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POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**



Economic and Monetary Affairs

Employment and Social Affairs

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**Internal Market and
Consumer Protection**

**Legal Perspective of the
Regulatory Framework
and Challenges for
Franchising in the EU**

Study for the IMCO Committee



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Legal perspective of the regulatory framework and challenges for franchising in the EU

STUDY

Abstract

This paper considers how the regulatory environment of the European Union impacts upon franchising. It suggests that the failure of franchising to fulfil its full potential in the EU is due, at least in part, to the dysfunctionality of the EU's regulatory environment. It concludes that in order to enable franchising to achieve its full potential it is necessary to re-engineer the EU's regulatory environment, by way of a franchise focused European Legal Act , in respect of how it impacts upon franchising and makes concrete proposals as to how this should be done.

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AUTHOR

Dr Mark ABELL, Bird & Bird

RESPONSIBLE ADMINISTRATOR

Mariusz MACIEJEWSKI
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

EDITORIAL ASSISTANT

Iveta OZOLINA

LINGUISTIC VERSIONS

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ABOUT THE EDITOR

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To contact Policy Department A or to subscribe to its newsletter please write to:
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@ep.europa.eu

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LIST OF ABBREVIATIONS

- AGRI** Agriculture and Rural Development Committee
- ALDE** Group of the Alliance of Liberals and Democrats for Europe
- BAS** Brake-assist systems
- CAP** Common Agricultural Policy
- CFP** Common Fisheries Policy
- CMO** Common market organisation
- CoR** Committee of the Regions
- CULT** Culture and Education Committee
- ECOSOC** Economic and Social Committee
- ECTS** European Credit Transfer System
- EPP-ED** Group of the European People's Party and European Democrats
- FAO** Food and Agriculture Organisation of the United Nations
- FPS** Frontal protection systems
- GDP** Gross Domestic Product
- GM** Genetically-modified
- Greens/EFA** Greens/European Free Alliance
- GUE/NGL** Confederal Group of the European United Left - Nordic Green Left
- IFI** International Fund for Ireland
- IND/DEM** Independence/Democracy Group

EXECUTIVE SUMMARY

Franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU. It **stimulates economic activity** by improving distribution and increasing competition. It delivers **economic advantages** to all those involved and consumers, by inter alia, giving businesses increased access to other EU member state markets.

There are **two distinct types** of franchise regulation in the EU. Those concerned with macro-economic issues and those concerned with both the way in which franchisors sell their franchises to potential franchisees and the rights of the two parties during the relationship.

Those regulations that **focus on the macro-economic issues** are over-concerned on intra-brand issues and fail to appreciate the value that franchising can contribute to the single market, both by enabling small and medium sized businesses to expand effectively throughout the EU, and by unleashing entrepreneurship in individual franchisees throughout the EU.

The various EU member state **sales/relationship regulations** lack any real uniformity, increasing cost and causing delays for franchisors seeking to roll out across the single market, thereby creating technical barriers to cross boarder franchising within the EU.

To further exacerbate the difficulties, the macro-economic and sales/relationship focused regulations been **developed in an uncoordinated manner**, in isolation from each other. This has **contributed to the dysfunctionality of franchise regulation in the EU**.

Self regulation of franchising in the EU lacks both homogeneity and a clear, consistent and effective approach to enforcement in addition to which there is a significant conflict of interest between the interests of franchisors and those of franchising. In any event, **nearly 80% of franchise chains in the EU are not members of national franchise associations and therefore not subject to the self-regulatory regime**.

The result of this dysfunctional regulation is that **franchising is substantially underperforming in the EU**. This is evidenced by the fact that 83.5 % of Franchising's turnover in the EU is concentrated in only 25 % of the member states and constitutes only 1.86 % of the EU's GDP, compared with 5.95 % of GDP in the US and 10.83 % of GDP in Australia.

This failure of the regulatory environment to recognise the value that franchising can deliver to the EU and to support and promote it as a way of helping SME's to grow across the EU can only be remedied by re-engineering the regulatory environment in the EU.

Franchising could better fulfil its potential in the EU if the regulatory environment is re-engineered in a manner that:

1. **promotes franchising and market confidence**, by underpinning and supporting the commercial advantages that franchising delivers to franchisors, franchisees and the single market.
2. ensures **pre-contractual hygiene in franchising**
3. ensures **a balance between the interests of franchisors and franchisees**
4. **reconciles the priorities and concerns** of the two different types of franchise regulation in an appropriate way,
5. is **harmonised** throughout each EU member state.

That could be best done by adopting a European Legal Act containing provisions regulating specific issues which would **increase market confidence** in franchising, **ensure pre-contractual hygiene** and **impose a mandatory taxonomy of rights and obligations**.

1. INTRODUCTION

Over the last 30 years two distinct trends have emerged and developed as regards the regulation of franchising in the EU. One is concerned with the macro-economic impact of franchising, the other with the way in which franchises are sold to franchisees and the management of the on-going relationship. Both concerns are legitimate, but unfortunately the development of the regulations have not been co-ordinated. As a result there is currently a dysfunctional regulatory environment for franchising in the EU and its member states.

There is substantial confusion amongst many involved in franchising as to the differing purpose and function of these two distinct types of franchise regulations in the EU. Discussions about how the regulation of franchising in the EU can best be developed therefore frequently generate more heat than light.

The first regulatory trend addresses macro-economic issues and is concerned with the way in which the competition law of the EU impacts upon franchising. This first arose as a result of the Pronuptia case in the mid 1980s¹, which was quickly followed by a series of decisions by the EU Commission regarding the way that EU competition law impacts upon franchising². This experience of franchising and the impact of competition law on it allowed the commission to adopt the Franchise Block Exemption in 1988³ followed by the 1999 block exemption on vertical restraints⁴ and the current block exemption⁵. Whilst EU competition law, embodied in these decisions and the vertical restraints regulation, does recognise some of the advantages of franchising, in reality it fails to appreciate the value that it can contribute to the single market both by enabling small and medium sized businesses to expand effectively throughout the EU and unleashing entrepreneurship in individual franchisees throughout the EU. It is too concerned with intra-brand issues between franchisor and franchisee and insufficiently concerned with the bigger picture of how SMEs and individuals can most effectively compete with big business.

At the same time as EU competition law was developing its approach to franchising, a number of EU member states were considering whether or not they should regulate the way in which franchisors sell their franchises to potential franchisees and the rights of the parties during the relationship.

Rather than being concerned with the macro-economic impact of franchising on the single market that concerned the EU Commission, this second regulatory trend was concerned with the perceived need to stop franchisors mis-selling franchises to naive and uninformed individuals with little or no previous business experience and abusing them during the term of the agreement. This trend was fuelled by both examples of sharp practice by a small number of high profile franchisors in the EU and the way that franchise sales are regulated

¹ Judgment of the Court of Justice of the European Union of 28 January 1986, in the case 161/84 Pronuptia de Paris GmbH and Pronuptia de Paris Irmgard Schillgallis [European Court Reports 1986, 00353]

² Decision 87/14/EEC Yves Rocher of 17 December 1986 (further Yves Rocher) [OJ EEC L 8/49 of 10 January 1987], Decision 87/17/EEC Pronuptia of 17 December 1986 (further Pronuptia decision) [OJ EEC L 13/39 of 15 January 1987], Decision 87/407 Computerland of 13 July 1987 (further Computerland) [OJ EEC L 222/12 of 10 August 1987], Decision 88/604 ServiceMaster of 20 August 1988 (further ServiceMaster) [OJ EEC L 332/38 of 3 December 1988 and Decision 89/94/EEC Charles Jourdan of 2 December 1988 (further Charles Jourdan) [OJ EEC L 35/31 of 7 January 1989]

³ Commission Regulation (EEC) No 1987/88 of 30 November 1988 on the application of Article 85(3) of the Treaty of Rome to categories of Franchise Agreements

⁴ Commission Regulation No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical restraints and concerted Practices [OJ L 336 of 29 December 1999]

⁵ Regulation No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices [OJ 102/1 of 23 April 2010]

in the US – an approach based upon the belief of the US authorities that such sales are analogous to the sale of securities and should be regulated accordingly.

France⁶ was the first EU member state to adopt such a franchise regulation, followed by Spain⁷, Italy⁸, Romania⁹, Sweden¹⁰, Estonia¹¹, Lithuania¹² and Belgium¹³.

Over the past 30 years or so these two trends in the regulation of franchising have developed more or less in isolation from each other. Attempts at self regulation have met with limited success and suffer three substantial handicaps – there are no self regulatory organisations in many of the EU member states, those that do exist represent franchisors rather than franchising and only a small percentage of EU franchisors are members of the national franchise associations that do exist.

In order to take a considered view on how franchising should be regulated in the EU and how those regulations can best help franchising to achieve its full potential to make a positive contribution to the EU economy, it is important to understand that the two trends in regulation address very different issues, that these issues need to be addressed in different ways and that the way in which the two sets of issues are addressed need to be co-ordinated and sit comfortably together. It is also necessary to understand that if individual member states regulate franchising differently it will amount to a technical barrier to cross boarder franchising in the single market.

⁶ Law No 89-1008 on Pre-Contractual Disclosure, 31 December 1989 (Loi Doubin).

⁷ Royal Decree 2485/1998 of 13 November 1988 regarding Retail Commerce Planning relating to the regulation of franchising and creating the franchisor's register.

⁸ Law of 6 May 2004, No 129 (Franchise Law).

⁹ Ordinance Regarding the Legal status of Franchises No 52.1997 of 28 August 1997 as approved and modified by Law No 79/1998.

¹⁰ Franchise Disclosure Act 2006 – Lag (2006:484).

¹¹ Law of Obligations Act Ch7.

¹² Civil Code Art 6.

¹³ Law governing pre-contractual information in the framework of agreements of commercial partnership, 2005

2. ECONOMIC ASPECTS OF FRANCHISING AND REASONS WHY IT IS NOT ACHIEVING FULL POTENTIAL IN THE EU

KEY FINDINGS

- Franchising is a distinct channel of distribution of goods and services which adds value to business
- In essence franchising comprises, 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.
- These features are not impacted by either economic or sectoral contextualisation.
- Franchising can add substantial value to both the businesses that use it and the economy
- Improved access to capital (the Agency, Transaction Cost and Resource Scarcity theories; bulk purchasing; economies of scale and enhanced product development) drive franchisors to use franchising
- A number of economic incentives resulting in an increased chance of success and various situational, and personality correlatives.
- Franchisors risk information asymmetry and moral hazard
- Franchisees risk misrepresentation; encroachment; poor quality business format and inadequate support.
- 83.5 % of Franchising's turnover in the EU is concentrated in only 25 % of the member states.
- Franchising constitutes only 1.86 % of the EU's GDP, compared with 5.95 % of GDP in the US and 10.83 % of GDP in Australia.
- This position will degenerate substantially if the UK leaves the EU, as the UK is one of the main centres of franchising in the EU.

2.1 Key factors about franchising

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.

There are many different definitions of franchising but it always involves 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.

Franchising is distinct from agency and distribution, the main difference being the business format and the ongoing support.

A wealth of statistics published by a variety of organisations evidence the value that franchising delivers to the economy. Of particular noteworthiness is the research conducted by Aliouche and Schlenrich¹⁴. This research suggests that over a ten year period between 1993 and 2002 US restaurant franchisors created more value than their non-

¹⁴ Does Franchising Create Value? An analysis of the financial performance of US public restaurant firms" Aliouche and Schlenrich, Working Paper No 2005-02 presented at the 19th Annual Conference of the International Society of Franchising, London, May 20-22 2005

franchised counterparts in that they have a higher propensity to create market value and economic value and generate on average higher added-value than non franchisors.

These features are not impacted by either economic or sectoral contextualisation.¹⁵ The legal architecture is uniform regardless of the legal system in which the franchise operates. 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 do not change the fundamental architectural features of franchising. 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.

2.1.1 The economic drivers that cause franchisors and franchisees to use franchising

Franchisors use franchising as part their commercial strategy in order to achieve, Improved access to appropriately qualified managerial resource; Improved access to capital (the Agency, Transaction Cost and Resource Scarcity theories; bulk purchasing; economies of scale and enhanced product development).¹⁶

Franchisees become involved in franchising due to 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) and various situational, and personality correlatives.¹⁷

2.1.2 The risks to which franchisors and franchisees are exposed

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).¹⁸

Franchisees are exposed to the risk of misrepresentation; encroachment; poor quality business format and inadequate support.¹⁹

2.1.3 Franchising is not achieving its full potential in the EU

Franchising plays an important role in the EU economy. 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 has appeal to large corporations and small businesses alike.

The 9971 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 (USD 300 billion).²⁰

It has great potential to stimulate economic activity within the EU. It can do this by improving the distribution of goods and/or services within and between member states.

¹⁵ Abell, M (2013) The Regulation of Franchising in the EU – Elgar Intellectual Property Law and Practice pp 48

¹⁶ Abell, M (2013) The Regulation of Franchising in the EU – Elgar Intellectual Property Law and Practice pp 27

¹⁷ Ibid pp 30

¹⁸ Ibid pp 31

¹⁹ Ibid pp 33

²⁰ Abell, Ibid pp 26

However, an estimated 83.5 % of its turnover is concentrated in only 25% of the member states. It is therefore over-concentrated in a small number of EU member states. A good measure of its under achievement is the fact that in comparison with the size of franchising in the USA and Australia.²¹

In 2010, with a gross turnover of USD 300 billion franchising amounted to 1.86 % of the EU's GDP and delivered a turnover of USD 600 per head of population. This compares very poorly with 5.95 % of GDP and a turnover per head of population of USD 2,792 in the USA (on a turnover of USD 868.3 billion) and 10.83 % of GDP and a turnover per head of population of USD 5,777 in Australia (on a turnover of USD 130billion). Given the fact that the UK accounts for USD 18.7billion out of the EU's total US£250billion franchising turnover, if the UK does leave the EU as a result of the "Brexit" referendum, the difference between the EU with the US and Australia will be even greater.²²

The numbers are very stark. Although the USA has only 60 % of the population of the EU and a lower GDP, franchising's turnover in the USA is more than double that in the EU.

This clearly suggests that franchising's potential to contribute to the single market and the growth of trade between member states is far from being fulfilled at present.

²¹ Abell, Ibid pp 26

²² Abell, Ibid pp 26

3. CURRENT LEGAL REGULATORY ENVIRONMENT IN THE EU

KEY FINDINGS

- Self regulation of franchising in the EU lacks both homogeneity and a clear, consistent and effective approach to enforcement.
- There is a significant conflict of interest between the interests of franchisors and those of franchising.
- Nearly 80 % of franchise chains in the EU are not members of national franchise associations and therefore not subject to the self-regulatory regime.
- There are franchise-specific disclosure laws in six member states
- In other EU member states general commercial law applies
- The lack of a homogenous approach to pre-contractual disclosure is problematic and creates a technical barrier to cross boarder franchising within the EU. The ongoing franchise relationship is regulated at member state level by a variety of laws, particularly good faith, unfair competition, consumer law and the application by analogy of commercial agency law.
- The lack of a homogenous approach to regulating the on-going relationship is problematic and creates a technical barrier to cross boarder franchising within the EU.
- EU competition law places franchise chains at a disadvantage compared to corporate chains, thereby preventing franchisors and franchisees, which are mostly SMEs and individuals, competing effectively with big business.
- 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
- The OECD's suggestion of a 'simple rule', which allows franchisors to use retail price maintenance in certain circumstances should be adopted.
- Multi-channel sales strategies, particularly online sales and other commercial use of the internet, are an important part of franchise chains.
- The dynamic and interactive nature of the worldwide web and its role in franchising needs to be reflected in EU competition law.
- Franchisors should 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.

2.2 Self-regulation of franchising in the EU does not work

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.²³

It lacks transparency, consistency, accountability and proportionality - and so will never be able to provide franchisees, potential franchisees or indeed franchisors with the level of protection that they require.

²³ Abell, Ibid pp 79

National Franchise Associations in the EU represent franchisors rather than franchising. Although the national franchise associations work to promote franchising as an ethical way of doing business there is an inevitable conflict of interest between representing franchising and franchisors. This is partly due to the fact that they are funded by franchisors.

Few, if any, of the national franchise associations in the EU have been willing to take decisive steps to enforce their code of conduct.

National franchise associations only account for just over a fifth of franchisors in the EU, so even if they successfully make the change from representing the interests of franchisors to representing those of franchising they will have limited impact.²⁴

Many EU member states do not have a franchise association and some of those that do exist are weak and under resourced.

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.

Franchise sales/relationship laws

Disclosure

There are franchise-specific disclosure laws in six member states. These laws try to reduce the 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.²⁵

Their success is dependent on the franchisees taking account of this information in taking their decision to enter the franchise.

The lack of any uniform approach to pre-contractual disclosure weakens the impact of franchise-specific laws.

Non-franchise-specific laws impact upon the pre-contractual regulatory environment in the EU in five distinct ways.²⁶

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 and 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 homogeneous 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.

²⁴ Abell, Ibid pp 87

²⁵ Abell, Ibid pp 92

²⁶ Abell, Ibid pp 62

The Ongoing franchisor/franchisee relationship.

In the EU this is impacted by a regulatory environment that includes; Good Faith, Unfair Competition, Consumer Law and application by analogy of commercial agency law.²⁷

The common law and civil law take a very different approach to the concept of good faith. The German and French approach is loose and amorphous based upon the Roman law concept of *bona fides*, whereas the common law takes a far more literal approach to contracts, using a variety of legal tools to ensure fairness in the relationship. Even with the civil approach to the concept of good faith differences exist between member states.

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.

In some EU member states (such as Germany), franchisees can take advantage of consumer law.

The application by analogy of commercial agency law in Germany erodes the economic drivers that attract franchisors to franchising and excessively de-risks it for franchisees

In a number of EU states, such as Germany, the view that franchisees are a type of employee erodes the economic drivers that attract franchisors to franchising and excessively de-risks it for franchisees

The result is that 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. This is borne out by empirical research carried out with franchisors in the UK, Germany, France and Spain.²⁸

1. Competition laws

The influence of Article 101 of the TFEU means that all member states take a similar approach to the regulation of vertical restrictions within the franchisor/franchisee relationship.

These antitrust laws properly regulate potentially anti-competitive aspects of franchising, and do recognise, in a tangible way, some of the value that franchising contributes to the economy of the EU. However, are in some respects over restrictive, eroding the economic drivers that attract franchisors to franchising and placing franchise chains at a disadvantage compared to corporate chains, thereby preventing franchisors and franchisees competing effectively with big business.

It is too concerned with intra-brand issues rather than empowering franchise chains to effectively compete with big business. Whilst one cannot deny that intra-brand competition cannot be totally ignored, the regulators give it disproportionate and inappropriate weight and at times "cannot see the macro-economic wood for the anti-trust trees".

This is particularly as regards retail price control and multi-channel strategies.

²⁷ Abell, *Ibid* pp 97 - 126

²⁸ Abell, *Ibid* pp 160-167

Resale Price Maintenance

Resale Price Maintenance is a hard core restriction under the Vertical Restraint Block Exemption²⁹ and was ruled against in both the *Pronuptia* and *Yves Rocher* cases.^{30 31} 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 franchisees 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, 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 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'³² the OECD acknowledged that although

²⁹ Ibid Article 4(a).

³⁰ [1981] OJL8/49. [1988] CMC R 592.

³¹ 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.

³² OECD, 'Competition Policy and Vertical Restraints: Franchising Agreements'.

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 restraints³³

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 ...

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.³⁴

It then continues by dismissing the concern that vertical price restraints maybe 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.³⁵

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.³⁶

³³ Ibid, p. 196.

³⁴ Ibid.

³⁵ Ibid.

³⁶ OECD, *ibid*, p. 197.

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 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.³⁷

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.³⁸

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.³⁹ In December 2006, the US Supreme Court granted review in the case of *Leegin Creative Leather Products, Inc v. PSKS, Inc.*⁴⁰ 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 Federal Trade Commission (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.⁴¹

The Supreme Court held⁴² that the manufacturer's 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 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

³⁷ Ibid.

³⁸ OECD, *ibid*, p. 186.

³⁹ Since the 1911 US Supreme Court decision in *Dr. Miles Medical Co v John D. Park & Sons Co*, 220 U.S. 373 (1911).

⁴⁰ (No. 06-480) 171 Feb. Appx. 464.

⁴¹ Brief of the United States as Amicus Curiae supporting petitioner, paras 3-4.

⁴² (No. 06-480) 171 Fed. Appx. 464.

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 new Vertical Restraints Block Exemption⁴³ suggest 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, such as in the Court of First Instance's judgment in the *GSK Spain* case⁴⁴ on the issue of restrictions designed to limit parallel trade in the pharmaceutical area. The Court of First Instance 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 as expressed in the Vertical Restraint Block Exemption Guidelines, it remains an object-type restriction and therefore hard to justify.

Multi-Channel Strategies.

The growing importance of a multi-channel sales strategy, particularly online 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 is using an outmoded approach to try to regulate the latest developments in electronic commerce. The EU Commission considers that 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 website 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 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.

⁴³ Commission Notice – Guidelines on Vertical Restraints Official Journal C 130, 19.05.2010.

⁴⁴ Case T-168/1 *GlaxoSmithKline v. Commission*, judgement 26 September 2006.

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 percentage of total retail sales increased from 2.9 % in November 2006 to 3.7 % in January 2009.⁴⁵ 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 tags cookies and other such practices means 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,⁴⁶ 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.

Franchisors should 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.⁴⁷ It is therefore recommended that, to borrow the words of the OECD, the Commission should 'allow franchisees to use either price or non-price vertical restraints in situations where the franchise faces strong market competition and collusion'.

⁴⁵ Retail Sales Business Monitor (SDM28), Office of National Statistics

⁴⁶ OECD, *Competition Policy and Vertical Restraints: Franchising Agreements*, p. 196

⁴⁷ Dixon H, 2010, 'The Impact of the Internet on Franchising as a Growth Strategy and the Implications for Franchisors Engaging in E-Commerce', Unpublished doctoral book submitted to the School of Business, Retail and Financial Services, Ulster Business School, University of Ulster

4. HOW THE REGULATORY ENVIRONMENT IN THE EU SHOULD BE RE-ENGINEERED TO ENABLE FRANCHISING TO BETTER FULFIL ITS POTENTIAL IN THE EU

KEY FINDINGS

- A European Legal Act should be used to bring a homogenous approach to the regulation of franchising in the EU.
- The European Legal Act should enable SME's use franchising to better compete with larger corporations through an "Exchange of Benefits"
- The European Legal Act should promote market confidence in franchising as a way of doing business, ensure pre-contractual hygiene and ensure a fair on-going relationship between franchisors and their franchisees by imposing appropriate rights and obligations on both parties.

4.1 What Legal Instrument?

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.

The catalyst for such harmonisation should be a European Legal Act containing provisions regulating specific issues.

Chapter 10 suggests provisions that the EU Commission could include in a European Legal Act in order to implement these recommendations. The European Legal Act should have three key focuses.

4.2 What is being regulated?

Franchising should be defined by reference to independence; economic interest; the brand; the business format; control and ongoing support.

4.3 The First Focus of the European Legal Act – Promoting Market Confidence in Franchising

Franchising should be seen by business, especially SMEs, as offering legal as well as commercial advantages to them. They should be offered certain benefits in exchange for using franchising and so allowing third parties to operate their own businesses using the franchisor's brand and know-how. Regulations should enable SME's to use franchising to better compete with larger corporations. This can be achieved through an "Exchange of Benefits".

This means that franchising must be clearly defined and be perceived as offering positive advantages to all involved in it.⁴⁸ In other words regulation should maintain and increase market confidence in franchising as a way of doing business as it encourages entrepreneurship not only in SMEs that become franchisors, but also in individuals who become franchisees. The following recommendations will achieve this. This is a positive contribution to the single market, franchisors, franchisees and consumers.

⁴⁸ Abell, Ibid pp 191-199

This can be achieved 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.⁴⁹

It should establish this by changes to anti-trust law, namely allowing franchisors to set the prices their franchisees may charge and restricting franchisee sales over the internet.⁵⁰

These changes will increase market confidence in franchising in the EU and so encourage SMEs and other businesses to adopt it as part of their growth strategy.

Fraud and sharp practice should be regulated by criminal law and not by a franchise focused European Legal Act.

4.4 The Second Focus of the European Legal Act – Ensuring Pre-Contractual Hygiene

Regulation should also ensure pre-contractual hygiene. That is, it should help ensure that when franchisors and their franchisees enter into a relationship with each other there is as little opportunity as possible for there to be a misunderstanding or mis-match of expectations between them. In order to achieve that franchisees should not only be strongly encouraged to take and follow expert advice, they should also understand exactly what they are buying – a blue print for a business, not a guarantee of success and an obligation to follow the franchisor's system.

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. It is therefore proposed that advisors (particularly lawyers) are required to take short on-line franchise education courses if they are to advise potential franchisees and potential franchisees investing more than Euro 20,000 must produce a certificate from their advisors to prove that they have taken such advice.⁵¹

National franchise associations can play an important part in educating potential franchisees that they have to work hard, follow the format, risk failure, and take and follow expert advice from appropriately experienced professionals. They should receive financial support from central government to help ensure their independence.

Pre-contractual disclosure should:⁵²

1. be given in a set form 15 working days before execution or payment;
2. cover details of the identity and experience of the franchisor, the franchise network, the terms of the franchise agreement and any earning claims;
3. be in plain language;
4. contain an appropriate risk statement;
5. be accompanied by a copy of the franchise agreement in the form in which it is to be executed;
6. include a five day cooling-off period after execution;

⁴⁹ Abell, *Ibid* pp 214-220

⁵⁰ Abell, *Ibid* pp 220-224)

⁵¹ Abell, *Ibid* pp 224-232

⁵² Abell, *Ibid* pp 211-259

7. 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 the non-compliance or 24 months of the date of execution, whichever is the later, if it resulted in defective consent having been given;
8. enable the appropriate regulatory authority to rescind the franchise and related agreements or claim damages;
9. allow the regulatory authorities to impose penalties including disqualification;
10. be allowed electronically;
11. give rise to personal liability for any individual responsible for the disclosure document being inaccurate; and
12. 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.

To ensure that the legal requirement is always in step with market practice there should be a regular review of the disclosure law every five years.

Misleading and deceptive behaviour (failing to comply with the pre-contractual disclosure obligations and making any statement which although literally true, misleads or deceives or is likely to mislead or deceive) should be prohibited.⁵³

Registration of documentation on a public register creates a catalogue of problems in those jurisdictions where it is required both in the EU and elsewhere. Indeed it has been some potential franchisees as an endorsement by the regulator of franchise systems that have proved to be unsuccessful. It is therefore not appropriate due not only to the practical difficulties it would give rise to in the EU member states, but also due to the cost-effectiveness of it and lack of impact.⁵⁴

4.5 The Third Focus of the European Legal Act – Ensuring a Fair Relationship.

Regulation must also ensure that both franchisor and franchisee act fairly towards each other reflecting the bargain that they have struck with each other. This can best be done by imposing mandatory terms onto the franchisor/franchisee relationship through the franchise agreement.⁵⁵

Discussion of these issues are often polemic and driven by the vested interests of individuals rather than higher level balance. For example the suggestion that franchisees should be free of any post-term restriction on using the franchisor's know-how is nothing less than theft of the franchisor's property and, if adopted, would constitute "free-riding" dealing a potentially near mortal body blow to franchising and the benefits that it delivers to all involved in it.⁵⁶

It is proposed that there must be a quality based restriction on franchisors that can take advantage of the benefits offered by the regulation. A franchise that has not operated the

⁵³ Abell, *Ibid* pp 237-240

⁵⁴ Abell, *Ibid* pp 260-265

⁵⁵ Abell, *Ibid* pp265-282

⁵⁶ Lafontaine, F (1992) Agency Theory and Franchising: Some Empirical Results, *Rand Journal of Economics*, Volume 23, Issue 2, 263-83

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'.

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.

Consideration of the realities of the franchise relationship and the risks that both franchisor and franchisee accept lead to the recommendations that;

Franchisees must:⁵⁷

1. not challenge the franchisor's intellectual property;
2. implement the business format;
3. not compete with the franchisor during the term and for a reasonable period thereafter;
4. allow the franchisor the right to purchase the franchisee's business on termination;
5. allow termination for cause without compensation;
6. allow the franchisor a pre-emptive right of purchase;
7. impose a duty of confidentiality; and
8. purchase tied goods and services from the franchisor or its nominated suppliers.

The franchisor must:⁵⁸

1. be the owner of or have the right to license the intellectual property rights on which the franchise is based;
2. provide a reasonable level of training;
3. refrain from encroachment;
4. allow the franchisee the right to sell its business (subject to the franchisor's pre-emptive right); and
5. not supply goods or services to the franchisee at overinflated prices or which are unfit for purpose.

Each of these can be justified in their own right, but would require more space than is available in this article.

In order to take account of the franchise agreement's long term and changing nature unconscionable behaviour by both parties must be prohibited.

The proposed provisions of a Franchise focused European Legal Act, detailed in section 10 below offers a way in which the EU Commission can implement this.

⁵⁷ Abell, Ibid pp271-272

⁵⁸ Abell, Ibid pp272-273

5. RECOMMENDATIONS:

KEY RECOMMENDATIONS

- A European Legal Act could be adopted with the aim to:
- define franchising,
 - require disclosure by both franchisors and franchisees,
 - dis-apply other duties of care and consumer rights,
 - allow franchisors to set retail prices and control use of the internet,
 - prohibit unconscionable behaviour,
 - impose a specific and exclusive duty of good faith,
 - support, and establish a clear role for, national franchise associations,
 - periodically review the terms of the European Legal Act.

The above proposed re-engineering of the EU's regulatory environment could be achieved by including the following provisions into a franchise focused European Legal Act.

5.1 Definition of Franchising

The European Legal Act would apply only to Business Format Franchising.

5.1.1 A Business Format Franchise exists where:

- (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.

5.1.2 For the avoidance of doubt, a franchise does not include motor vehicle dealerships, employee/employer relationship, agencies, landlord and tenants and co-operatives.

5.1.3 An affiliate is an entity in which the Franchisor has a controlling interest.

5.2 Disclosure by Potential Franchisees

5.2.1 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:

- (a) Full name and address including e-mail address and telephone number.
- (b) Details of education and employment.
- (c) Details of business experience including directorships and any direct or indirect shareholdings in privately held companies.
- (d) Personal bankruptcy history.
- (e) Details of the insolvency of any company in which he/she was a director or shareholder.
- (f) 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 franchisee's application.
- (g) Personal medical history and that of their spouse/partner and children.
- (h) Criminal record and that of their spouse/partner.
- (i) Details of any judgment against it.
- (j) Copy of driving licence and passport.
- (k) Banker's reference.
- (l) Details of personal assets and those of spouse/partner including details of status of current home and any charges on those assets.

5.2.2 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.

5.2.3 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.

5.3 Disclosure by the Franchisor

5.3.1 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.

5.3.2 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.

5.3.3 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'.

5.3.4 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.

5.4 Exemptions to Requirement for Disclosure by the Franchisor

5.4.1 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.

5.4.2 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.

5.4.3 A franchisee is a de minimis franchisee if it pays €1 000 or less for the franchise.

5.4.4 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.

5.4.5 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.

5.4.6 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.

5.5 Making the Disclosure Effective.

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.

5.5.2 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.

5.5.3 Potential franchisees must be informed by the franchisor in the disclosure document that:

- (a) Franchisees must work hard and for long hours. This is a clear and obvious factor of success in any business.
- (b) 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.
- (c) There is a risk of failure and what this could mean in both financial and personal terms. Failure is inevitably a risk in running one's own business. It is fundamentally different from employment,
- (d) 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.

5.5.4 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).

5.5.5 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.

5.5.6 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.

- 5.5.7 All earning claims made by the franchisor must be accurate, fair and made in good faith.
- 5.5.8 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.
- 5.5.9 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.
- 5.5.10 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.
- 5.5.11 Receipt of the disclosed document can be acknowledged by any affirmative action by the recipient to authenticate his/her identity and confirm receipt. This can include, for example, a handwritten signature, an electronic signature, passwords or a security code.
- 5.5.12 The disclosure document should be accompanied by a copy of the franchise agreement in the form in which it is to be executed.
- 5.5.13 The Disclosure Document must be updated by the franchisor within 6 months of the end of each financial year.
- 5.5.14 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.
- 5.5.15 Plain language is the organisation 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.

- 5.5.16 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.

- 5.5.17 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.
- 5.5.18 If a franchisor does not have outlets in the target market it should disclose details of its business in another member state.
- 5.5.19 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').

5.6 Penalties for Non-Compliance with Disclosure Obligation

- 5.6.1 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).
- 5.6.2 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 leads 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,
- 5.6.3 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 five years.

- 5.6.4 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.

5.7 Dis-applying Duties of Care and Consumer Rights

- 5.7.1 All pre-contractual duties of care and consumer rights applied by member states on franchising be dis-applied and replaced with the following provisions:

- (a) 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 European Legal Act. Failure to do so will be deemed to be unconscionable behaviour.
- (b) 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.
- (c) 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.

5.8 No Need for Registration of Franchise Agreements

- 5.8.1 Registration of Franchise Agreements, disclosure documents and related documents should not be required.

5.9 Allowing Franchisors to Set Retail Prices and Regulate Use of the Internet

- 5.9.1 Franchisors are allowed to set retail prices for their franchisees and dictate the networks multi-channel sales strategy.
- 5.9.2 Franchisors can control the franchisees 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.

5.10 Unconscionable Behaviour by Franchisee

- 5.10.1 Franchise Agreements must provide that the franchisee is under an obligation not to act in an unconscionable manner and, in particular, must:

- (a) 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;

- (b) 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;
- (c) Fully and faithfully implement the franchisor's system, including but not restricted to undertaking all training required by the franchisor;
- (d) Not compete with the franchisor or its franchisees during the term of the franchisee's franchise agreement;
- (e) 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;
- (f) 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;
- (g) Allow the franchisor to terminate the franchise agreement for breach without having to pay the franchisee any compensation;
- (h) 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;
- (i) 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.

5.10.2 Failure to comply with the provisions of this Article will render the Franchise Agreement null and void *ab initio*.

5.11 Unconscionable Behaviour by Franchisor

5.11.1 Franchise Agreements must provide that the franchisor must not act in an unconscionable manner and in particular must:

- (a) be the owner of, or have the legal rights to use, the network's trade name, trade mark and other distinguishing identification;¹
- (b) provide the franchisee with a reasonable level of initial training and continuing commercial and/or technical training during the entire life of the agreement;¹
- (c) render reasonable ongoing technical and consulting assistance to the franchisee;¹
- (d) refrain from encroachment on the territory of an exclusive franchisee;¹
- (e) 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);
- (f) 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.

5.11.2 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.'

5.11.3 Failure to comply with the provisions of this Article will render the Franchise Agreement null and void *ab initio*.

5.12 Duty of Good Faith

5.12.1 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.

5.12.2 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.

5.12.3 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 led 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.

5.12.4 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:
 - (i) any intended conduct of the franchisor that might affect the interests of the franchisee; and
 - (ii) 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.

5.12.5 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) threatening to terminate franchise agreements rather than negotiate and consider important issues;
- (j) unreasonably forcing franchisees to buy supplies from the franchisor at a greater cost than they could buy elsewhere;
- (k) preventing franchisees and their staff from wearing appropriate uniforms;
- (l) refusing to allocate jobs to franchisees in order to force them into accepting settlements in respect of totally unrelated disputes;
- (m) 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;
- (n) unreasonably refusing franchisees access to its records to ensure all payments due to the franchisees by the franchisor had in fact been made;
- (o) unreasonably discriminating against individual franchisees.

5.13 Mandatory Nature of National Franchise Associations and their Role.

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 associations must be not-for-profit organisations and be funded by membership subscriptions and member state subsidies.

5.14 Review of the European Legal Act

The European Legal Act will be reviewed every five (5) years to ensure that the contents of the Disclosure Document continue to be relevant to the market.

6. CONCLUSIONS

In conclusion there are two types of franchise regulation in the EU - macro-economic and sales/relationship rules.

Those regulations that focus on the macro-economic issues fail to appreciate the value that franchising can contribute to the single market both by enabling small and medium sized businesses to expand effectively throughout the EU and unleashing entrepreneurship in individual franchisees throughout the EU.

The various EU member state sales/relationship regulations lack any real uniformity, increasing cost and causing delays for franchisors seeking to roll out across the single market, thereby creating technical barriers to cross boarder franchising within the EU.

To further exacerbate the difficulties, the macro-economic and sales/relationship focused regulations been developed in an uncoordinated manner, in isolation from each other. This has contributed the dysfunctionality of franchise regulation in the EU. Franchising has failed to fulfil its potential in the EU in part at least due to the current regulatory environment.

This failure of the regulatory environment to recognise the value that franchising can deliver to the EU and to support and promote it can only be remedied by re-engineering the regulatory environment in the EU.

This re-engineering should under pin the reasons that both franchisors and franchisees become involved in franchising and moderate (but not entirely remove) the associated risks. In order to achieve that the regulations should increase market confidence in franchising, ensure pre-contractual hygiene and impose a mandatory taxonomy of rights and obligations.

Franchising could better fulfil its potential in the EU if the regulatory environment is re-engineered in a manner that;

1. Promotes franchising and market confidence by it, under pinning and supporting the commercial advantages that franchising delivers to franchisors, franchisees and the single market.
2. Ensures pre-contractual hygiene in franchising
3. Ensures a balance between the interests of franchisors and franchisees
4. Reconciles the priorities and concerns of the two different types of franchise regulation in an appropriate way,
5. is harmonised throughout each EU member state.

This is best done by adopting a Franchise focused European Legal Act which increases market confidence in franchising, ensures pre-contractual hygiene and imposes a mandatory taxonomy of rights and obligations.

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