to prevent Free Riding and other misdemeanours, not only by limiting its right to terminate the agreement, but also by removing its ability to make

[^1287]: Ibid
[^1291]: Corones believes it to be an attempt to limit the ability of franchisors to exploit the vulnerability of franchisees. Corones, Australian Business Law Review, 2000, Vol. 28, No. 6, pp. 462-469
[^1292]: See 3.8 above
[^1293]: Ibid
decisions at its sole discretion\textsuperscript{1294}, without regard for the franchisee’s interests. This is particularly pronounced in Germany. Unfair Contract Term laws can also restrict the franchisor’s discretion in respect of how it deals with its franchisee’s\textsuperscript{1295}. Anti-trust law tends to undermine some of financial drivers by denying the franchisor the right to determine a uniform pricing and multichannel strategies.

It is suggested that the franchise directive should impose mandatory clauses which re-enforce the economic drivers and reduce the inherent consequential risks to franchisors. In other words franchise agreements should become Nominate or Type agreements in civil jurisdictions. Although German law does not recognise franchise agreements as nominate agreements, it protects the franchisors’ rights to receive fees from the franchisee, recognises the franchisee’s obligations to purchase tied goods from the franchisor and protects the franchisor’s know-how from abuse by the franchisee\textsuperscript{1296}. These should be included in the directive, but by themselves are not sufficient to protect the franchisor’s interests.

\textsuperscript{1294} ibid
\textsuperscript{1295} ibid
\textsuperscript{1296} BGH, WBI 1989, 131
The Directive should ensure that regulatory environment takes into account the economic drivers that encourage franchisors to become involved in franchising and the inherent commercial risks they assume. Franchisees must therefore be placed under a general duty of confidentiality as regards the franchisor’s trade secrets, including its know-how, providing that they are not placed in the public domain by or with the consent of the franchisor. This means that franchisees must be under an obligation not to act in an unconscionable manner and, in particular, must:

1. Not in any way challenge the validity or ownership of the franchisor’s intellectual property rights and to keep the franchisor’s know-how confidential and only use it in operating the franchise;

2. Fully and faithfully implement the franchisor’s system, including but not restricted to undertaking all training required by the franchisor;

3. Not compete with the franchisor or its franchisees during the term of the franchisee’s franchise agreement;

4. Not compete with the franchisor or its franchisees for a reasonable time within a reasonable geographical area following the termination of the franchisee’s franchise agreement;

5. Allow the franchisor to purchase the franchisee’s business on termination for a reasonable valuation, which will include all premises and fixtures used in the business and stock but exclude all goodwill. The franchisor will not however have an obligation to purchase the franchisee’s business;

6. Allow the franchisor to terminate the franchise agreement for breach without having to pay the franchisee any compensation;

7. Allow the franchisor to sell, transfer or licence its business to a third party subject to that third party purchaser agreeing to honour the franchisor’s obligations to the franchisee, without recourse against the franchisor in the event that the assignee/transferee/purchaser fails to honour such obligations;

8. Purchase tied goods and services from the franchisor or its nominated suppliers.

A franchisee’s failure to respect these rights of the franchisor should give the franchisor the right to terminate the franchise agreement and sue for damages or loss of future profits.
5.5.4 Protecting the Franchisee’s Interests

As identified in Chapter 2, the key economic drivers that attract franchisees to franchising are an increased chance of success due to access to a proven format, a recognised brand, ongoing support, economies of scale and so on. The inherent consequential risks to which they are exposed are misrepresentation, encroachment, poor quality business formats and inadequate support.

The franchise directive should impose mandatory clauses which re-enforce these economic drivers and reduce the inherent consequential risks. In civil jurisdictions, franchise agreements should be recognised as “nominate” or “type” agreements.

Although German law does not recognise franchise agreements as “nominate” or “type” agreements, it identifies the franchisees’ interests as including receiving advice and supervision from the franchisor, the franchisor refraining from interfering in the franchisee’s business and not being forced to pay inflated prices for product supplied by the franchisor. It also prohibits what it deems to be inappropriate rights for the franchisor such as the right to determine what its contractual duties are and reducing or enrolling the franchisee’s exclusivity as a result under performance without a right to remedy and termination on short notice.

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1297 See 2.3 above
1298 Ibid
1299 Gesler, Franchiseverträge 1. Introduction; BAG 30.05.1978, BB 1979, 325
1300 Op cit, Petsche, A, Riegler, S and Theiss, W, 2004, p.3,4
1301 Giesler, Franchiseverträge, Rn 60
1302 BGB 305-310 – see 3.10.4 pp 128
It is suggested that the Directive should provide that the franchisor should not act in an unconscionable manner and in particular should;

(1) be the owner of, or have the legal rights to use, the network’s trade name, trade mark and other distinguishing identification;

(2) provide the franchisee with a reasonable level of initial training and continuing commercial and/or technical training during the entire life of the agreement;

(3) render reasonable ongoing technical and consulting assistance to the franchisee;

(4) refrain from encroachment on the territory of an exclusive franchisee;

(5) allow the franchisee to sell its franchise on to a third party approved by the franchisor as an appropriate franchisee (subject to the franchisor’s preemptive right of purchase on the same terms),

(6) not supply goods or services to the franchisee at inflated prices or which are unfit for purpose.

For the avoidance of doubt it should be expressly stated that, as regards their relationship with the franchisor, franchisees and potential franchisees are not consumers and are not entitled to enjoy any of the rights afforded to consumers as regards their relationship with the franchisor.

Termination on short notice or without an opportunity to remedy (unless it was a fundamental breach) would be deemed to be unconscionable. This will ensure that the franchisee obtains what it entered into the franchise agreement to gain.

5.5.5 The Prohibition of Unconscionable Conduct

By identifying mandatory provisions for a franchise agreement, and so establishing it as a specific “type-agreement” it is possible to re-enforce many of the economic drivers that attract franchisors and franchisees to franchising and reduce many of the inherent consequential risks they both expose themselves to. However, the dynamic and ever

1303 As provided for by the European Franchise Federation in their Code of Ethics - www.eff-franchise.com
1304 Ibid - www.eff-franchise.com
1305 As per Lithuanian Civil Code Article 6.770(2).
1306 As held by the case of Scheck v Burger King Corp 756 F Supp. 548 (S.D. Fla. 1991). See Chapter 19 p. 279.
changing nature of the franchisor/franchisee relationship\textsuperscript{1307} means that these mandatory provisions by themselves will not reduce those risks to an appropriate level.

It is suggested that in order to reduce the risks to both franchisor and franchisee to an appropriate level a more dynamic and flexible approach is also needed. One that can deal with the tensile stresses resulting from the franchise relationship’s long term and changing nature. However this in itself brings about other challenges.

It is therefore proposed that the EU Franchise Directive expressly disapply to franchising any general duty of good faith found in EU member state law and replace it with a specific prohibition of unconscionable conduct by parties to a franchise, breach of which will enable the courts to act in a restrictive and adaptive manner.

In order to give effect to this, the EU Franchise Directive should provide that all parties to a franchise agreement and related documentation must refrain from exercising their rights and obligations under the agreement, and must not otherwise conduct themselves, in an unconscionable manner during the term of the franchise agreement.

The franchise relationship’s ongoing nature differentiates it from “one-off” transactions\textsuperscript{1308} such as the sale of goods, which are “discrete transactions …. of short duration, involving limited personal interactions and with precise party measurements of easily measured objects of exchange”\textsuperscript{1309}. Franchise relationships are fundamentally different. They are relational and are characterised by

“long duration, personal involvement by the parties and the exchange, at least in party, of things difficult to monetize or otherwise measure”\textsuperscript{1310}.

As a result

“obligations are not frozen in an initial bargain. They evolve over time and circumstances change. The object of contracting is to establish and define a co-operative relationship, not merely to allocate risk”\textsuperscript{1311}.

This means that

“parties are obliged to behave in a way that promotes the relationship, and ….. is consistent with the needs and expectations of both parties”\textsuperscript{1312}.

\textsuperscript{1307} See 3.4 above
\textsuperscript{1308} ibid
\textsuperscript{1309} Op cit Gudel 1998, p.763
\textsuperscript{1310} Ibid.
\textsuperscript{1311} Op cit Leichtling 1994, p.671
\textsuperscript{1312} Ibid Leichtling quoting Parritt at 717.
However, franchise agreements do not evolve or change over the years as the franchise system develops. They are static documents fixed for a term of years. They require mutual performance over a number of years and therefore do not always define the parties’ full obligations. Because of their longevity and the multilateral nature of franchising they inevitably vest the Franchisor with an amount of discretion as to how the rights and obligations of both parties will be performed. How the franchisor exercises its discretion will inevitably impact upon the franchisees’ operation of its business.

“In making discretionary decisions, franchisors can extract value from the franchisees in many ways, such as granting additional franchises in close proximity, raising the price of goods sold to franchisees, increasing rent on the franchisees locations, increasing inventory and growth requirements, as well as increasing advertising funds. Conflicts invariably arise when the franchisee perceives the franchisor’s exercise of discretion to be unfair.”

The implied covenant of good faith is

“the doctrinal tool necessary to bring the resolution of franchise contract disputes into line with the realities of the franchise relationship.”

It helps to restrain the franchisor from over-stepping the mark. Its flexibility is what enables it to do this. However it is that very flexibility which also creates the uncertainty that can undermine the economic drivers that attract franchisors to franchising.

It is the way in which such a flexible approach has manifested itself in a number of jurisdictions, including Germany, France and (to a limited extent) the USA. It has a substantial impact upon the regulation of franchising in Germany and a number of other EU member states. However, few jurisdictions include it in their franchise specific regulations, it takes a different form in each jurisdiction.

In the USA for example, the doctrine of good faith has very limited impact upon franchising at Federal level. The statutory concept only relates to the supply of goods whilst the common law concept, despite once being the centre of great debate in the celebrated case of

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1313 See 3.4 above
1316 See 3.3 above
1317 Ibid
1318 See 3.8 above
1319 Ibid
1320 The Uniform Commercial Code concept of good faith applies only to transactions in goods Article 2 (§2 – 102).
Scheck v Burger King Corp\textsuperscript{1321}, seems to be of little real relevance nowadays. The Australian government have failed to accept the Australian Franchise Federation’s suggestion that a franchise specific duty of good faith be adopted\textsuperscript{1322}.

Uncertainty, the flip side of its flexibility, presents a real difficulty in franchising. This is succinctly described by the Australian government in its response to the Commonwealth Joint Committee on Corporation and Financial Services 2008 Inquiry into improving franchising conduct\textsuperscript{1323}. It is considered that\textsuperscript{1324} as

“the inclusion of a general obligation of good faith in the Franchising Code would increase uncertainty in franchising. Neither franchisors nor franchisees would be certain of the occurrence of a breach: court proceedings would be required to establish whether or not these had been a breach\textsuperscript{1325}.

The uncertainty arising from a general duty of good faith was felt to have adverse commercial consequences for franchisees.

“Franchisors would seek compensation for the extra risk they faced through larger franchise fees and more onerous terms and conditions in other parts of the agreement. And banks and other financiers would be more reluctant to provide credit to franchisees and franchisors in these more rising commercial circumstances.”\textsuperscript{1326}

It concludes that a general undefined good-faith obligation would only make matters worse for franchisors and franchisees alike.

This uncertainty is increased still further given the wide range of ways in which member states interpret that duty of good faith\textsuperscript{1327}. Similar circumstances involving franchising can therefore lead to very different outcomes in different member states. This does not maintain market confidence in cross border franchising in the EU or encourage its use as a tool to increase inter state trade.

\footnotesize{\textsuperscript{1321} In this case the court ruled that “lack of franchisee exclusivity did not allow Burger King to open other neighbouring franchises regardless of their effect on the existing franchisee” destroying the right of the franchisee to enjoy the fruits of the contract”. 756 F. Supp. 548 (S.D. Fla 1991).}
\footnotesize{\textsuperscript{1322} See 4.5 above}
\footnotesize{\textsuperscript{1324} Finding a Balance: Towards Fair Trading in Australia (The Fair Trading Report), May 1997.}
\footnotesize{\textsuperscript{1326} AFF’s Submission dated 15 August 2006}
\footnotesize{\textsuperscript{1327} See 3.8 above}
However, as evidenced by the sample agreements considered in Section 3.3 above, franchise agreements do not impose heavy obligations on the franchisor to support the franchisee and there is no standard of performance specified. Indeed, the ever changing nature of the franchise relationship and the demands of the market in which the franchise network operates makes it extremely difficult, if not impossible, to stipulate in detail the support that the franchisor must deliver to the franchisee. This enables unethical franchisors to act unconscionably and abuse their contractual rights.

The challenge is balancing the flexibility that good faith delivers with the lack of certainty it presents. Adopting a finely tuned franchise specific prohibition of unconscionable conduct would help find this balance. If the EU Franchise Directive could prevent unconscionable behaviour in franchising in a more specific manner, it would reduce the uncertainty.

An EU wide franchise specific prohibition of unconscionable conduct could reduce uncertainty and help ensure that member state courts take a more uniform approach to contractual interpretation, so reducing barriers to cross border franchising. However, that will only be achieved if what amounts to unconscionable behaviour in franchising is clearly spelt out in the Directive. Without this guidance the judicial tradition of each member state is likely to lead to different results in similar circumstances.

As the German concept of good faith is the most developed and influential one in the EU, its three pronged approach would certainly be a popular way of preventing unconscionable behaviour in some member states as potentially being the least disruptive option. However, it is difficult to see how such a broad and general ability of the courts to impose new obligations upon parties to the franchise agreement and even change the legal relationship as a result of a change in circumstances will do much to limit uncertainty and so maintain market confidence in franchising. Franchisors would have to accept that the courts could effectively rewrite the franchise agreement at will. There would be no guarantee that the risks to the franchisor’s business would be properly recognised and respected. There would be a very real probability that the German tendency to view franchisees as consumers would take hold and reduce the franchisee’s obligation to be responsible for its own actions.

The differing approach of the German and French courts to good faith also suggests that there would be no uniform EU wide approach to how good faith would be applied to franchising. That would severely reduce the positive impact of the franchise Directive on removing

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1329 Collateral, adaptive and restrictive. See 3.8 above
1330 Austria, Greece and Portugal
artificial borrowing to the use of franchising as a way of increasing trade between member states.

A more focused, better defined prohibition of unconscionable conduct is required. One such as that laid out in the Australian Trade Practices Act 1998\footnote{See Chapter 12. It prohibits unconscionable, misleading and deceptive conduct.}.

It is proposed that the Directive restricts the parties from unreasonably exercising their rights in a way that would damage market confidence and discourage new entrants of the right calibre whilst recognising and respecting the risks adopted by both the franchisees and the franchisor is needed.

This will help to strike the appropriate balance between flexibility and uncertainty\footnote{The so-called restrictive approach. See 3.8 above}. The amorphous nature of good faith, (which is what many believe makes the implied covenant work, allowing it to be applied effectively on a case by case basis)\footnote{Iglesias. J, 2004, “Applying the Implied Covenant of Good Faith and Fair Dealing to Franchises”, Houston Law Review, Volume 40, p.1423} must be tempered by a reasonable degree of certainty.

The EU Franchise Directive must balance the flexibility and uncertainty presented by a franchise specific prohibition of unconscionable conduct\footnote{ Whilst the Australian Trade Practices Act 1998 has not replaced the common law doctrine of good faith, it has substantially reduced its role. The common law doctrine of good faith is “still evolving and …[lacks] a single definition or standard set of behaviours” (http://ministerinnovation.gov.au/Emerson/Documents/Additional%information%20on%20Franchising%20Code%20and%20Unconscionable%20Conduct%20Reforms.pdf.}. Rather than refer to good faith, like the TPA it should prohibit unconscionable conduct. A detailed description of unconscionable conduct is required to reduce any uncertainty.

The prohibition of unconscionable behaviour\footnote{TPA s. 51AC} will impact upon unjust contractual terms, bad faith in the operation of the contract, excessive pricing, hidden rebates and commissions, discrimination between franchisees, encroachment and so on.

Prohibiting unconscionable conduct offers a way in which the certainty demanded by the commercial imperatives can be balanced with the flexibility that the franchising relationship requires. A way that is based more on the real commercial needs of the relationship rather than the views of individual judges with little or no understanding of the dynamics of the franchise relationship.

Franchisees will be able to take advantage of the prohibition of unconscionable conduct regardless of
“whether they be astute or gullible, intelligent or not so intelligent, well-educated or poorly educated franchisees”\textsuperscript{1336}, although franchisees who are “extraordinarily stupid” or gullible, or whose reactions are “extreme or fanciful” are unlikely to be used as the standard against which a franchisor’s conduct will be judged\textsuperscript{1337}. 

By striking the right balance between flexibility and certainty, an obligation that prohibits unconscionable behaviour by either party to a franchise will maintain market confidence in franchising, re-enforce the economic drivers that attract franchisees to franchising and provide adequate protection for franchisors and franchisees without stifling innovation and competition. As evidenced by the Australian \textit{Hungry Jack} case\textsuperscript{1338} even the most reputable franchisors can act in unconscionable ways to further their own best interests. If it is to re-enforce the economic drivers that encourage franchisors to become involved in franchising, an EU Franchise Directive should not grant courts the power to modify agreements which are one-sided and favour the franchisor simply because the franchisee is considered the weaker party and the courts take pity upon it. Franchisees are entrepreneurs even though they might not have a great deal of experience. Unconscionability must be the key.

The prohibition of unconscionable conduct is what should enable the courts to restrict the parties’ ability to exercise their contractual rights.

However, although unconscionability is mentioned in a number of EU directives it is not defined in any of them. It is necessary to define it so as to increase certainty.

\begin{quote}
It is therefore proposed that for conduct to be regarded as unconscionable, serious misconduct or something clearly unfair or unreasonable must be demonstrated. Unconscionable should mean actions showing no regard for conscience or that are irreconcilable with what is right or reasonable.\textsuperscript{1339}
\end{quote}

\textsuperscript{1337} Ibid. See also \textit{Telstra Corp Ltd v Cable & Wireless Optus Ltd} [2002] FCAFC 296 and \textit{Taco Co of Australia Inc v Taco Bel Pty Ltd} [1982] FCA 136.
\textsuperscript{1338} [1999] NSW SC1029. See Chapter 12 above.
\textsuperscript{1339} \textit{ACCC v Simply No Knead (Franchising) Pty Ltd & Cameron Bates} (2000) ATPR n.68, 40,585.
Examples of unconscionable behaviour should be detailed so as to keep uncertainty to a bare minimum.

A prohibition of unconscionable conduct should require a party “not to act capriciously.”¹³⁴⁰ It should also require it not to act in a way that allows either party to the franchise agreement to obtain an unreasonable material commercial advantage or suffer a material commercial disadvantage that neither party would have contemplated had they been aware of the change in circumstances that lead to the behaviour in question. It should take account of the varying levels of experience of the parties in seeking to deliver an appropriate level of protection.

Having defined ‘unconscionable conduct’, in order to reduce uncertainty as far as possible, it is then necessary first to outline the grounds upon which unconscionability will be judged and secondly to provide examples of what will amount to unconscionable behaviour.

¹³⁴⁰ Finkelstein, J. (1999) ATPR 41-703 n.61, 43,014.
It is proposed that the grounds on which unconscionability will be judged should be as follows;

(a) The relative strengths of the bargaining positions of the franchisor and the franchisee.

(b) Whether, as a result of conduct engaged in by the franchisor, the franchisee was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the franchisor.

(c) Whether the franchisee was able to understand any documents relating to the franchise and the supply or possible supply of the goods or services.

(d) Whether any undue influence or pressure was exerted on, or any unfair tactics were used against the franchisee by the franchisor in relation to the franchise or the supply of the goods or services.

(e) The amount for which, and the circumstances under which, the franchisee could have acquired identical or equivalent goods or services from a person other than the franchisor.

(f) The extent of which the franchisor’s conduct towards the franchisee is consistent with the franchisor’s conduct towards its other franchisees.

(g) The requirements of “best practice” as detailed in the European Code of Ethics.

(h) The extent to which the franchisor unreasonably failed to disclose to the franchisee:

(1) any intended conduct of the franchisor that might affect the interests of the franchisee; and

(2) any risks to the franchisee arising from the franchisor’s intended conduct (being risks that the franchisor should have foreseen would not be apparent to the franchisee)

(i) The extent to which the franchisor was willing to negotiate the terms and conditions of the franchise agreement with the franchisee.

(j) The extent to which the franchisor and franchisee act to protect the legitimate interests of other franchisees and the franchise network as a whole.
It is proposed that examples of unconscionable conduct should include, but not be limited to, the following:

(a) unreasonably encroaching upon an exclusive territory\(^\text{1341}\)

(b) failing to provide the franchisee with a reasonably sufficient level of training and support

(c) unreasonably withholding, delaying or conditioning consent or approval, forcing franchisees to purchase goods or services at what, on a like for like basis and having regard to the obligations of the franchisor and its affiliates and the full financial and other terms of the agreement, amount to an unreasonably excessive price

(d) unreasonably refusing to discuss matters of dispute with the other party

(e) unreasonably terminating a franchise over a dispute of an insubstantial amount of money

(f) using the confidential information of the franchisor in a manner that is against the best interests of the franchisor or the franchise network

(g) unreasonably competing with the franchisor or other franchisees in the network in a manner not expressly allowed by the franchise agreement, during the term of the franchise agreement and for a reasonable period after its termination or expiry

(h) making an unreasonable profit on goods or services supplied to franchisees which they cannot or are not permitted to purchase from independent third parties

(i) include terminating a franchise over a dispute of an insubstantial sum of money;

(j) threatening to terminate franchise agreements rather than negotiate and consider important issues;

\(^{1341}\) In *Dymocks Holdings Pty Ltd & Ors v Top Ryde Book Sellers Pty Ltd & Ors* (2000)217 ALR 615; [2000] NSWSC 390; BC200002404 the court passed direct comment on the issue of encroachment. The case related in part to a dispute between a franchisor and some of its franchisees as a result of the franchisor establishing a website for the purpose of selling books directly to consumers. The dispute was essentially contractual, although it does illustrate how much the Internet market can change in a short period. Dymocks were in essence seeking a court ruling to help them unwind a commercial arrangement they had established in good faith and for valid commercial reasons a couple of years earlier. They had set up their Internet site such that it was to be owned and run by the advertising fund and administered by a joint committee of franchisor and franchisee representatives. Less than two years later it became obvious that the site needed funding on a major scale beyond the capacity of the marketing fund. Dymocks successfully obtained the
(k) unreasonably forcing franchisees to buy supplies from the franchisor at a
greater cost than they could buy elsewhere;

(l) preventing franchisees and their staff from wearing appropriate uniforms;

(m) refusing to allocate jobs to franchisees in order to force them into accepting
settlements in respect of totally unrelated disputes;

(n) penalising, suspending or threatening to penalise or suspend franchisees
because they were associating with other franchisees; requiring franchisees to
attend seminars unrelated to the core business of the franchise;

(o) unreasonably refusing franchisees access to its records to ensure all payments
due to the franchisees by the franchisor had in fact been made\textsuperscript{1342};

(p) unreasonably discriminating against individual franchisees.

The risks to both franchisors and franchisees need to be addressed through an objective
analysis of what is reasonable bearing in mind the best interests of the franchise network. As
appreciated by the Romanian franchise law\textsuperscript{1343} the best interests of an individual franchisee or
the franchisor may be at odds with those of the majority of franchisees involved in the
franchise. In such circumstances it should be the interests of the franchise network as a whole
that takes priority\textsuperscript{1344}. If the interests of the network as a whole are not adversely affected by
the circumstances then an objective analysis of what is reasonable as regards the parties
involved in the dispute should be made. This approach will help avoid the difficulties
sometimes presented by Article 242 of the German Civil Code. The duty of “\textit{Treu und
Glauben}”\textsuperscript{1345} can mean that the interests of a single franchisee can take precedent over those
the entire network.

\textsuperscript{1342} Many of these are listed in the unreported Australian case of \textit{ACCC v Cheap as Chips Franchising Pty Ltd & P Hudousek} - Gadens Lawyers, Franchising Update, September 1999.

\textsuperscript{1343} See 3.3 above

\textsuperscript{1344} Article 3 of the Romanian franchise ordinance expressly states that the duty of good faith requires that
the agreement reflects the interests of the members of the franchise network. This seems to suggest that any
exercise of the duty of good faith would require that it takes into account the interests of all of the
franchisees not merely the one who is in dispute with the franchisor.

\textsuperscript{1345} See 3.3 above
A prohibition of unconscionable behaviour during the term of a franchise agreement that gives priority to the interests of the franchise network as a whole over those of an individual franchisee, should maintain market confidence\(^\text{1346}\).

The prohibition on unconscionable conduct does not focus on “fuzzy” subjective concepts of honesty, loyalty and good morals but rather upon objectively unconscionable conduct which results in an unanticipated and unreasonable gain or loss for one of the parties. The prioritisation of the interests of the whole network over those of an individual will certainly encourage new entrants as it greatly increases the security of the investment made by both the franchisees and the franchisor.

The proposed prohibition of unconscionable conduct therefore strikes an appropriate equilibrium between flexibility and certainty. It presents franchisees with an adequate, but not over burdensome level of protection against franchisors behaving badly towards them by acting inappropriately within the terms of the franchise agreement.

Unconscionable conduct will result in the courts being able to make orders to restrict the party acting unconscionably from enjoying its contractual rights or other benefits resulting from that unconscionable conduct, set aside or vary the franchise agreement and other related agreements, to require the unconscionable conduct to cease and to award damages to the party suffering from the effects of the unconscionable conduct. When considering what remedy to apply the court shall give priority to the best interests of the franchise network as a whole, before considering what is reasonably appropriate for the parties in dispute. The parties involved and the regulatory authorities may apply for such remedies.

5.5.6 **Sub-Conclusion**

In order to reinforce the economic drivers that attract both franchisors and franchisees to franchising and reduce the inherent consequential risk to an appropriate level it is suggested that franchise agreements have mandatory clauses imposed on them. Franchisees must not challenge the franchisor’s intellectual property; implement the business format, not compete with the franchisor during the term and for a reasonable period thereafter allow the franchisor the right to purchase the franchisees business on termination, allow termination for cause without compensation, allow the franchisor or pre-emptive right of purchase, impose a duty of confidentiality and purchase tied goods and services from the franchisor or its nominated supplier.

\(^\text{1346}\) This was proposed by the failed Belgian Parliamentary bill of 17 March 2004. Doc 51 0924/001 – See 4.5 above
In return the franchisor must be the owner of or have the right to licence the intellectual property rights on which the franchise is based, provide a reasonable level of training, refrain from encroachment, allow the franchisee the right to sell its business (subject to the franchisor’s pre-emptive right) and not supply goods or services to the franchisee at inflated prices or which are unfit for purpose. In order to take account of the franchise agreement’s long term and changing nature unconscionable conduct must be prohibited. Unconscionable conduct is conduct showing no regard for conscience or that is irreconcilable with what is objectively right or reasonable taking into account the best interests of the franchise network before those of individual franchisees and the franchisor. In order to increase certainty details of the grounds upon which unconscionability will be judged and examples of what amounts to unconscionable conduct should be given in the directive.

The Proposed Draft Franchise Directive in Appendix 1 offers an appropriate way to implement these proposals.

5.6 Conclusion

The critical analysis in this chapter achieves the third objective of this thesis. It establishes how the regulatory environment in the EU can be re-engineered to enable franchising to better fulfil its potential in the EU\(^{1347}\). It is suggested that franchising be defined in accordance with the Marketing Plan approach that originated in the US and is found in various forms in six of the eight EU member states with franchise specific regulations\(^{1348}\). It focuses upon independence, economic interest, the brand, the business format, control and ongoing support. It also includes a qualitative threshold to ensure that the advantages of being a franchise are only available to businesses that have a track record and that start up franchises are not overwhelmed with regulatory requirements\(^{1349}\). A franchise that has not operated the business format for at least 12 months or which is operating less than four outlets will not have to comply with the regulation and cannot enjoy the “Exchange of Benefits”\(^{1350}\).

In order to ensure that the EU regulatory environment is fit for purpose as regards franchising and so enables franchisors and franchisees to access the economic drivers that attract them to franchising whilst reducing the risks involved to a reasonable level, its legal eco-systems must accentuate the influence of three Commercial Imperatives\(^{1351}\). These are maintaining market confidence, ensuring pre-contractual hygiene and imposing a mandatory taxonomy of

\(^{1347}\) See 5.2 above  
\(^{1348}\) See 5.1 above  
\(^{1349}\) ibid  
\(^{1350}\) ibid  
\(^{1351}\) See 5.2 above
rights and obligations onto the franchisor/franchisee relationship through the franchise agreement.

None of the EU’s legal eco-systems currently do this\textsuperscript{1352}. Likewise neither do either of the proposals to re-engineer the EU’s regulatory environment for franchising made by the Amsterdam Team or UNIDROIT\textsuperscript{1353}.

It is proposed that the EU Franchise Directive actively promotes franchising and accentuates the impact of the need to increase market confidence on the EU legal eco-systems\textsuperscript{1354}. It should do this by enabling franchisors to require pre-contractual disclosure by franchisees, focusing regulation only where it is required (by excluding fractional franchisees, de minimis franchisees, sophisticated investors, large investors, large franchisees and insiders) and allowing franchisees to compete on a level playing field with corporate chains\textsuperscript{1355}.

It should establish this partly by allowing franchisors to set the prices of their franchisees and restrict franchisee sales over the internet\textsuperscript{1356}.

These two provisions will accentuate the impact of the need for increased market confidence in franchising on the EU’s legal eco-system\textsuperscript{1357}.

It is suggested that in order to help ensure pre-contractual hygiene potential franchisees must be given access to appropriate information and equipped to interpret it in an appropriate manner\textsuperscript{1358}.

This means that potential franchisees must be educated out of the ‘psychology of failure’ that encourages failed franchisees to blame others for their own failures. They must understand what they are committing themselves to when they buy a franchise and the need to take and follow appropriate expert professional advice\textsuperscript{1359}. It is proposed that advisors are required to take short on-line franchise education courses if they are to advise potential franchisees and

\textsuperscript{1352} ibid
\textsuperscript{1353} See 5.2.3 above
\textsuperscript{1354} See 5.3 above
\textsuperscript{1355} See 5.3 above
\textsuperscript{1356} Failing a wholesale change in the EU’s approach to competition law, Finland has found a way forward on this issue that may suggest a viable compromise. The EU authorities may be willing to accept this more readily than a more fundamental reappraisal of their “per se” approach. The Finnish Competition Authority issued an exemption on price cooperation by businesses while implementing a campaign of offers intended for consumers. (Exemption No. 187/67/2003, dated 14.03.2003) This exemption was valid until 28 February 2008. There is currently no intention to issue a new exemption. (Petri Rinkinen, Franchising Legislation in Finland, www.franchising.fi/ukindex.html). The effect of the exemption is that price campaigns within a chain are made possible as long as the campaign does not take place for a period of more than two months. In addition, the vendor must maintain the right to sell the product or service at an even lower price at any time (Petri Rinkinen, Franchising Legislation in Finland, www.franchising.fi/ukindex.html)
\textsuperscript{1357} See 5.3 above
\textsuperscript{1358} ibid
\textsuperscript{1359} ibid
that potential franchisees investing more than US$20,000 must produce a certificate from
their advisers to prove that they have taken such advice\textsuperscript{1360}. National franchise associations
can play an important part in educating potential franchisees about the facts of life of
franchising – they have to work hard, follow the format, risk failure and take and follow
expert advice from appropriately experienced professionals\textsuperscript{1361}.

Pre-contractual disclosure should be given in a set form 15 working days before execution or
payment, covering details of the identity and experience of the franchisor, the franchise
network, the terms of the franchise agreement and any earning claims\textsuperscript{1362}. It should be in
plain language and contain an appropriate risk statement\textsuperscript{1363}. A copy of the franchise
agreement in the form in which it is to be executed should accompany the disclosure
document\textsuperscript{1364}. There should also be a five day cooling off period after execution\textsuperscript{1365}. Failure
to comply with the disclosure requirements should lead to the right for the franchisee and
government authorities to terminate or claim damages within 12 months of the franchisee
becoming aware of it or 24 months of the date of execution, whichever is the later if it
resulted in defective consent having been given\textsuperscript{1366}. Electronic disclosure should be
permitted\textsuperscript{1367}. There should be personal liability for any individual responsible for the
disclosure document being inaccurate\textsuperscript{1368}. Those disclosure obligations should apply to
foreign franchisors with no presence in the relevant member state who should be under an
obligation to disclose relevant information about analogous markets\textsuperscript{1369}.

There should be a regular review of the law every 5 years\textsuperscript{1370}. Failure to comply with the
disclosure requirements, if it leads to defective consent, should enable both the franchisee and
the appropriate regulatory authority to rescind the franchise and related agreements or claim
damages\textsuperscript{1371}. The claim must be made within 12 months of the franchisee becoming aware of
the failure on 24 months of it taking place, whichever is the latest\textsuperscript{1372}. The regulatory
authorities should be able to impose penalties including disqualification\textsuperscript{1373}.

\textsuperscript{1360} ibid
\textsuperscript{1361} ibid
\textsuperscript{1362} ibid
\textsuperscript{1363} ibid
\textsuperscript{1364} ibid
\textsuperscript{1365} ibid
\textsuperscript{1366} ibid
\textsuperscript{1367} See 5.4 above
\textsuperscript{1368} ibid
\textsuperscript{1369} ibid
\textsuperscript{1370} ibid
\textsuperscript{1371} ibid
\textsuperscript{1372} ibid
\textsuperscript{1373} ibid
Misleading and deceptive behaviour should be prohibited\textsuperscript{1374}. Such behaviour comprises failing to comply with the pre-contractual disclosure obligations and making any statement which although literally true, misleads or deceives is or likely to mislead or deceive\textsuperscript{1375}.

It is suggested that registration of documentation on a public register is not appropriate due not only to the practical difficulties it would give rise to in the 27 EU member states, but also due to the cost effectiveness of it and the law likelihood of it making any tangible contribution to accentuating the impact of the second commercial imperative on the EU’s legal eco-systems\textsuperscript{1376}.

In order to re-enforce the economic drivers that attract both franchisors and franchisees to franchising and reduce the inherent consequential risk to an appropriate level it is suggested that franchise agreements have mandatory clauses imposed on them\textsuperscript{1377}. Franchisees must not challenge the franchisor’s intellectual property; implement the business format, not compete with the franchisor during the term and for a reasonable period thereafter allow the franchisor the right to purchase the franchisees business on termination, allow termination for cause without compensation, allow the franchisor or pre-emptive right of purchase, impose a duty of confidentiality and purchase tied goods and services from the franchisor or its nominated suppliers.

In return the franchisor has mandatory obligations\textsuperscript{1378}. It must be the owner of or have the right to licence the intellectual property rights on which the franchise is based, provide a reasonable level of training, refrain from encroachment, allow the franchisee the right to sell its business (subject to the franchisor’s pre-emptive right) and not supply goods or services to the franchisee at over inflated prices or which are unfit for purpose. In order to take account of the franchise agreement’s long term and changing nature unconscionable behaviour must be prohibited\textsuperscript{1379}. Unconscionable conduct is conduct showing no regard for conscience or that is irreconcilable with what is objectively right or reasonable taking into account the best interests of the franchise network before those of individual franchisees and the franchisor. In order to increase certainty details of the grounds upon which unconscionability will be judged and examples of what amounts to unconscionable conduct should be given in the directive\textsuperscript{1380}.

These proposals could be implemented by the EU Commission adopting the Proposed Draft Franchise Directive detailed in Appendix 1.

\textsuperscript{1374} ibid
\textsuperscript{1375} ibid
\textsuperscript{1376} ibid
\textsuperscript{1377} See 5.5 above
\textsuperscript{1378} ibid
\textsuperscript{1379} ibid
\textsuperscript{1380} ibid
Chapter 6  Conclusion

6.1  The Three Objectives of this Thesis

The hypothesis of this thesis is that franchising has failed to fulfil its potential in the EU, that this is in part due to the regulatory environment and that this failure can be remedied by re-engineering the legal eco-systems that comprise the regulatory environment in the EU.

This thesis has three primary objectives.

The first objective is to establish that although franchising is specific, distinct and uniform type of commercial activity with a positive influence in the EU which stimulates economic activity by improving distribution, giving business increased access to other activity by offering economic advantages to all those involved and improving distribution and giving businesses increased access to other EU member state markets, it is not fulfilling its potential to contribute to the realisation of the single market. It seeks to achieve this by providing critical analysis in respect of franchising’s basic architecture, its historical development, its rationale and its contextualisation, differentiating it from other business models and identifying why franchisors and franchisees are attracted to franchising and are prepared to accept the inherent consequential risks. It considers the spread of franchising amongst all 27 EU member states and then benchmarks the contribution of franchising in the EU with that in the USA and Australia. It concludes that it is not fulfilling its potential in the EU.

The second objective is to establish whether the regulatory environment in the EU is in any way responsible for this underachievement of franchising in the single market. It does this by providing critical analysis in respect of the need for regulation, the difficulties encountered by member states in seeking to regulate it, the lack of homogeneity between the legal eco-systems that constitute the regulatory environment within the single market and the failure of those eco-systems to re-enforce the economic drivers that attract franchisors and franchisees to franchising or to reduce inherent consequential risks. It analyses the nature of these shortcomings and the difficulties they impose on franchising.

The third objective is to consider how the regulatory environment in the EU can be re-engineered to enable franchising to better fulfil its potential in the EU. It seeks to achieve this by providing critical analysis of how the legal eco-systems comprising the regulatory environment can be re-engineered, by way of a directive, so that it imposes a harmonised approach across the EU which accentuates the impact of three commercial imperatives — market confidence, pre-contractual hygiene and a mandatory taxonomy of rights and obligations. It also proposes a draft franchise directive that will implement these recommendations.
6.2  The First Objective

Critical analysis in Chapter 2 has achieved the first objective of this thesis.

As explained in Chapter 2, business format franchising is the latest incarnation of a long established business structure\textsuperscript{1381}. Its importance is acknowledged by a wide range of institutions\textsuperscript{1382} and it has emerged as an important vehicle for entrepreneurship that has appeal to large corporations and small businesses alike. The 9,971 or so franchise networks operating in the EU and the 405,000 or so outlets make a substantial contribution to the GDP of a number of member states, with a roughly estimated total turnover of €215 billion (US$300 billion)\textsuperscript{1383}. It has great potential to stimulate economic activity within the EU by improving the distribution of goods and/or services within and between member states. However, it is over concentrated in a small number of EU member states\textsuperscript{1384} and a comparison with the size of franchising in the USA and Australia suggests that its potential to contribute to the single market and the growth of trade between member states is far from being fulfilled at present\textsuperscript{1385}. An estimated 83.5\% of its turnover being concentrated in only 25\% of the member states.

The economic drivers that lead franchisors and franchisees to become involved in franchising and the consequential inherent risk differ\textsuperscript{1386}.

As detailed in Chapter 2, improved access to both appropriately qualified managerial resource and capital (the Agency, Transaction Cost and Resource Scarcity theories) and other economic drivers such as bulk purchasing, economies of scale and enhanced product development explain why businesses use franchising as part of their commercial strategy. A number of economic incentives resulting in an increased chance of success (such as a access to a proven format, a nationally recognised brand, ongoing support, economies of scale and so on) supported by various situational, personality and economic correlatives explain the attraction of franchising to franchisees.

There are a number of different risks inherent in franchising for franchisors and franchisees\textsuperscript{1387}. As explained in chapter 2, franchisors are exposed to risks arising from information asymmetry and moral hazard (such as underpayment, in term competition, abuse of the franchisor’s brand and non compliance with the business format). Whilst franchisees

\textsuperscript{1381} See 2.1 above  
\textsuperscript{1382} See 2.1.2 above  
\textsuperscript{1383} See 2.2 above  
\textsuperscript{1384} ibid  
\textsuperscript{1385} ibid  
\textsuperscript{1386} See 2.3 above  
\textsuperscript{1387} See 2.4 above
are exposed to the risk of misrepresentation, encroachment, poor quality business formats and inadequate support.

Franchising is a symbiotic relationship between two legally independent businesses that is used in a wide range of sectors and on a broad spectrum of scale and value which can be differentiated from commercial agency and distribution. Chapter 2 establishes that the architecture of franchising comprises six basic features; independence of the parties involved, economic interest, a business format, a brand, control of the franchisee by the franchisor and the provision of assistance to the franchisee by the franchisor. It is distinct from agency and distribution, the main difference being the business format and the ongoing support. These features are not impacted by either economic or sectoral contextualisation\textsuperscript{1388}. The legal architecture is uniform regardless of the legal system in which the franchise operates\textsuperscript{1389}.

Despite the differing nature of the sectors in which franchising is used these differences do not impact upon the architecture of franchising. Likewise although the value of investment required from franchisees inevitably defines the type of franchisee attracted to each franchise system, the resulting differences in economic bargaining power does not change the fundamental architectural features of franchising\textsuperscript{1390}.

This architecture is subjected to tensile stresses as a result of the long term and ever changing nature of the franchise relationship. In order to withstand these stresses the franchise agreements give the franchisor a degree of flexibility that can result in abuse of the franchisee\textsuperscript{1391}.

6.3 \textbf{The Second Objective}

Critical analysis in Chapter 3 has achieved the second objective of this thesis.

It has been established that the regulatory environment in the EU is partly responsible for franchising’s under achievement in the single market. It has established that franchising needs to be regulated\textsuperscript{1392} and that the contractual\textsuperscript{1393} and regulatory\textsuperscript{1394} environment in the EU (both self regulatory\textsuperscript{1395} and legal) within which franchising operates does not adequately protect and re-enforce the economic drivers that attract franchisors and franchisees to become involved in franchising. Nor does it adequately reduce the consequential inherent risks\textsuperscript{1396}.

\textsuperscript{1388} See 2.5.1 above
\textsuperscript{1389} See 2.5.5 and 2.5.6 above
\textsuperscript{1390} Ibid
\textsuperscript{1391} See 2.5.4 above
\textsuperscript{1392} See 3.2 above
\textsuperscript{1393} See 3.3 and 3.4 above
\textsuperscript{1394} See 3.8 above
\textsuperscript{1395} Ibid
\textsuperscript{1396} See 3.6 above
In some cases it over protects the franchisees, so increasing the risks to franchisors and eroding the economic drivers that attract them to franchising in the first place.

As detailed in Chapter 3, the contractual environment tends to support and re-enforce the economic drivers that encourage franchisors to become involved in franchising and reduces their consequential risk to a reasonable level\textsuperscript{1397}. However, it does not always re-enforce the economic drivers that encourage franchisees to become involved in franchising and it fails to reduce the consequential risks for franchisees adequately\textsuperscript{1398}. Self regulation of franchising does not work\textsuperscript{1399}. Although the BFA sees its mandate as seeking “to deliver self-regulation frameworks and then (delivering) that product to prospective franchisees”\textsuperscript{1400}, it seems to have achieved little. Such intransigence gives little credibility to those advocating self-regulation. If the franchisor’s trade body fails to respond to its member’s request for a higher level of self-regulation, how can self-regulation be expected to gain the confidence of either the public or the legislature? Historically it has been unwilling to take steps to enforce its code of conduct\textsuperscript{1401}. These are substantial flaws in the BFA’s credentials as an effective self regulatory body.

The inevitable conclusion made in Chapter 3 is that franchising needs to be legally regulated in the EU and that self regulation lacking transparency, consistency, accountability and proportionality will never be able to provide franchisees, potential franchisees or indeed franchisors with the level of protection that they require.\textsuperscript{1402} Even the most mature national franchise associations are struggling to make the change from representing the interests of franchisors to representing those of franchising. Even if they successfully make that change, they only account for just over a fifth of franchisors in the EU. Given the international nature of franchising, any self regulatory system must cover all 27 EU member states, and that is extremely unlikely to happen in a consistent manner given the current state of national franchise associations in the EU. There is a lack of suitably experienced, authoritative, fully representative and sufficiently resourced franchise associations.

As even the Director General of the BFA admits that self regulation is “simply not viable on a pan EU basis”\textsuperscript{1403}, one is led to conclude that the self regulatory environment in the EU does not adequately support the economic drivers or reduce the consequential risks inherent in the franchisor/franchisee relationship.

\textsuperscript{1397} See 3.5.1 above
\textsuperscript{1398} ibid
\textsuperscript{1399} See 3.6 above
\textsuperscript{1400} ibid
\textsuperscript{1401} Between 1997 and 2007 the BFA expelled fewer than 5 members.
\textsuperscript{1402} www.berr.gov.uk/whatwedo/bre/index.html, accessed 08.10.2009.
\textsuperscript{1403} Brian Smart in an interview with the author on 18 September 2008.
Chapter 3 establishes that despite clear and substantial differences between the civil and common law approaches to drafting commercial contracts franchise agreements exhibit a uniform architecture which comprises provisions detailing the grant made by the franchisor to the franchisee, the term and renewal, targets, the obligations of both parties, confidentiality, non competition, transfer, product and services ties, good will and termination.\textsuperscript{1404} There is a contractual asymmetry due to the multi-lateral nature of the franchise relationship (each franchisor having several/many franchisees) and the long term, dynamic and changing nature of the franchisor/franchisee relationship.\textsuperscript{1405}

The contractual environment in the EU supports the economic drivers that encourage franchisors to become involved in franchising.\textsuperscript{1406} It does not adequately support all of the economic drivers that encourage franchisees to become involved in franchising.\textsuperscript{1407} It provides for a brand, a format and support but it does not impose a qualitative measure for the format or assistance provided.

The contractual environment in the EU reduces the consequential risk inherent for the franchisor to a reasonable level, but it does not do so for the franchisee.\textsuperscript{1408}

The self regulatory environment does not effectively support or re-enforce the drivers that attract either franchisors or franchisees to franchising. Neither does it reduce the consequential inherent risks for either party.\textsuperscript{1409}

Chapter 3 establishes that the self regulatory environment in the EU is marked by a complete lack of homogeneity, the lack of a clear or consistent approach to enforcement, a significant conflict of interest between the interests of franchisors and franchising as a whole and an inability to have any influence whatsoever on nearly 80\% of franchise chains in the EU, as they are not members of the national franchise associations.\textsuperscript{1410}

The regulatory environment in the EU seeks by way of franchise specific laws in six member states to reduce to risks to which franchisees are exposed by ensuring that they have sufficient information to allow them to take a view of the adequacy of the business format and the support delivered by the franchisor to its franchisees and the franchisor’s historical approach to encroachment. Its success in reducing those risks is dependent on the franchisee carefully considering the information it receives, particularly the feedback from existing franchisees and is comprised by the inevitable fact of life that the franchisor’s historical conduct may not

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{1404} See 3.4 above
\item \textsuperscript{1405} ibid
\item \textsuperscript{1406} ibid
\item \textsuperscript{1407} ibid
\item \textsuperscript{1408} ibid
\item \textsuperscript{1409} See 3.6 above
\item \textsuperscript{1410} ibid
\end{itemize}
\end{footnotesize}
be indicative of its future behaviour. The lack of homogeneity of approach between the different EU member states further substantially dilutes its impact on cross border franchising. The lack of any uniform approach to pre-contractual disclosure further weakens the impact of franchise specific laws\(^{1411}\).

They do not seek to reduce the risks of informational asymmetry and moral risk to which the franchisor is exposed\(^{1412}\). Some regulatory regimes seek to redress this imbalance by imposing a duty of pre-contractual disclosure on the potential franchisee\(^{1413}\) but that is not part of the EU pre-contractual regulatory environment.

Chapter 3 establishes that the economic drivers which attract franchisors into franchising and those that attract franchisees to it are neither supported nor eroded in any particular way by the pre-contractual disclosure franchise specific regulatory environment in the EU\(^{1414}\).

Non franchise specific laws impact upon the pre-contractual regulatory environment in the EU in five distinct ways. They impose a duty not to misrepresent facts\(^{1415}\), an obligation to disclose relevant information to potential franchisees\(^{1416}\), an extra contractual obligation to disclose relevant information to potential franchisees\(^{1417}\), an extra contractual obligation of confidentiality\(^{1418}\), an obligation to enter into the franchise agreement once negotiations have passed a certain point\(^{1419}\) and a right to withdraw from the contract within a limited time period\(^{1420}\). Each member state takes a different approach to each of these issues resulting in the lack of any homogenous approach. This in turn substantially weakens their impact upon cross border franchising within the EU and creates a technical barrier to franchising between EU member states\(^{1421}\).

\(^{1411}\) See 3.8 above
\(^{1412}\) ibid
\(^{1413}\) In Vietnam not only does the franchisor have to disclose information to the franchisee, but so does the franchisee to the franchisor. In order to assist a franchisor when deciding to grant commercial rights, Article 9 of the Commercial Law provides that, upon receiving a reasonable request from the franchisor the franchisee is under an obligation to supply the franchisor with information about itself. The earlier Chinese franchise law (the Measures for the Regulation of Commercial Franchises issued by the Ministry of Commerce of the People’s Republic of China, December 31, 2004, Chapter III Article 9) also provided for this but it was dropped (without any explanation) from the most recent Chinese statute.
\(^{1414}\) See 3.8 above
\(^{1415}\) ibid
\(^{1416}\) ibid
\(^{1417}\) ibid
\(^{1418}\) ibid
\(^{1419}\) ibid
\(^{1420}\) ibid
\(^{1421}\) ibid
The ongoing franchisor/franchisee relationship in the EU is impacted by a regulatory environment that comprises a duty of good faith, anti-trust, unfair competition and consumer law.

Chapter 3 establishes that the common law and civil law takes a very different approach to the concept of good faith. Whereas the German and French approach is loose and amorphous based upon the Roman law concept of bona fides, the common law takes a more literal approach to contracts, using a variety of legal tools to ensure fairness on the relationship. However, even with the Civil approach to the concept of good faith differences exist between member states. The influence of Article 101 of the TFEU mean that all member states take a similar approach to the regulation of vertical restrictions within the franchisor/franchisee relationship whereas Unfair Competition and Confidentiality lies very substantially on a member state by member state basis. Unfair Contract term provisions are harmonised by the Unfair Competition Terms Directive.

Thus there is a complete lack of harmony between the various regimes seeking to regulate the franchise relationship by statute in the EU. Some issues, deemed worthy of specific regulation in certain jurisdictions outside of the EU are not dealt with at all. Franchisors embarking upon a European “roll out” of their concept must expect to encounter delays and costs that are a direct result of this heterogeneous approach— an artificial barrier to pan European expansion. The duty of good faith has a significant impact upon the economic drivers that encourage franchisors and franchisees to become involved in franchising and

1422 ibid
1423 ibid
1424 ibid
1425 ibid

The role of third parties in franchising is not regulated by any of the EU member states. However, there are examples of such regulation in other jurisdictions such as Malaysia (Malaysia governs the activities of Franchise Brokers "doing business as an agent or representative of a franchisor to sell a franchise to any person for a certain consideration but does not include any director, officer or employee of the franchisor or franchisee" (The Franchise Act 1998 Part I Section 4)), Korea (In Korea the law provides for the registration at the Fair Trade Commission of Franchise Consultants (Act on Fairness in Franchise Transactions Chapter III Article 28) and impose on them a duty to act “with dignity” and honesty (Act on Fairness in Franchise Transactions Chapter III Article 30) and can be struck off for inappropriate behaviour (Act on Fairness in Franchise Transactions Chapter III Article 31)) and Kazakhstan (in Kazakhstan Licence brokers, (those “engaged in mediation activities in the course of concluding and performance of the complex business license contract”) are expressly acknowledged by the law which states that they “may act both on their own behalf and at their own risk, and on behalf and at the risk of the licensor, licensee or other subjects of franchising relations in consideration for a license broker's fee which can be payable in the form of a fixed single or periodic payment, fixed payments or otherwise, as provided by the contract” (Law on Complex Business Licence (Franchising) (Law No 330: June 24, 2002.) Chapter 3 Article 13)). None of the EU member states stipulate a minimum term for franchise agreements. However, two jurisdictions outside of the EU do. In Malaysia the franchise agreement must be for a minimum period of five years (The Franchise Act 1998 Part III Section 25.). In Indonesia, there is a minimum period of 5 years (The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated July 30, 1997) Chapter II, Article 8.) and ten years for master franchise agreements (Cornwallis, International Journal of Franchising Law, 2006, Vol. 4 Issue 3 p. 5)).
reduces the consequential inherent risk. The lack of homogeneity through the EU greatly dilutes this impact on cross border franchising. The regulation of vertical restraints has an undermining impact upon the economic drivers that encourage franchisors to become involved in franchising.

Chapter 3 establishes that the legal regulatory environment in the EU does not support any of the economic drivers that encourage franchisors to become involved in franchising and does not significantly reduce any of the risks that franchisors are exposed to\textsuperscript{1426}. However, it over reduces the risks to which franchisees are exposed and an over re-enforces the economic drivers that encourage them to become involved in franchising\textsuperscript{1427}. All member states recognise the right to terminate for breach, although some (e.g France) are more formulaic in how it has to be exercised than others\textsuperscript{1428}. However the duty of good faith in some member states, such as Germany over protects franchisees, entitling them to refunds of upfront fees on termination in some circumstances\textsuperscript{1429}. An inappropriate use of employment law in some member states can also over protect some franchisees\textsuperscript{1430}. Likewise the application by analogy of commercial agency law in Germany erodes the economic drivers that attract franchisors to franchising and excessively de-risk it for franchisees\textsuperscript{1431}. Post-termination restrictive covenants are an essential element in reducing the risks inherent in franchising for franchisors, but German law applies commercial agency by analogy to erode this protection\textsuperscript{1432}.

This thesis therefore achieves its second objective and establishes in Chapter 3 that the regulatory environment in the EU is in part responsible for the underachievement of franchising in the EU.

### 6.4 The Third Objective

Critical analysis has achieved the third objective of this thesis. As detailed in Chapter 4 the European Commission is unequivocal in its belief that a regulatory environment comprising harmonised legal eco-systems is necessary to ensure that franchisors and other businesses can operate across borders efficiently\textsuperscript{1433}. The current heterogeneous regulatory environment creates obstacles that hinder franchisors from taking full advantage of the single market. The same problem confronted commercial agency and was overcome by the adoption of a

\textsuperscript{1426} See 3.8 above  
\textsuperscript{1427} ibid  
\textsuperscript{1428} ibid  
\textsuperscript{1429} ibid  
\textsuperscript{1430} ibid  
\textsuperscript{1431} ibid  
\textsuperscript{1432} ibid  
\textsuperscript{1433} See 4.1 above
directive\textsuperscript{1434}. Empirical research referred to in Chapter 4 supports the case for harmonisation\textsuperscript{1435}. The catalyst for such harmonisation should be either a directive or a common civil code\textsuperscript{1436}. It is suggested in Chapter 4 that a directive is more appropriate. This is because the considerable difficulties involved in a common civil code means that proposals for a non mandatory common frame of reference have taken over those for a common civil code and the non binding nature of such a “tool box” will not achieve the homogenised regulatory environment required.

The regulatory environment in the EU should be re-engineered to enable franchising to better fulfil its potential in the EU. This can be achieved as explained in Chapter 5 and is summarised below. The Draft Proposed Franchise Directive in Appendix I suggests how the EU Commission could implement these recommendations.

It is suggested in Chapter 5 that Franchising should be defined in accordance with the Marketing Plan approach and focuses upon:

- independence,
- economic interest,
- the brand,
- the business format,
- control and
- ongoing support.

A franchise that has not operated the business format for at least 12 months or which is operating less than four outlets will not have to comply with the regulation and cannot enjoy the “Exchange of Benefits”\textsuperscript{1437}.

As discussed in Chapter 5, in order to ensure that the EU regulatory environment is fit for purpose as regards franchising and so enables franchisors and franchisees to access the economic drivers that attract them to franchising whilst reducing the risks involved to a reasonable level, its legal eco-systems must accentuate the influence of three Commercial Imperatives. These are

- maintaining market confidence,
- ensuring pre-contractual hygiene and

\textsuperscript{1434} See 4.2 above
\textsuperscript{1435} See 4.3 above
\textsuperscript{1436} See 4.4 above
\textsuperscript{1437} See 5.1 above
• imposing mandatory terms onto the franchisor/franchisee relationship through the franchise agreement\textsuperscript{1438}.

As discussed in Chapter 5, it is proposed that the EU Franchise Directive actively promotes franchising and accentuates the impact of the need to increase market confidence on the EU legal eco-systems by

• enabling franchisors to require pre-contractual disclosure by franchisees,
• focusing regulation only where it is required (by excluding fractional franchisees, de minimis franchisees, sophisticated investors, large investors, large franchisees and insiders),
• allowing franchisees to compete on a level playing field with corporate chains\textsuperscript{1439}.

It should establish this by

• allowing franchisors to set the prices of their franchisees and
• restricting franchisee sales over the internet\textsuperscript{1440}.

These two provisions will accentuate the impact of the need for increased market confidence in franchising on the EU’s legal eco-system.

As discussed in Chapter 5, it is suggested that in order to help ensure pre-contractual hygiene potential franchisees must be given access to appropriate information and equipped to interpret it in an appropriate manner\textsuperscript{1441}. It is therefore proposed that

• advisors are required to take short on-line franchise education courses if they are to advise potential franchisees;
• potential franchisees investing more than US$20,000 must produce a certificate from their advisers to prove that they have taken such advice;
• national franchise associations play an important part in educating potential franchisees that they have to
  o work hard,
  o follow the format,
  o risk failure and

\textsuperscript{1438} See 5.2 above
\textsuperscript{1439} See 5.2 above
\textsuperscript{1440} See 5.3 above
\textsuperscript{1441} See 5.4 above
Pre-contractual disclosure should

- be given in a set form 15 working days before execution or payment
- cover details of the identity and experience of the franchisor, the franchise network, the terms of the franchise agreement and any earning claims
- be in plain language
- contain an appropriate risk statement
- be accompanied by a copy of the franchise agreement in the form in which it is to be executed
- include a five day cooling off period after execution
- if not complied with, lead to the right for the franchisee and government authorities to terminate or claim damages within 12 months of the franchisee becoming aware of it or 24 months of the date of execution, whichever is the later if it resulted in defective consent having been given
- enable the appropriate regulatory authority to rescind the franchise and related agreements or claim damages
- allow the regulatory authorities to impose penalties including disqualification
- be allowed electronically
- give rise to personal liability for any individual responsible for the disclosure document being inaccurate
- apply to foreign franchisors with no presence in the relevant member state who should be under an obligation to disclose relevant information about analogous markets

There should be a regular review of the disclosure law every 5 years.

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1442 ibid
1443 ibid
1444 See 5.4.3 above
Misleading and deceptive behaviour (failing to comply with the pre-contractual disclosure obligations and making any statement which although literally true, misleads or deceives is or likely to mislead or deceive) should be prohibited\textsuperscript{1445}.

As detailed in Chapter 5, registration of documentation on a public register is not appropriate due not only to the practical difficulties it would give rise to in the 27 EU member states, but also due to the cost effectiveness of it and lack of impact\textsuperscript{1446}.

In order to reinforce the economic drivers that attract both franchisors and franchisees to franchising and reduce the inherent consequential risk to an appropriate level it is suggested that franchise agreements have mandatory clauses imposed on them.

As detailed in Chapter 5, franchisees must not

\begin{itemize}
  \item challenge the franchisor’s intellectual property,
  \item implement the business format,
  \item not compete with the franchisor during the term and for a reasonable period thereafter
  \item allow the franchisor the right to purchase the franchisees business on termination,
  \item allow termination for cause without compensation,
  \item allow the franchisor or pre-emptive right of purchase,
  \item impose a duty of confidentiality and
  \item purchase tied goods and services from the franchisor or its nominated suppliers\textsuperscript{1447}.
\end{itemize}

The franchisor must

\begin{itemize}
  \item be the owner of or have the right to licence the intellectual property rights on which the franchise is based,
  \item provide a reasonable level of training,
  \item refrain from encroachment,
  \item allow the franchisee the right to sell its business (subject to the franchisor’s pre-emptive right) and
\end{itemize}

\textsuperscript{1445} See 5.4.4 above
\textsuperscript{1446} See 5.4.5 above
\textsuperscript{1447} See 5.5.3 above
• not supply goods or services to the franchisee at over inflated prices or which are unfit for purpose\textsuperscript{1448}.

In order to take account of the franchise agreement’s long term and changing nature unconscionable behaviour must be prohibited.

This thesis therefore achieves its third objective and suggests how the regulatory environment in the EU can be re-engineered to enable franchising to better fulfil its potential in the EU. It does this by proposing to re-engineer the regulatory environment so that it imposes a harmonised approach across the EU which accentuates the impact of the three commercial imperatives.

The proposed draft Franchise Directive, detailed in Appendix 1 offers a way in which the EU Commission can implement this.

\textbf{6.5 Conclusion}

In conclusion, this thesis achieves all three of its objectives and so proves the hypothesis that franchising has failed to fulfil its potential in the EU and that this is in part due to the regulatory environment.

It recommends seismic changes in the EU’s Regulatory environment to remedy this failure. This creative destruction of key parts of those parts of the legal eco-systems that impact upon franchising results in a vigorous re-engineering of the regulatory environment in the EU. This re-engineering involves accentuating the impact of three commercial imperatives. Market confidence, pre-contractual hygiene and a mandatory taxonomy of rights and obligations.

“A perfection of means and a confusion of aims, seems to be our main problem”

\textit{Albert Einstein, 1879-1955}

\textsuperscript{1448} See 5.5.4 above
Appendix 1

Proposed Draft Franchise Directive


The Council of the European Communities

Having regard to the Treaty on the Functioning of the European Union

Whereas, the approximation of the laws of the member states impacting upon franchising is necessary because the existing divergence may distort competition and affect the movement of goods and services within the common market and regulate franchising differently on each member state.

Whereas, business format franchising is a specific, distinct and uniform type of Commercial activity with significant beneficial economic impact in the EU. It stimulates economic authority by offering economic advantages to all those involved, improving distribution and growing business increased access to other member states. However, compared to its scale in other markets business format franchising is not realising its full potential in the single market and there is a disproportionate concentration of it in the larger national economies in the EU.

Whereas, there is a lack of homogeneity between the laws of member states an regards how they regulate business format franchising and these differences creates a barrier to business format franchising between member states. Existing member state laws that regulate business format franchising fail to reduce the inherit risks to which those involved in business format franchising are exposed to an appropriate level. These laws also fail to re-enforce the economic drivers that encourage both corporations and individuals to become involved in business format franchising as a way of carrying on business between member states.

Whereas, the harmonisation of member state laws that regulate business format franchising will encourage the use of business format franchising on a way of doing business between member states and remove barriers to it.

Whereas, harmonised laws regulating business format franchising should promote market confidence on it, ensure pre-contractual hygiene during the franchise sale process and impose mandatory rights and obligations on both franchisors and franchisees.

The Commission has adopted this Directive:

Article 1

This directive applies only to Business Format Franchising

A Business Format Franchise exists where;
1.1 (a) one party (the “Franchisor”) who owns or has the right to license other parties to operate a business format offering, supplying or distributing goods or services or both

(b) grants another party (a “Franchisee”)

(c) the right to carry on a business using that business format under a system or in accordance with a marketing plan substantially determined, controlled and/or suggested by the Franchisor or one of its associates or otherwise assisted by the franchisor or one of its associates (a “Shared Marketing Plan”).

(d) The operation of the business is substantially or materially associated with a brand owned, used or licensed by the Franchisor or an associate of the Franchisor.

(e) The Franchisee pays monies to the Franchisor or its affiliate, by way of, for example only:

(i) an initial capital investment and/or

(ii) a payment for goods or services and/or

(iii) an ongoing or periodic fee of any discharge from and/or

(iv) a training fee and/or

(v) repayment for a lien made by the Franchisor.

(f) A business using the business format has been operated by the Franchisor or its affiliate for a period of 12 months.

1.2 For the avoidance of doubt, a franchise does not include, motor vehicle dealerships, employee/employer relationship, agencies, landlord and tenants and co-operatives.

1.3 An affiliate is an entity in which the Franchisor has a controlling interest.
Article 2

2.1 Franchisors have the right, but not the obligation, to require that (at least 10 working days before entering into any agreement which obliges or potentially obliges a Franchisor to grant a potential franchisee a franchise) the potential franchisee provides the franchisor with the following information about the franchisee and its spouse/partner, if any, or if it is a limited liability company, its shareholders and officers:

(1) Full name and address including e-mail address and telephone number.

(2) Details of education and employment.

(3) Details of business experience including directorships and any direct or indirect shareholdings in privately held companies.

(4) Personal bankruptcy history.

(5) Details of the insolvency of any company in which he/she was a director or shareholder.

(6) Details of family situation including details of any divorce, child maintenance and other such court orders and arrangements, a signed statement from the prospective franchisee’s spouse/partner that they fully support the prospective franchisees application.

(7) Personal medical history and that of their spouse/partner and children.

(8) Criminal record and that of their spouse/partner.

(9) Details of any judgment against it.

(10) Copy of driving licence and passport.

(11) Banker’s reference.

(12) Details of personal assets and those of spouse/partner including details of status of current home and any charges on those assets.

2.2 The consequences of a potential franchisee failing to supply all such information to any franchisor that has requested it, is to give the franchisor the right to terminate the franchise agreement on the basis of defective consent within twelve (12) months of the failure coming to the franchisor’s attention or within two (2) years of the franchisee signing the franchise agreement, whichever is the earliest.

2.3 A franchisee that has made any material or substantial wrongful or lack of disclosure will be deprived of any right to claim damages or other remedy from the franchisor
unless the franchisor is shown to have intentionally and materially breached the terms of the franchise agreement or intentionally and materially made wrongful or incomplete pre-contractual disclosure to the franchisee.

Article 3

3.1 The franchisor must provide the potential franchisee with a written statement informing him/her that it wishes to exercise its right to require disclosure in plain language. This must be delivered to the potential franchisee at least 14 days prior to the date on which the potential franchisee must make the disclosure.

3.2 The statement must also be accompanied by a form, in plain language and in a Question and Answer format, setting out exactly what information is required in order to comply with the obligation, so that the franchisee need only complete the form.

3.3 Notices of the potential franchisee’s pre-contractual disclosure obligations should be in prominent and easily legible form and read as follows:

“THIS IS A VERY IMPORTANT NOTICE.

YOU MUST READ IT CAREFULLY AND DO AS IT SAYS BEFORE YOU ENTER INTO ANY AGREEMENT WITH US.

IT REQUIRES YOU TO GIVE US CERTAIN INFORMATION ABOUT YOU AND YOUR SPOUSE/PARTNER/SHAREHOLDERS/OFFICERS (IF APPLICABLE).

YOU MUST GIVE THIS INFORMATION TO US AT LEAST 14 DAYS BEFORE YOU SIGN ANY AGREEMENT WHICH ENTITLES YOU TO THE FRANCHISE YOU CAN GIVE US THIS INFORMATION BY ACCURATELY COMPLETING THE ATTACHED QUESTIONNAIRE. ALTERNATIVELY, IF YOU CHOOSE TO DO SO, YOU CAN GIVE IT IN ANY OTHER WRITTEN FORM.

IF YOU DO NOT GIVE US ALL THIS INFORMATION, OR IF ANY OF THE INFORMATION THAT YOU GIVE US IS FALSE, INCORRECT OR INCOMPLETE, YOU MAY LOSE YOUR RIGHT TO THE FRANCHISE AND SOME OF YOUR OTHER IMPORTANT LEGAL RIGHTS MAY BE SEVERELY RESTRICTED”.

3.4 Failure by a franchisee to comply with a franchisor’s request for disclosure by the franchisee will result in the franchisor having the right to terminate the franchise agreement within 12 months of the failure coming to the franchisor’s attention or within two years of the franchisee signing the franchise agreement, whichever is the earlier. The franchisee will also be deprived of any right to claim damages or other
remedy unless the franchisor has intentionally and materially either breached the franchise agreement or made wrongful or incomplete disclosure to the franchisee.

**Article 4**

4.1 Franchisors are only required to make pre-contractual disclosure when it is appropriate and not in the case of fractional franchisees, de minimis franchisees, sophisticated franchisees, large investors, large franchisees and insiders.

4.2 A franchisee is a fractional franchisee if (1) the franchisee or its principals have more than two years of experience in the same line of business or is otherwise already familiar with the products and services to be sold through the franchise; and (2) the parties reasonably expect that the franchisee’s sales from the new line of business will not exceed 20% of its total sales the disclosure requirement.

4.3 A franchisee is a de minimis franchise if it pays €1,000 or less for the franchise.

4.4 A franchisee is a sophisticated franchisee if it invests €500,000 or more (excluding funds obtained from the franchisor or its affiliates) in a franchise and has signed an acknowledgement that the sale is exempt from the disclosure requirement because the initial investment is over the threshold.

4.5 A franchisee is a large franchisee if it pays an upfront fee of €5 million or more and has at least 5 years experience of the type of business being franchised.

4.6 A franchisee is an insider franchisee if a franchisor sells a franchise to one of its current or former (someone who has worked in the franchisor for two years or more) managers or other officers.

**Article 5**

5.1 It is the franchisor’s obligation to ensure that if a franchisee is required to invest a sum greater than €20,000, the franchisee takes legal and financial advice from advisers affiliated to the national franchise associations. This obligation is satisfied by the franchisor being presented with a certificate from the potential franchisee’s legal and financial advisors stating that the potential franchisee has taken appropriate advice from them and that they have completed the self study module. Potential franchisees must also certify that they understand that they are taking a substantial risk if they do not follow appropriate advice and accept that they may be responsible for any loss they suffer as a result of not taking such advice.

5.2 Franchisors are obliged to deliver standard form pre-contractual disclosure to potential franchisees 15 working days before execution of any agreement which commits the potential franchisee to take up the franchise or payment of any fees in
connection with the franchise sale. Franchisors must deliver details of the identity and experience of the franchisor, the target market and the franchise network, the terms of the franchise agreement and any earning claims. There must be a five working day cooling off period. Failure to comply will enable both the franchisee and national regulatory authorities take action against the franchisor.

5.3 Potential franchisees must be informed by the franchisor in the disclosure document that:

5.3.1 Franchisees must work hard and for long hours. This is a clear and obvious factor of success in any business.

5.3.2 The franchisees must follow the franchise system. The whole reason for buying a franchise rather than starting a business from scratch is that the franchisor has, through its own experience, identified how the business should be run.

5.3.3 There is a risk of failure and what this could mean in terms of both financial and personal terms. Failure is inevitably a risk in running one’s own business. It is fundamentally different from employment.

5.3.4 It is important to take expert legal and financial advice from acknowledged experts before being legally committed to a franchise. In order to make an informed decision, advice is essential.

5.4 Details of the identity and experience of the franchise and its directors must include the franchisor’s litigation history over the previous 36 months and the bankruptcy history of the franchisor and its directors and substantial shareholders (holding over 25% of the issued shares).

5.5 Details of the franchise network must include details of the franchise network in the target market (or, if there are none, an analogous market), including the contact details of existing franchisees and any franchisees that have failed in the previous 12 months.

5.6 A summary of the terms of the franchise agreement must be detailed in the disclosure document. These are:

- the Initial and Ongoing Fees,
- Intellectual Property,
- Franchise Territory,
- Supply of Goods and Services,
- Marketing and other co-operative funds,
• any financing arrangements provided by the franchisor,
• the Franchisor’s Obligations,
• the Franchisee’s Obligations and Restrictions,
• Related Agreements,
• Renewal,
• Termination,
• Post-termination restrictions
• Dispute Resolution
• Earning claims

5.7 All earning claims made by the franchisor must be accurate, fair and made in good faith.

5.8 On each renewal of a franchise agreement the franchisor and the franchisee must comply with the pre-contractual disclosure obligations as if they did not have an existing franchisor/franchisee relationship.

5.9 Delivery of the disclosure document to the prospective franchisee should be 15 working days before the execution of any agreement which commits the prospective franchisee to take up the franchise or payment of any fees in connection with the franchise sale.

5.10 The disclosure document must be delivered to a prospective franchisee, that is any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.

5.11 Receipt of the disclosed document can be acknowledged by any affirmative action by the recipient to authenticate his/her identify and confirm receipt. This can include, for example, a handwritten signature, an electronic signature, passwords or a security code.

5.12 The disclosure document should be accompanied by a copy of the franchise agreement in the form in which it is to be executed.

5.13 The Disclosure Document must be updated by the Franchisor within 6 months of the end of each financial year.

5.14 The language of the disclosure document should be the plain language(s) of the member state in which the franchisee will be operating its business or, in member
states in which there is more than one official language, the official language which
the franchisee designates as its preference.

5.15 Plain language is the organization of information and language usage understandable
by a person unfamiliar with the franchise business. It incorporates short sentences;
definite, concrete, everyday language; active voice; and tabular presentation of
information, where possible. It avoids legal jargon, highly technical business terms,
and multiple negatives.

5.16 A Risk Statement which identifies known significant risks that could have a material
impact on the franchisee must be placed on the front of the disclosure document. It
must read as follows:

“Investing in a franchise can be a risky business. There is no guarantee that your
franchise will be a success. You could lose your investment. In order to succeed you
will have to work long and hard. It is not a road to instant success and riches. You
must think about it carefully before you enter into the franchise agreement. Some of
the information you need in order to make an informed decision” is contained in this
disclosure document. Take your time, read all documents carefully, talk to other
franchisees and assess your own financial resources and capabilities to deal with
requirements of the franchised business. You should also make your own enquiries,
get independent legal, accounting and business advice, prepare a business plan and
projections for profit and cash flow and consider educational course, particularly if
you have not operated a business before.”

5.17

5.17.1 A franchisor granting a franchise to a party in a member state in which it is not based
(the target member state) should disclose details of its franchise in the target member
state.

5.17.2 If a franchisor does not have outlets in the target market it should disclose details of
its business in another member state.

5.17.3 If the franchisor does not have any outlets in the whole of the EU, it should disclose
details of its franchise in the country in which it is based or another country which it
can reasonably justify as being appropriate (“the Analogous Market”).

Article 6

6.1 Inadequate or inaccurate disclosure by the franchisor will entitle the franchisee who
received such disclosure and/or the relevant government agency the right to terminate
the resulting franchise agreement ab initio or claim damages. This right to terminate
or claim damages due to inadequate disclosure must be exercised by the franchisee (or the member state regulatory authority) within 12 months of the franchisee becoming aware of the failure or 24 months of the date of the franchise agreement, whichever is the later. If the agreement continues after this time the franchisee, will be deemed to have affirmed the franchise agreement and so lose both its right to terminate the agreement and the right to sue for damages (as does the member state regulatory authority).

6.2 If disclosed information is inaccurate it will be immaterial if the inaccuracy has not led to defective consent being given by the franchisee and that it is a violation for a franchisor to fail to use best endeavours to ensure the accuracy of the disclosed information. Liability for inaccurate disclosure that lead to defective consent attaches not only to the franchisor, but also to any individual working for or with the franchisor who can be shown to have been responsible for the disclosure of the inaccurate information, who knew (or should have known) the legal or commercial significance of those facts, and was in a position to influence the outcome of the matter.

6.3 Member state regulatory authorities have the right to require a franchisor to desist from making wrongful or inadequate disclosure if there is found to be an established pattern of such behaviour. Failure to comply with the prohibition will lead to the imposition of substantial fines on the franchisor and the disqualification of its directors as directors of a company for up to 5 years.

6.4 During a period of five working days following the day on which the franchise agreement is executed by both parties the franchisee has the right to withdraw by written notice, without penalty and receive a full refund of all monies paid by it to the franchisor.

**Article 7**

All pre-contractual duties of care and consumer rights applied by member states on franchising be disapplied and replaced with the following provisions;

1. The proposed parties to a franchise agreement and related documentation must comply with the duty of the pre-contractual disclosure expressly provided for in this Directive. Failure to do so will be deemed to be unconscionable behaviour.

2. In addition to this all parties must refrain from any misleading or deceptive conduct when making any pre-contractual disclosure. This will include, but is not limited to, making statements which, although literally true misleads or deceives or is likely to mislead or deceive.
(3) If the misleading or deceptive behaviour leads to defective consent by the franchisee the courts have the power to make orders preventing such misleading or deceptive behaviour and preventing the franchisor from enjoying the benefits acquired by such behaviour being set aside or varying the franchise agreement or related documents and awarding damages. When considering what remedy to apply the court shall give consideration to the best interests of the franchise network as a whole and not just the best interests of the franchisee concerned. The parties involved and the regulatory authorities may apply for such remedies.

**Article 8**

Registration of Franchise Agreements, disclosure documents and related documents should not be required.

**Article 9**

9.1 Franchisors are allowed to set retail prices for its franchisees and dictate the network’s multi channel sales strategy.

9.2 Franchisors can control the Franchisee’s use of the internet so that they can add greater value to both the franchisee’s business and their own by being proactive in the use of the internet to increase operational efficiencies and communication.

**Article 10**

10.1 Franchise Agreements must provide that the Franchisee is under an obligation not to act in an unconscionable manner and, in particular, must;

(1) Not in any way challenge the validity or ownership of the franchisor’s intellectual property rights and to keep the franchisors know-how confidential and only use it in operating the franchise;

(2) Comply with a general duty of confidentiality as regards the franchisor’s trade secrets, including its know-how, providing that they are not placed in the public domain by or with the consent of the franchisor;

(3) Fully and faithfully implement the franchisor’s system, including but not restricted to undertaking all training required by the franchisor;

(4) Not compete with the franchisor or its franchisees during the term of the franchisee’s franchise agreement;

(5) Not compete with the franchisor or its franchisees for a reasonable time within a reasonable geographical area following the termination of the franchisee’s franchise agreement;
(6) Allow the franchisor to purchase the franchisee’s business on termination for a reasonable valuation, which will include all premises and fixtures used in the business and stock but exclude all goodwill. The franchisor will not however have an obligation to purchase the franchisee’s business;

(7) Allow the franchisor to terminate the franchise agreement for breach without having to pay the franchisee any compensation;

(8) Allow the franchisor to sell, transfer or licence its business to a third party subject to that third party purchaser agreeing to honour the franchisor’s obligations to the franchisee, without recourse against the franchisor in the event that the assignee/transferee/purchaser fails to honour such obligations;

(9) Purchase tied goods and services from the franchisor or its nominated suppliers.

A franchisee’s failure to respect these rights of the franchisor gives the franchisor the right to terminate the franchise agreement and sue for damages or loss of future profits.

10.2 Failure to comply with the provisions of this Article will render the Franchise Agreement null and void ab initio.

**Article 11**

11.1 Franchise Agreements must provide that the Franchisor must not act in an unconscionable manner and in particular must;

(1) be the owner of, or have the legal rights to use, the network’s trade name, trade mark and other distinguishing identification1449;

(2) provide the franchisee with a reasonable level of initial training and continuing commercial and/or technical training during the entire life of the agreement1450;

(3) render reasonable ongoing technical and consulting assistance to the franchisee1451;

(4) refrain from encroachment on the territory of an exclusive franchisee1452;

(5) allow the franchisee to sell its franchise on to a third party approved by the franchisor as an appropriate franchisee (subject to the franchisor’s pre-emptive right of purchase on the same terms),

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1449 As provided for by the European Franchise Federation in their Code of Ethics - www.eff-franchise.com
1450 Ibid - www.eff-franchise.com
1451 As per Lithuanian Civil Code Article 6.770(2).
1452 As held by the case of Scheck v Burger King Corp 756 F Supp. 548 (S.D. Fla. 1991). See Chapter 19 p. 279.
(6) not supply goods or services to the franchisee at inflated prices or which are unfit for purpose.

For the avoidance of doubt as regards its relationship with the franchisor, franchisees and potential franchisees are not consumers and are not entitled to enjoy any of the rights afforded to consumers as regards its relationship with the franchisor.

11.2 The front of each franchise agreement must be endorsed with the following statement:

“This franchise will not provide a guaranteed income to you. In entering into this franchise you are accepting the risk that you may lose your investment. If you get into financial trouble whilst operating your franchised business your franchisor has no obligation to rescue you. It is therefore essential that before entering this franchise you take legal and financial advice from professionals with a proven track record of advising prospective franchisees on their intended investment and that you follow their advice. You must also carefully read the disclosure document. It contains important information that you must read before entering into the franchise agreement. Remember, if your franchised business fails depending upon your circumstances you could end up losing your home and becoming bankrupt.”

11.3 Failure to comply with the provisions of this Article will render the Franchise Agreement null and void ab initio.

**Article 12**

12.1 Any general duty of good faith found in EU member state law is disapplied to franchising and replaced with a specific prohibition of unconscionable conduct by parties to a franchise, breach of which will enable the courts to act in a restrictive and adaptive manner.

12.2 All parties to a franchise agreement and related documentation must therefore refrain from exercising their rights and obligations under the agreement, and must not otherwise conduct themselves, in an unconscionable manner during the term of the franchise agreement.

12.3 To be regarded as unconscionable, serious misconduct or something clearly unfair or unreasonable must be demonstrated. Unconscionable means actions showing no regard for conscience or that are irreconcilable with what is right or reasonable. No party should act capriciously or act in a way that allows either party to the franchise agreement to obtain an unreasonable material commercial advantage or suffer a material commercial disadvantage that neither party would have contemplated had they been aware of the change in circumstances that lead to the behaviour in question.
This must take account of the varying levels of experience of the parties in seeking to deliver an appropriate level of protection.

12.4 The grounds on which unconscionability will be judged are as follows;

(a) The relative strengths of the bargaining positions of the franchisor and the franchisee.

(b) Whether, as a result of conduct engaged in by the franchisor, the franchisee was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the franchisor.

(c) Whether the franchisee was able to understand any documents relating to the franchise and the supply or possible supply of the goods or services.

(d) Whether any undue influence or pressure was exerted on, or any unfair tactics were used against the franchisee by the franchisor in relation to the franchise or the supply of the goods or services.

(e) The amount for which, and the circumstances under which, the franchisee could have acquired identical or equivalent goods or services from a person other than the franchisor.

(f) The extent of which the franchisor’s conduct towards the franchisee is consistent with the franchisor’s conduct towards its other franchisees.

(g) The requirements of “best practice” as detailed in the European Code of Ethics.

(h) The extent to which the franchisor unreasonably failed to disclose to the franchisee:

(1) any intended conduct of the franchisor that might affect the interests of the franchisee; and

(2) any risks to the franchisee arising from the franchisor’s intended conduct (being risks that the franchisor should have foreseen would not be apparent to the franchisee).

(i) The extent to which the franchisor was willing to negotiate the terms and conditions of the franchise agreement with the franchisee.

(j) The extent to which the franchisor and franchisee act to protect the legitimate interests of other franchisees and the franchise network as a whole.

12.5 Examples of unconscionable conduct include, but are not limited to, the following:

(a) unreasonably encroaching upon an exclusive territory

(b) failing to provide the franchisee with a reasonably sufficient level of training and support
(c) unreasonably withholding, delaying or conditioning consent or approval, forcing franchisees to purchase goods or services at what, on a like for like basis and having regard to the obligations of the franchisor and its affiliates and the full financial and other terms of the agreement, amount to an unreasonably excessive price.

(d) unreasonably refusing to discuss matters of dispute with the other party.

(e) unreasonably terminating a franchise over a dispute of an insubstantial amount of money.

(f) using the confidential information of the franchisor in a manner that is against the best interests of the franchisor or the franchise network.

(g) unreasonably competing with the franchisor or other franchisees in the network in a manner not expressly allowed by the franchise agreement, during the term of the franchise agreement and for a reasonable period after its termination or expiry.

(h) making an unreasonable profit on goods or services supplied to franchisees which they cannot or are not permitted to purchase from independent third parties.

(i) include terminating a franchise over a dispute of an insubstantial sum of money;

(j) threatening to terminate franchise agreements rather than negotiate and consider important issues;

(k) unreasonably forcing franchisees to buy supplies from the franchisor at a greater cost than they could buy elsewhere;

(l) preventing franchisees and their staff from wearing appropriate uniforms;

(m) refusing to allocate jobs to franchisees in order to force them into accepting settlements in respect of totally unrelated disputes;

(n) penalising, suspending or threatening to penalise or suspend franchisees because they were associating with other franchisees; requiring franchisees to attend seminars unrelated to the core business of the franchise;

(o) unreasonably refusing franchisees access to its records to ensure all payments due to the franchisees by the franchisor had in fact been made;

(p) unreasonably discriminating against individual franchisees.

**Article 13**

Each member state must have a national franchise association which is recognised as a legally acknowledged source of best practice in franchising and membership of it as an indication (but not a guarantee) that a franchisor has met certain minimum criteria as regards best
practice. They must educate the public as to the benefits and risks of franchising but not the regulation of franchising. The franchise association must be not-for-profit organisations and be funded by membership subscriptions and member state subsidies.

**Article 14**

This EU Directive will be reviewed every five (5) years to ensure that the contents of the Disclosure Document continues to be relevant to the market.

**Article 15**

Member states shall bring into force, not later than two years from the date of notification of this Directive, the laws, regulations and administrative provisions necessary to comply with this Directive. They shall forthwith inform the Commission thereof.

**Article 16**

Member states shall communicate to the Commission the texts of the main provisions of national law which they subsequently adopt in the field governed by this directive.

**Article 17**

Every five years the Commission shall present a report to the Council on the application of this Directive and, if necessary, shall submit appropriate proposals to it.

**Article 18**

This Directive is addressed to the member states.

Done at Brussels, [ ] 2011

*For the Council*

*The President*

/[ ]
Appendix 2
Survey of Potential Franchisees

A. BASIS ON WHICH SAMPLE WAS CHOSEN
Conducted during 2008 through interviews with individuals attending franchise exhibitions in London, Paris and Madrid who stated that they had an interest in buying a franchise.

B. REASONS FOR QUESTIONS ASKED
The aim was to try to identify the profile of potential franchisees and their reasons for considering purchasing a franchise. The questions are based upon the reasons identified by research conducted by Stanworth and Kauffman and other commentators referred to in Chapter 2.

C. HOW THE SURVEY WAS CONDUCTED
60 potential franchisees were surveyed at the British Franchise Exhibition at Olympia on 4 April 2008.

60 at the Salon de Franchise in Paris at Porte de Versailles on 16 March 2008.

50 potential franchisees at the Spanish Franchise exhibition at EXPO FRANQUICIA ’08 on 22 June 2008.

<table>
<thead>
<tr>
<th>Question</th>
<th>UK Sample</th>
<th>French Sample</th>
<th>Spanish Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Gender:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>75%</td>
<td>83%</td>
<td>92%</td>
</tr>
<tr>
<td>Female</td>
<td>25%</td>
<td>37%</td>
<td>8%</td>
</tr>
<tr>
<td>Age</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 – 30</td>
<td>22.5%</td>
<td>34%</td>
<td>10%</td>
</tr>
<tr>
<td>30 – 40</td>
<td>42.5%</td>
<td>40%</td>
<td>30%</td>
</tr>
<tr>
<td>40 – 50</td>
<td>30%</td>
<td>25%</td>
<td>42%</td>
</tr>
<tr>
<td>50 – 60</td>
<td>5%</td>
<td>1%</td>
<td>18%</td>
</tr>
<tr>
<td>2 University degree:</td>
<td>35%</td>
<td>45%</td>
<td>42%</td>
</tr>
<tr>
<td>4 What are the attractions to you of buying a franchise rather than starting up your own business?</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>(a) Guarantee of Success</td>
<td>65%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>(b) Access to a well known brand</td>
<td>95%</td>
<td>5%</td>
<td>100%</td>
</tr>
<tr>
<td>(c) Access to a tried + tested formula</td>
<td>100%</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>Question</td>
<td>UK Sample</td>
<td>French Sample</td>
<td>Spanish Sample</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>-----------</td>
<td>---------------</td>
<td>----------------</td>
</tr>
<tr>
<td>(d) Access to franchisor’s knowledge of the most appropriate pricing structure for the goods/services</td>
<td>72% 28%</td>
<td>62.5% 37.5%</td>
<td>58% 42%</td>
</tr>
<tr>
<td>(e) Access to an established supply chain</td>
<td>60% 40%</td>
<td>80% 20%</td>
<td>76% 24%</td>
</tr>
<tr>
<td>(f) Access to on-going support and guidance</td>
<td>91.66% 8.33%</td>
<td>60% 40%</td>
<td>68% 32%</td>
</tr>
<tr>
<td>g) Any other reasons?</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>5 If you buy a franchise would you expect the franchisor to have the experience to enable it to set an appropriate price for the goods/services and require that all other members of the franchise network adopt that pricing structure?</td>
<td>Yes No</td>
<td>Yes No</td>
<td>Yes No</td>
</tr>
<tr>
<td></td>
<td>80% 20%</td>
<td>75% 25%</td>
<td>60% 40%</td>
</tr>
<tr>
<td>If yes, is this because</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) It prevents them competing with you for custom on the basis of price?</td>
<td>75% 25%</td>
<td>65% 35%</td>
<td>58% 42%</td>
</tr>
<tr>
<td>(b) Different pricing structures would damage the brand to reduce the attraction of it to potential customers due to the lack of uniform pricing?</td>
<td>93.32% 6.68%</td>
<td>87.5% 12.5%</td>
<td>68% 32%</td>
</tr>
<tr>
<td>6 Do you have any prior experience of running your own business?</td>
<td>Yes No</td>
<td>Yes No</td>
<td>Yes No</td>
</tr>
<tr>
<td></td>
<td>10% 90%</td>
<td>15% 85%</td>
<td>30% 70%</td>
</tr>
<tr>
<td>7 How will you finance your investment in a franchise?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Savings</td>
<td>65% 35%</td>
<td>91.66% 8.33%</td>
<td>90% 10%</td>
</tr>
<tr>
<td>(b) Redundancy payment or other lump sum received by you such as an inheritance?</td>
<td>11.66% 88.34%</td>
<td>45% 55%</td>
<td>28% 72%</td>
</tr>
<tr>
<td>(c) Unsecured borrowing</td>
<td>40% 60%</td>
<td>65% 35%</td>
<td>66% 34%</td>
</tr>
<tr>
<td>(d) Borrowing secured on your main asset (e.g. your home)</td>
<td>86.66% 23.34%</td>
<td>54% 46%</td>
<td>58% 42%</td>
</tr>
<tr>
<td>Question</td>
<td>UK Sample</td>
<td>French Sample</td>
<td>Spanish Sample</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>-----------</td>
<td>---------------</td>
<td>----------------</td>
</tr>
<tr>
<td>(e) Other</td>
<td>0%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>8  Do you intend to pay for both legal and financial advice on the franchise before legally committing yourself to it?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Yes</td>
<td>55%</td>
<td>36.66%</td>
<td>22%</td>
</tr>
<tr>
<td>(b) No</td>
<td>35%</td>
<td>40%</td>
<td>14%</td>
</tr>
<tr>
<td>(c) Maybe</td>
<td>10%</td>
<td>23.33%</td>
<td>64%</td>
</tr>
</tbody>
</table>
Appendix 3
Survey of Franchisors

A. THE BASIS ON WHICH THE SAMPLE WAS CHOSEN

25 Franchisors were interviewed in the UK, 25 in Germany, 25 in France and 25 in Spain. They were chosen because they are all undertaking business in more than one EU Member State or have stated their intent to do so.

B. HOW THE SURVEY WAS CONDUCTED

Interviews were conducted by way of a mixture of face to face and telephone interviews. All of the face to face interviews in Paris were conducted at the Salon de Franchise in Paris on 16 March 2008. All of the face to face interviews in Spain were conducted at Expofranquicia '08 on 22 June 2008. Some of the face to face interviews in the UK were conducted at the British Franchise Exhibition at Olympia on 4 April 2008. All other interviews were conducted at a variety of meetings and through telephone interviews. All of the interviews with German franchisors were conducted by way of telephone in May 2008.

C. THE FRANCHISORS SURVEYED

French Franchisors interviewed

Ecole Banette Proximed
Beauty Success Résponse Lit
Ecoute! Ecoute! Rouge Tendance
Elyse Avenue Soleil Sucré
Espace Revetements Café Leffe
Family Dom Petit Casino 24
Keops Cuisinella
Kidzy Pasta Pates
Le Piment Bleu Patchagogo
Liberto Petit Petons
<table>
<thead>
<tr>
<th>Maisons Pierre</th>
<th>Pizza Mania</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mary Cohr Le Jardin Des Soins</td>
<td>Yves Rocher</td>
</tr>
<tr>
<td>Potiron</td>
<td></td>
</tr>
</tbody>
</table>

**Spanish Franchisors interviewed**

<table>
<thead>
<tr>
<th>By-print</th>
<th>Clean &amp; Clean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chocolate Graphics</td>
<td>Expense Reduction Analysts</td>
</tr>
<tr>
<td>Farmarosa</td>
<td>Funk Fish</td>
</tr>
<tr>
<td>Happy Days</td>
<td>Kool</td>
</tr>
<tr>
<td>La Pizza Laggera</td>
<td>Macson</td>
</tr>
<tr>
<td>Neck &amp; Neck</td>
<td>October</td>
</tr>
<tr>
<td>Pet’s Place</td>
<td>Pic Ouic</td>
</tr>
<tr>
<td>Real Colour</td>
<td>RK Rock &amp; Ribs</td>
</tr>
<tr>
<td>Restaurantes “El Don Juan”</td>
<td>Senior Stores</td>
</tr>
<tr>
<td>Serjent Major</td>
<td>Smartee</td>
</tr>
<tr>
<td>The Soap Story</td>
<td>Total Line Protection</td>
</tr>
<tr>
<td>Toma Jamon</td>
<td>KA International</td>
</tr>
</tbody>
</table>

**German Franchisors interviewed**

<table>
<thead>
<tr>
<th>MBE Deutschland GmbH</th>
<th>Schweinske Franchise-Management GmbH</th>
</tr>
</thead>
<tbody>
<tr>
<td>MINIT Deutschland GmbH &amp; Co. KG</td>
<td>TopaTeam AG</td>
</tr>
<tr>
<td>Morgengold Frühstücksdienste Franchise GmbH</td>
<td>Tchibo</td>
</tr>
<tr>
<td>OPTICO Auto-Spezialreinigung</td>
<td>Town &amp; Country</td>
</tr>
<tr>
<td>Paint Express HESSE GmbH &amp; Co</td>
<td>Town &amp; Country Haus Lizenzgeber GmbH</td>
</tr>
<tr>
<td>PC Spezialist (SYNAXON AG)</td>
<td>TUI Leisure Travel Management Gmb</td>
</tr>
<tr>
<td>PC-Feuerwehr Computer Service GmbH</td>
<td>Türenfein Färber GmbH</td>
</tr>
<tr>
<td>Personal Total Franchise AG</td>
<td>VARIA Franchise GmbH</td>
</tr>
<tr>
<td>PIRTEK Deutschland GmbH</td>
<td>Vergölst GmbH Franchise Deutschland</td>
</tr>
</tbody>
</table>
D. REASONS FOR THE QUESTIONS ASKED

The aim was to:

1. understand the risks, advantages franchisors perceive in franchising their business. The questions reflect the reasons proposed in Chapter 2 in this thesis

2. understand their views of the regulation of franchising in the EU.
Questions contained in the Survey of franchisors

1. What are the main barriers to franchisors expanding into other EU member states? Do you consider the following factors to be very significant, significant or insignificant barriers?

2. What are the greatest risks that a franchisor incurs in deciding to franchise its business?

3. Why did you franchise your business? Do you consider the following factors to have been very significant, significant or insignificant?

4. Which of the following obligations are very significant, significant or insignificant in protecting your business from franchisee abuse?

5. Are you in favour of the Statutory Regulation of Franchising in the EU?

6. If franchising is regulated by law, should it be done at an EU level rather than a national level?

7. Has the statutory regulation of franchising in your country had an adverse impact upon your business?

8. Do you believe that specific statutory regulation of pre-contractual disclosure is more effective than self regulation in preventing abuse of franchisees?

9. Do you believe that the legal regulation of duties and obligations of franchisors and franchisees during the term of the franchise agreement would significantly reduce disputes between franchisors and franchisees?

10. Do you believe that statutory regulation of franchising is more likely to improve the quality of franchising than self regulation?

11. Do you think that statutory regulation of pre-contractual disclosure in franchising will enable disputes between franchisors and franchisees to be resolved in a more effective manner?

12. Are franchised businesses disadvantaged as compared to non-franchised businesses as regards
   (a) Their ability to set prices in all of their outlets
   (b) Their ability to control the franchisees' use of the internet

13. In your experience if prospective franchisees are given lengthy documentation to read giving details about the franchise, its performance and the role of franchisees do they read it?
14. In your experience do the cultural and commercial differences between different national markets give rise to different problems and issues for franchisors?
Appendix 4
Survey of Franchise Lawyers

A. BASIS ON WHICH SAMPLE WAS CHOSEN
All members of the sample are all listed as experts in Franchising in the International Who’s Who of Franchising, published by Law Business Research Ltd.

B. HOW WAS THE SURVEY CONDUCTED
An e-mail survey of the 25 lawyers detailed below, was conducted in June 2008.

C. THE INDIVIDUALS IN THE SAMPLE
- Penny Ward, Baker McKenzie, Sydney
- Stephen Giles, Deacons, Sydney
- Carl Zwisler, Haynes & Boone, Washington D.C.
- Remi Delforge, Donald Manasse & Remi Delforge Avocats Associes, Paris
- Andrew Selden, Briggs & Morgan, Minneapolis
- Ronald T. Coleman, Jr., Paul Hastings Janofsky Walker, Atlanta
- Kenneth R. Costello, Bryon & Eve, Los Angeles
- Gayle Cannon, Haynes & Boone, Dallas
- Franklin C. Jesse, Gray Plant Mooty, Minneapolis
- David Holmes, Holmes & Lofstorm, St Louis Obispo, California
- Richard Asbill, Paul Hastings Janofsky Walker, Atlanta
- Dr. Christoph Wildhaber, Streichenberg, Zurich
- Quentin Wittrock, Gray Plant Mooty, Minneapolis
- Ned Levitt, Gowlings, Toronto
- Rupert Barkoff, Kilpatrick Stockton, Atlanta
- William L. Kilion, Faege Benson, Minneapolis
- Paul D. Jones, Jones & Co, Toronto
- John F. Baer, Sonnenscheins, Chicago
- Gaylen L. Knack, Gray Plant Mooty, Minneapolis
- Lew Rudnick, DLA Piper, Chicago
D. REASONS FOR QUESTIONS ASKED

This was to obtain the view of highly reputed, international expert franchise practitioners.

The questions posed to the franchise lawyers surveyed

A. Which of the following obligations are of fundamental importance to the protection of a franchised business from franchisee abuse?

Percentage of respondents who rated each obligation in order of importance with 1 being the most important and 5 being the least important

<table>
<thead>
<tr>
<th>Obligation</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non competition by franchisee during term of the Franchise Agreement</td>
<td>16%</td>
<td>48%</td>
<td>28%</td>
<td>8%</td>
<td>0%</td>
</tr>
<tr>
<td>Non competition by former franchisees for a reasonable period after the expiry of the Franchise Agreement</td>
<td>8%</td>
<td>0%</td>
<td>56%</td>
<td>16%</td>
<td>12%</td>
</tr>
<tr>
<td>No challenge of the Franchisor’s Intellectual Property rights</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>36%</td>
<td>4%</td>
</tr>
<tr>
<td>Franchisees must follow the Franchisor’s system</td>
<td>56%</td>
<td>24%</td>
<td>0%</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>Others e.g. timely payment, failure to participate in advertising programmes</td>
<td>0%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>88%</td>
</tr>
</tbody>
</table>

B. Is Statutory Regulation more effective than Self Regulation?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>Maybe</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>22</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>88%</td>
<td>8%</td>
<td>4%</td>
</tr>
</tbody>
</table>
C. Should the EU regulate franchising uniformly?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Yes</strong></td>
<td>19 (76%)</td>
</tr>
<tr>
<td><strong>No</strong></td>
<td>2 (8%)</td>
</tr>
<tr>
<td><strong>Maybe</strong></td>
<td>4 (16%)</td>
</tr>
</tbody>
</table>
Appendix 5

Survey of Franchisees

A. BASIS ON WHICH SAMPLE WAS CHOSEN

The sample comprised UK franchisees who were currently running a franchised business from a broad spread of businesses.

B. HOW AS THE SURVEY CONDUCTED?

This survey of 30 franchisees was conducted through a mix of telephone and face to face interviews between January 2004 and April 2007. In order to encourage a candid response, anonymity of the respondents was essential.

C. REASONS FOR QUESTIONS ASKED

The aim was to understand the view of UK franchisees on self regulation and the reason they became franchisees (based upon the reasons proposed in Chapter 2 in the thesis.

D. WHO COMPRISES THE SAMPLE

- 3 Green Thumb franchisees (a garden care business)
- 2 Kumon franchisees (a home education business)
- 2 Domino’s franchisees (a pizza business)
- 8 Minuteman franchisees (a printing business)
- 2 Hair on Broadway franchisees (a hairdressing business)
- 2 Mahogany franchisees (a hairdressing business)
- 8 Durham Pine franchisees (a retail business)
- 3 Kall Kwik franchisees (a printing business)
Do you feel disadvantaged as a franchisee compared to a corporate owned business as they are able to deliver a price guarantee to customers that a franchised business cannot?

Yes  23  
No  5  
Don’t know  2  

Do you see the British Franchise Association as represents the interests of

Franchising in general?  4  
Franchisors?  26  
Franchisees?  0  

The BFA has a three pronged dispute resolution procedure comprising conciliation, mediation and arbitration.

Do you trust its impartiality?

Yes  2  
No  26  
Don’t know  2  

Would you use BFA arbitration rather than litigation to settle disputes with your franchisor?

Yes  2  
No  18  
Don’t know  10  

Would you be willing to try to resolve a dispute with your franchisor by non binding conciliation or mediation?

Yes  30  
No  0  
Don’t know  0  

If yes, why?

Cost  29  
Speed  30  
Effectiveness  12
<table>
<thead>
<tr>
<th>Reason</th>
<th>Yes</th>
<th>No</th>
<th>Don’t know</th>
</tr>
</thead>
<tbody>
<tr>
<td>The training/know-how available</td>
<td>18</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Opportunity to own your own business</td>
<td>30</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ongoing support to be delivered by franchisee</td>
<td>28</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>The brand</td>
<td>30</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Less chance of failure</td>
<td>26</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Increased willingness of banks to lend</td>
<td>16</td>
<td>4</td>
<td>0</td>
</tr>
</tbody>
</table>
Appendix 6

Franchise Executive Interviews

A. BASIS ON WHICH SAMPLE WAS CHOSEN

Members of the sample were all senior executives in companies that franchise in the EU.

B. HOW WERE THE INTERVIEWS CONDUCTED

They were either face to face or telephone interviews, sometimes complimented by written questions and answers.

C. REASONS FOR QUESTIONS ASKED

To obtain a better understanding of the commercial realities of the issues considered in this thesis.

The following Executives were interviewed by the author during the period March – July 2006

D. THE INDIVIDUALS COMPRISING THE SAMPLE

1. Chris Nowak, Vice President and Legal Counsel at Wyndham (a hotel business)
2. Nuns Moodliar, General Counsel Hertz Europe (a car rental business)
3. Jane Colton, Vice President and Legal Counsel, Vanguard Rental EMEA (a car rental business)
4. Roger Wilde, Managing Director, ChipsAway Limited (a car repair business)
5. Paul Currie, Franchise Director Hamleys Ltd (a retail business)
6. Rosalynde Harrison, Head of Legal Monsoon Plc (a retail business)
7. Steve Mills, International Director, MRI (a recruitment business)
8. Adam Goldman, Head of Legal, Arcadia Plc (a retail business)
9. Peter Neighbour, Franchise Manager, LighterLife (a weight loss business)
10. Octavia Morley, CEO, LighterLife (a weight loss business)
Appendix 7
Survey of Franchise Disputes

A. BASIS ON WHICH SAMPLE WAS CHOSEN

40 franchise disputes advised upon by Field Fisher Waterhouse during the period 2006-2010 were considered. “Dispute” is not limited to litigation but includes disagreements which result in the involvement of legal advisers by at least one side. It is important to note that these grounds of dispute are those raised by the parties, not always proved to the satisfaction of a court.

B. HOW WAS THE SURVEY CONDUCTED

Face to face interviews with individuals involved in the disputes.

C. REASONS FOR QUESTIONS ASKED

The aim was to understand the reason for disputes between franchisees and their franchisor.

D. THE MEMBERS OF THE SAMPLE

Anonymity was essential to obtain any responses.

The disputes involved franchisees of the following brands. This includes a mix of retail, service and fast food businesses and a range of different size franchisees.

- Agent Provocateur (1) – retail
- Chips Away (3) – service
- Durham Pine (8) – retail
- Green Thumb (1) – service
- LighterLife (2) – service
- Domino’s (3) – fast food
- Minuteman Press (1) – service
- Flowers Forever (1) – retail
- Kallkwik (10) – service
- Prontaprint (10) – service
- Snappy Snaps (5) – service/retail
- Dollond & Aitchison (3) – retail
90% of the disputes arose 2 years or more after the parties entered into the franchise agreement.

<table>
<thead>
<tr>
<th>Cause of Dispute</th>
<th>Total %age</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisee competing with Franchisor during term of Franchise</td>
<td>(28) 70%</td>
</tr>
<tr>
<td>Alleged failure by Franchisor to adequately support Franchisee</td>
<td>(32) 80%</td>
</tr>
<tr>
<td>Failure to maintain brand standards by Franchisee*</td>
<td>(36) 90%</td>
</tr>
<tr>
<td>Alleged misrepresentation by Franchisor in recruiting the Franchisee</td>
<td>(34) 85%</td>
</tr>
<tr>
<td>Alleged encroachment by the Franchisor</td>
<td>(28) 70%</td>
</tr>
</tbody>
</table>

There are multiple claims on each dispute, so the total percentage exceeds 100%.

* failure to meet brand standards means not following the business format prescribed by the franchisor by, for example, selling/providing inappropriate or substandard goods or services or failing to follow key procedures.
Appendix 8

Analysis of Franchise Agreements

The samples represent both civil and common law, a variety of sectors and a range of investment profiles.

A. Jurisdiction

The agreements are of franchisors doing business in the three largest franchise markets in the EU (the UK, Germany and France) and two other jurisdictions in which franchising is common (the USA and Australia). The sample therefore includes agreements drafted under both civil and common law.

B. Sectors

The sample includes franchises in the retail, service, food and hotel sectors. Some are mobile some are location based.

C. Investment Scale

The sample includes small scale “man in a van” job franchises and large scale hotel and restaurant franchises. It is generally the start up investment rather than the upfront franchise fee that requires most funding. The higher the start up investment the higher the upfront fees tend to be. The upfront fees and the upfront investment costs vary from country to country depending on a wide range of external variables, such as, for example, the cost of real estate. Therefore the exact level of the upfront franchise fee and start up investment are not exactly the same on a like for like basis. This sample details the type of start up investment required not the exact figure. It categorises them as low, medium, substantial and high. In the UK, low is nothing to £10,000, medium is over £20,000 to £100,000, substantial is over £100,000 to £500,000 and high is over £500,000. In the other countries in the sample it is the same number in the local currency (e.g. £20,000 becomes €20,000 and US$20,000), not the sterling figure converted into the local currency. This is sufficient to give an appropriate understanding of the scale of investment and therefore the type of franchisee involved in each franchise.
### Australian Agreements

<table>
<thead>
<tr>
<th>Business</th>
<th>Sector</th>
<th>Level of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>BB’s Coffee &amp; Muffins</td>
<td>Food/Restaurant</td>
<td>Medium investment in prime retail location and fit out</td>
</tr>
<tr>
<td>Bartercard</td>
<td>Services/Mobile</td>
<td>Low investment required</td>
</tr>
<tr>
<td>Cash Converters</td>
<td>Retail</td>
<td>Substantial investment required</td>
</tr>
<tr>
<td>Choice Hotels</td>
<td>Hotels</td>
<td>High investment required</td>
</tr>
<tr>
<td>Expense Reduction Analysts</td>
<td>Other services/mobile</td>
<td>Low investment required</td>
</tr>
</tbody>
</table>

### US Agreements

<table>
<thead>
<tr>
<th>Business</th>
<th>Sector</th>
<th>Level of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercontinental Hotels</td>
<td>Retail</td>
<td>High investment required</td>
</tr>
<tr>
<td>Coverall</td>
<td>Other services</td>
<td>Low investment required</td>
</tr>
<tr>
<td>Domino’s Pizza</td>
<td>Food (Mobile)</td>
<td>Substantial investment required</td>
</tr>
<tr>
<td>Snap-on-tools</td>
<td>Retail (Mobile)</td>
<td>Medium investment required</td>
</tr>
<tr>
<td>National Car Rental</td>
<td>Car Rental</td>
<td>Substantial investment required</td>
</tr>
</tbody>
</table>

### UK Agreements

<table>
<thead>
<tr>
<th>Business</th>
<th>Sector</th>
<th>Level of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Coffee</td>
<td>Food/Restaurant</td>
<td>Medium level investment required</td>
</tr>
<tr>
<td>Hertz</td>
<td>Car rental</td>
<td>High investment required</td>
</tr>
<tr>
<td>Ramada</td>
<td>Hotels</td>
<td>High investment required</td>
</tr>
<tr>
<td>Jani-King</td>
<td>Other services (mobile)</td>
<td>Low investment required</td>
</tr>
<tr>
<td>Kall Kwik</td>
<td>Retail</td>
<td>Substantial investment required</td>
</tr>
</tbody>
</table>

### German Agreements

<table>
<thead>
<tr>
<th>Business</th>
<th>Sector</th>
<th>Level of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applebees</td>
<td>Restaurant</td>
<td>Substantial investment required</td>
</tr>
<tr>
<td>Starwood</td>
<td>Hotels</td>
<td>High investment required</td>
</tr>
<tr>
<td>Hertz</td>
<td>Services/Car Rental</td>
<td>High investment required</td>
</tr>
<tr>
<td>Business</td>
<td>Sector</td>
<td>Level of Investment</td>
</tr>
<tr>
<td>--------------------</td>
<td>--------------------</td>
<td>-------------------------</td>
</tr>
<tr>
<td>Eismann</td>
<td>Retail (Mobile)</td>
<td>Low investment required</td>
</tr>
<tr>
<td>Polo Ralph Lauren</td>
<td>Retail</td>
<td>Medium investment required</td>
</tr>
</tbody>
</table>

**French Agreements**

<table>
<thead>
<tr>
<th>Business</th>
<th>Sector</th>
<th>Level of Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yves Rocker</td>
<td>Retail</td>
<td>Medium investment required</td>
</tr>
<tr>
<td>Ibis</td>
<td>Hotel</td>
<td>High investment required</td>
</tr>
<tr>
<td>Pronuptia</td>
<td>Retail</td>
<td>Substantial investment required</td>
</tr>
<tr>
<td>Artezia</td>
<td>Other services</td>
<td>Low investment required</td>
</tr>
<tr>
<td>La Boîte à Pizza</td>
<td>Food (mobile)</td>
<td>Substantial investment required</td>
</tr>
</tbody>
</table>
## Categorisation of Sample by Sectors

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Retail</td>
<td>✗</td>
<td>✔</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
</tr>
<tr>
<td>Other Services</td>
<td>✔</td>
<td>✔</td>
<td>✗</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Food/Restaurant</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
</tbody>
</table>

## Categorisation of Sample by Investment Required

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Medium</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>Substantial</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>High</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
<td>✔</td>
</tr>
</tbody>
</table>

## Categorisation of Sample by Mobile/Location Based Criteria

<table>
<thead>
<tr>
<th></th>
<th>Australia</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Totally Mobile</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Location Based</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Both</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>
Appendix 9

Excerpts of Foreign Franchise Legislation

Australia

Section 51AC of the TPA - The factors are:

(a) The relative strengths of the bargaining positions of the supplier and the business consumer.

(b) Whether, as a result of conduct engaged in by the supplier, the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier.

(c) Whether the business consumer was able to understand any documents relating to the supply or possible supply of the goods or services.

(d) Whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the business consumer or a person acting on behalf of the business consumer or a person acting on behalf of the business consumer by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services.

(e) The amount for which, and the circumstances under which, the business consumer could have acquired identical or equivalent goods or services from a person other than the supplier.

(f) The extent of which the supplier's conduct towards the business consumer was consistent with the supplier's conduct in similar transactions between the supplier and other like business consumers.

(g) The requirements of any applicable industry code.

(h) The requirements of any other industry code, if the business consumer acted on the reasonable belief that the supplier would comply with that code.

(i) The extent to which the supplier unreasonably failed to disclose to the business customer:

(1) any intended conduct of the supplier that might affect the interests of the business consumer; and

(2) any risks to the business consumer arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the business consumer)
(j) The extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer.

(k) The extent to which the supplier and the business consumer acted in good faith.

Belgium

The Belgian House Of Representatives, 30 Oct 2003, Clause 10:

“If the annual turnover of the franchisee's business has decreased by 7% or more, or the survival of the franchisee’s business is compromised, the franchisee can require at the franchisor’s expense either that the franchise agreement be terminated together with the payment of damages, or he can require the payment of damages alone”.

The Belgian House Of Representatives, 30 Oct 2003, Clause 13:

Agreements for a fixed period are to be automatically renewable either “for an indefinite period or for any period envisaged in any implied renewal clause, in the absence of either party giving notice by registered letter at least six months or at most nine months before the agreed due termination date” and “where a franchise agreement entered into for a fixed period has been renewed twice, whether or not the terms of the original agreement have been modified by the parties, or where the franchise agreement has been impliedly extended on two occasions by the operation of one of the clauses of the agreement, any further extension will be deemed to have been agreed for an indefinite period”.

Article 4 para 1 1° of the Law Governing Pre-contractual Information Within the Framework of Commercial Partnership Agreements:

“reference to whether or not the commercial partnership agreement is made in consideration of the person; the obligations; the consequences of failure to comply with the obligations; the method of calculation of the remuneration paid by the recipient of the right, and the method of any review during the course of the contract period and upon renewal of the contract; non-competition clauses, including their duration and conditions; the duration of the commercial partnership agreement the conditions of renewal; notice provisions and provisions for termination of the agreement, in particular in relation to charges and investments; the right of pre-emption or the purchase option in favour of the grantor of the right and the rules governing the valuation of the business when such a right or option is exercised and terms of exclusivity reserved for the grantor of the right”.

383
Canada

Alberta Franchises Act Section 1(d):

“franchise” means a right to engage in a business:

(i) in which goods or services are sold or offered for sale or are distributed under a marketing or business plan prescribed in substantial part by the franchisor or its associate;

(ii) that is substantially associated with a trademark, service mark, trade name, logotype or advertising of the franchisor or its associate or designating the franchisor or its associate, and

(ii) that involves:

(A) a continuing financial obligation to the franchisor or its associate by the franchisee and significant continuing operational controls by the franchisor or its associate on the operations of the franchised business, or

(B) the payment of a franchise fee;

and includes a master franchise and a sub-franchise;”

France

French Commercial Code Article L.330-1:

“Any person who provides another person a corporate name, trademark or trade name, by requiring therefrom an exclusivity or quasi-exclusivity undertaking in order to carry out their activity, shall be required, prior to the signature of any contract concluded in the common interest of both parties, to provide the other party with a document giving truthful information allowing the latter to commit to this contract with full knowledge of the facts.

This document, whose content shall be fixed by decree, shall specify in particular the age and experience of the undertaking, the state and prospects for development of the market concerned, the size of the network of operators, the term and conditions of renewal, cancellation and assignment of the contract and the scope of the exclusive rights.

When the payment of a sum is required prior to the signature of the contract indicated above, particularly to obtain the reservation of an area, the benefits provided in return for this sum shall be specified in writing together with the reciprocal obligations of the parties in the event of renunciation.

The document specified by the first paragraph and the draft contract shall be notified at least twenty days before the signature of the contract or, where applicable, before the payment of the sum indicated in the above paragraph.”
Italy

Law of 6 May 2004, No. 129 Article 1.1:

“franchising is an agreement by which one party grants to the other, for a consideration, the use of a combination of intellectual property and/or industrial rights, related to trademarks, trade names, utility models, industrial designs, copyright, know-how, patents, technical and commercial assistance or consulting, as well as the opportunity to be part of a franchising network.”

Korea

Act on Fairness in Franchise Transactions Chapter1 Article 2.1 defines a franchise as:

“a continuous business relationship in which a franchisor provides a franchisee with the right to use his trademarks, service marks, trade name, signs and other business marks (hereinafter "business marks") and provides a right to offer products (including raw materials and supplementary materials) and services under specified quality standards in which the franchisor supports, educates and controls a franchisee in relation to the management and business operations in connection with the above rights and in which the franchisee pays franchise fees to the franchisor as consideration for the right to use the franchisor's business marks and for support and education related to the franchise's management and business operations”.

Lithuania

Lithuanian Civil Code Article 6.766(1):

“Under a franchise contract, one party (the rightholder) shall undertake to grant the other party (the user) for a remuneration and for a specified or unspecified period of time the right to use in the course of the user’s entrepreneurial activity a complex of exclusive rights belonging to the rightholder (the right to use the firm name, the trade mark, the service mark, protected commercial information, and the like), and in return the other party shall undertake to pay a remuneration stipulated by the contract.”

Lithuanian Civil Code Article 6.766(2):

“The franchise contract shall provide for the use of complex of exclusive rights, business reputation and commercial expertise of the rightholder to a specified extent (establishing the minimum or maximum method or other form of use). The franchise contract may also provide for the territory of the application of such exclusive rights, business reputation or commercial expertise, or the sphere of entrepreneurial activity to which it shall be applied (sales of goods, provision of services, etc.).”
Lithuanian Civil Code Article 6.766(1):

“one party (the rightholder) shall undertake to grant the other party (the user) for a remuneration and for a specified or unspecified period of time the right to use in the course of the user’s entrepreneurial activity a complex of exclusive rights belonging to the rightholder (the right to use the firm name, the trade mark, the service mark, protected commercial information, and the like), and in return the other party shall undertake to pay a remuneration stipulated by the contract.”

Mexico

Law on Industrial Property, Title 4 Chapter VI Article 142:

defines franchising as existing whenever: “in conjunction with the license to use a trademark, technical knowledge is transmitted or technical assistance is furnished in order to enable the licensee to produce or sell goods or render services in a uniform manner and with the operating, commercial and administrative methods established by the holder of the trademark, aimed to maintain the quality, prestige and image of the products or services distinguished by the trademark”.

Romania

Ordinance Regarding the Legal Status of Franchises (Government Ordinance 52/1997) as approved and modified by Law 79/1998, Chapter 1 Article 1(a):

“a trading system based on a continuous collaboration between financially independent natural persons or legal entities, whereby a person referred to as the franchisor (franciza) grants to another person referred to as beneficiary (beneficiar) the right to make profit from or develop a business, product, technology or service.”

USA

FTC Rule Section 436.1(h):

“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 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.”

FTC Rule Section 437.2:

“As used in this part, the following definitions shall apply:

(a) The term business opportunity means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1) A person (hereinafter ‘business opportunity purchaser’) offers, sells or distributes to any person other than a ‘business opportunity seller’ (as hereinafter defined) goods, commodities or services which are:

(i) [A] Supplied by another person (hereinafter ‘business opportunity seller’) or

[B] Supplied by a third person (e.g. supplier) with whom the business opportunity purchaser is directly or indirectly required to do business by another person (hereinafter ‘business opportunity seller’); or

[C] Supplied by a third person (e.g. a supplier) with whom the business opportunity purchaser is directly or indirectly advised to do business by another person (hereinafter “business opportunity seller”) where such third person is affiliated with the business opportunity seller; and

(ii) The business opportunity seller:

[A] Secures for the business opportunity purchaser retail outlets or accounts for said goods, commodities, or services; or

[B] Secures for the business opportunity purchaser locations or sites for vending machines, rack displays, or any other product sales displays used by the business opportunity purchaser in the offering, sale, or distribution of said goods, commodities, or services; or

[C] Provides to the business opportunity purchaser the services of a person able to secure the retail outlets, accounts, sites or locations referred to in paragraphs (a)(ii)[A] and [B] of this section; and

(2) The business opportunity purchaser is required as a condition of obtaining or commencing the business opportunity operation to make a payment or a
commitment to pay to the business opportunity seller, or to a person affiliated with the business opportunity seller.”

FTC Rule Section 436.8(a):

Exemptions. The provisions of part 436 shall not apply if the franchisor can establish any of the following:

1. The total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee’s business is less than $500.

2. The franchise relationship is a fractional franchise.

3. The franchise relationship is a leased department.


5. (i) The franchisee’s initial investment, excluding any financing received from the franchisor or an affiliate and excluding the cost of improved land, totals at least $1 million and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: “The franchise sale is for more than $1 million - excluding the cost of unimproved land and financing received from the franchisor or an affiliate – and thus is exempted from the Federal Trade Commission’s franchising Rule disclosure requirements, pursuant to 16 CFR 436.8(a)(5)(i); or

(ii) The franchisee (or its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least $5 million.

6. One or more purchasers of at least 50% ownership interest in the franchise: within 60 days of the sale, has been, for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor’s franchise or the administrator of the franchised network; or within 60 days of the sale, has been, for at least two years, an owner of at least a 25% interest in the franchisor.

7. There is no written document that describes any material term or aspect of the relationship or arrangement.

FTC Rule at 436.8:

(i) The total amount of payments required to be made any time or within 6 months after commencing operation of the franchisee’s business is less than USD $500;
(ii) The franchise relationship is a fractional franchise;

(iii) The franchise relationship is a leased department;

(iv) The franchise relationship is governed by the Petroleum Marketing Practices Act, 15 U.S.C 2801;

(v) The franchisees is making a major initial investment of more than USD $1 mil. (excl. real estate and franchisor-financed amounts);

(vi) The franchisee in question is a ‘large’ franchisee, i.e. at least five years in business with a net worth of at least USD $5 mil.; or

(vii) The franchise sale in question is an ‘insider’ franchise purchase involving owners or officers of the franchise system or managers with at least two years’ management experience in the franchise system.

**Article 2-302 provides of the Uniform Commercial Code:**

“If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause so as to avoid any unconscionable result.”

**Statutes of the twenty states – plus the District of Columbia, Puerto Rico, and the Virgin Islands – that have enacted laws of general application that govern franchise relationships and terminations:**

- Alaska Statutes, 45.25,
- Arkansas Franchise Practices Act, Sec. 4-72-204,
- California Franchise Relations Act, Secs. 20021, 20025, 20026, 20030,
- Connecticut Franchises Law, Sec. 42-133f,
- Delaware Franchise Security Law, Sec. 2554,
- District of Columbia Franchising Act, Sec. 29-1122,
- Illinois Franchise Disclosure Act, Sec 815 ILCS 705/19, 815 ILCS 705/20,
- Indiana Deceptive Franchise Practices Law, Sec 23-2-2.7-3,
- Iowa Franchises Law, Secs. 523H.8,
- Kentucky- 2000 KY Acts Ch 23, Section 3 [KRS 190.045]
- Michigan Franchise Investment Law, Sec. 445.1527,
Minnesota Franchises Law, Sec. 80C.14,
Mississippi Franchises Law, Sec. 75-24-53,
Missouri Franchises Law, Sec. 407.405,
Nebraska Franchise Practices Act, Sec. 87-404,
New Jersey Franchise Practices Act, C.56
South Dakota Codified Law Title 37 Chapters 5, 5A, 5B,
Washington Franchise Investment Protection Act, Sec. 19.100.180,
Wisconsin Fair Dealership Law, Wisconsin Statute Section 135.04,
Virgin Islands Franchised Business Law, Sec. 131;
Virginia Code Title 13.1, Chapter 8

Section II.B.2,b, 72 Fed. Reg at 15469, Statement of Basis and Purpose:

“The Commission intends that the 14 days commence the day after delivery of the disclosure document and that the signing of any agreement or receipt of payment can take place on the 15th day after delivery. That ensures that prospective franchisees have at least a full 14 days in which to review the disclosures.”

European Union

EU Franchise Block Exemption Regulation EC 4748/88 definitions:

"Know-how" is defined as a body of non-patented practical information, resulting from experience and testing by the Franchisor, which is secret, substantial and identified, http://www.eff-franchise.com/IMG/article_PDF/article_13.pdf page 3 accessed 7 September 2009;

"secret" means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; it is not limited in the narrow sense that each individual component of the know-how should be totally unknown or unobtainable outside the Franchisor's business, http://www.eff-franchise.com/IMG/article_PDF/article_13.pdf

"substantial" means that the know-how includes information which is of importance for the sale of goods or the provision of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services, methods of dealing with customers, and administration and financial management; the know-how must be useful for the Franchisee by being capable, at the date of conclusion of the agreement, of improving the competitive position of the Franchisee, in particular by improving the

"identified" means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality; the description of the know-how can either be set out in the franchise agreement or in a separate document or recorded in any other appropriate form.

**Study Group on a European Civil Code’s Recommendations**

**Article 3:101 Commercial Agency, Franchise And Distribution Amsterdam Team 8th Draft (21 May, 2003):**

It defines franchising as “contracts whereby one party (the franchisor) grants the other party (the franchisee), in exchange for remuneration, the right to conduct a business (franchise business) within the franchisor’s network for the purposes of selling certain goods or services on the franchisor's behalf and in the franchisor's name, and whereby the franchisee has the right and the obligation to use the franchisor’s trade name or trademark, the know-how and the business method.”

**UNIDROIT**

**Model Franchise Disclosure Law, Article 2:**

“franchise means the rights granted by a party (the franchisor) authorising and requiring another party (the franchisee), in exchange for direct or indirect financial compensation, to engage in the business of selling goods or services on its own behalf under a system designed by the franchisor which includes know-how and assistance, prescribes in substantial part the manner in which the franchised business is to be operated, includes significant and continuing operational control by the franchisor, and is substantially associated with a trademark, service mark, trade name or logotype designated by the franchisor. It includes:

(A) the rights granted by a franchisor to a sub-franchisor under a master franchise agreement;

(B) the rights granted by a sub-franchisor to a sub-franchisee under a sub-franchise agreement;

(C) the rights granted by a franchisor to a party under a development agreement.

For the purposes of this definition “direct or indirect financial compensation” shall not include the payment of a bona fide wholesale price for goods intended for resale.”
Appendix 10
Statutes of the 21 countries outside of the EU that have franchise specific laws

Albania
Civil Code of the Republic of Albania Approved by Law no. 7850, dated 29.7.1994

Australia
Trade Practices Act 1974

Barbados
The Barbados Franchises (Registration and Control) Act

Belarus
Decree of the Cabinet of Ministers of 21 March 2009 N 346 on the registration of license contracts, contracts of a concession and pledge contracts of the rights to objects of the industrial property and contracts of the complex enterprise license (franchise)

Brazil
Law No 8.955 of 15 December 1994 providing for the contract of franchise business, and other measures

Canada

China
Regulation on Administration of Commercial Franchise 2007

Georgia
Civil Code Book Three, Title One; Chapter Seven Articles 607-614

Indonesia

Japan
FTC Franchise Guidelines April 2002

Kazakhstan
Law on Complex Business Licence (Franchising) Law No 330 June 24, 2002
Korea
The Fair Franchise Transaction Act 2002

Malaysia
The Franchise Act 1998

Moldova
Law on Franchising No. 1335 of 1 January 1997

Mexico
Decree No 35/2006/ND-CP

Russia
Civil Code Pt II Chapter 54

Taiwan
The FTC’s Guidelines on Standards Governing Disclosure of Information by Franchisors; 1999

Ukraine
Civil Code Chapter 76 Articles 1115 to1129

USA
See Chapter 12

Venezuela
The Pro-Competition Agency Guidelines for the Evaluation of Franchise Agreements, January 7, 2000

Vietnam
Article 2 of the Commercial Law of 2001
Appendix 11

European Franchise Associations and membership

The aggregate membership is approximately 1,577:

**Austrian Franchise Association**
45 members

**Belgian Franchise Association**
30 members

**British Franchise Association**
350 members

**Czech Franchise Association**
20 members

**Danish Franchise Association**
46 members

**Finnish Franchise Association**
105 members

**French Franchise Federation**
125 members

**German Franchise Association**
200 members

**Greek Franchise Association**
48 members

**Hungarian Franchise Association**
46 members

**Italian Franchise Association**
204 members

**Netherlands Franchise Association**
193 members

**Portuguese Franchise Association**
24 members

**Slovenian Franchise Association**

107 members

**Swedish Franchise Association**

51 members

**Ireland Franchise Association**

57 members

N.B. Some brands are members of more than one national franchise association.

The number of brands represented by national franchise associations is therefore less than 1,577.

The estimated number of brands in the EU is 9,971.
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**Finland**

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**Georgia**

Civil Code Book Three, Title One; Chapter Seven Articles 607-614

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Article 309 of the Civil Code
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Article 505 of the Civil Code
Article 507 of the Civil Code
Article 89 of the Commercial Code

**Greece**

Law 146/14 on Unfair Competition
Article 140 of the Civil Code
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Article 330 of the Civil Code
Article 673 of the Civil Code
Article 919 of the Civil Code

**Hungary**

Article 81 of the Civil Code
Article 210 of the Civil Code
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**Kazakhstan**

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