

Legal perspective of regulatory
framework and challenges for
Franchising in the EU & Bird & Bird

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A. EXECUTIVE SUMMARY

- Franchising has failed to fulfil its potential in the EU. This is in part due to regulatory environment.
- This failure can be remedied by re-engineering the regulatory environment in the EU.
- Over 30 years as a specialist franchise lawyer and 5 years research for my doctorate has lead me to draw the following three conclusions as to what needs to be addressed about franchising and its regulatory framework in the EU.

- Franchising is not achieving its full potential in the EU.
- This failure is due, at least in part, to the regulatory framework in the EU.
- The regulatory environment in the EU should be re-engineered to enable franchising to better fulfil its potential in the EU.

B. THE FIRST CONCLUSION

Franchising is not achieving its full potential in the EU

- Franchising plays an important role in the EU economy. It is 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 (US\$300 billion).

- 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.
- However, it is therefore over-concentrated in a small number of EU member states with an estimated 83.5% of its turnover concentrated in only 25% of the member states.
- In comparison with the USA and Australia franchising in the EU is under performing.

Franchising 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
- provision of assistance to the franchisee by the franchisor.

These features are not impacted by either economic or sectoral contextualisation

Franchisors use Franchising because;

- 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

Franchisees use franchising because;

- an increased chance of success (such as access to a proven format, a nationally recognised brand, on-going support, economies of scale and so on)
- various situational, and personality correlatives

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)

Franchisees are exposed to the risk of

- misrepresentation,
- encroachment,
- poor quality business formats and
- inadequate support

What should Regulation should focus on?

Any regulation of franchising should support the reasons that franchisors and franchisees are involved with it and reduce – but not remove - the related risks for both parties as much as is commercially appropriate

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.

Franchising is distinct from agency and distribution, the main difference being;

- the business format and
- the ongoing support

**C. THE SECOND CONCLUSION –
Franchising's failure to fulfil its potential in
the EU is due to the way it is regulated.**

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.

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.

- National Franchise Associations in the EU represent franchisors rather than franchising
- 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

- 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.

The Legal Regulatory Environment in the EU

Disclosure.

- There are franchise-specific disclosure laws in six member states
- 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.

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 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.

The Ongoing franchisor/franchisee relationship

In the EU this is impacted by a regulatory environment that includes;

- Good Faith.
- Anti-trust
- Unfair Competition
- Consumer law
- The application by analogy of commercial agency law
- The application of Employment law to protect franchisees

The Impact of this Regulatory Matrix

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.

This Regulatory matrix is an artificial barrier to pan-European expansion

D. THE THIRD CONCLUSION - The need to re-engineer the Regulatory Environment.

A Directive is Needed

- 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 directive

Definition of Franchising

Franchising should be defined by reference to :

- independence,
- economic interest,
- the brand,
- the business format,
- control, and
- ongoing support

"Carrot" rather than a "Stick"

The "Exchange of Benefits" approach

In order to encourage entrepreneurs to use franchising to expand across member state borders, Franchisors should be offered benefits in exchange for complying with the Directive

Three Commercial Imperatives – Ensuring that the Directive is fit for purpose.

The Directive must accentuate the influence of three Commercial Imperatives.

These are

- maintaining market confidence,
- ensuring pre-contractual hygiene, and
- imposing mandatory terms onto the franchisor/franchisee relationship through the franchise agreement.

Increasing Market Confidence in Franchising

This can be done 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

It should establish this by changes to anti-trust law

- allowing franchisors to set the prices their franchisees may charge (on a rule of reason basis) , and
- Some restriction of franchisee sales over the internet.

Ensuring Pre-contractual Hygiene

This can be done by;

- Education and Pre-contractual processes
- Mutual Disclosure , and
- Empowering National Franchise Associations with a new Role.

Education and Pre-Contractual Processes

Potential franchisees must be;

- given access to appropriate information ,
- equipped to interpret that information in an appropriate manner.
- obliged to take advice from professionals with appropriate experience and expertise.

It is therefore proposed that;

- Their advisors (particularly lawyers) 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 advisors to prove that they have taken such advice.
- Potential Franchisees must undertake a short on-line educational programme about the risks and rewards of franchising and certify that they have done this before signing the agreement.

A new role for National Franchise Associations

National franchise associations should ;

- Be part funded by government
- Represent Franchising not Franchisors
- Run the franchisee pre-contractual education programme ,
- Run a professional education programmes for advisors, and
- Generally promote Franchising.

The pre-contractual education programme

This should stress four basic principles- that franchisees have to;

- work hard,
- follow the franchise format,
- risk failure and economic loss, and
- take and follow expert advice from appropriately experienced professionals.

Pre-contractual disclosure should emphasise the quality and timing of disclosure, not quantity and;

- 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

- be allowed electronically
- 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.

Failure to comply should result in

- 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
- personal liability for any individual responsible for the disclosure document being inaccurate
- the regulatory authorities being able to rescind the franchise and related agreements or claim damages
- the regulatory authorities being able to impose penalties including disqualification

Mandatory Clauses in Franchise Agreements

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 franchisee's business on termination,
- allow termination for cause without compensation,
- allow the franchisor a pre-emptive right of purchase,
- impose a duty of confidentiality, and
- purchase tied goods and services from the franchisor or its nominated suppliers.

The franchisor must

- be the owner of or have the right to license 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 overinflated 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

E. CONCLUSION

- Franchising has failed to fulfil its potential in the EU and that this is in part due to the regulatory environment.
- Vigorous re-engineering of the regulatory environment is needed to remedy this failure.
- This re-engineering involves accentuating the impact of three Commercial Imperatives:
 - market confidence,
 - pre-contractual hygiene and
 - mandatory rights and obligations.

Thank you & Bird & Bird

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