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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

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STUDY GROUP ON FRANCHISING

Report on the first session

(Rome, 16 to 18 May 1994)

(prepared by the Unidroit Secretariat)

Rome, September 1994

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The first session of the *Unidroit Study Group on Franchising* met in Rome, at the seat of the Institute, from 16 to 18 May 1994. A list of participants appears as Annex II to this report. The terms of reference of the Study Group as defined by the Governing Council at its 72nd session in June 1993 were to examine different aspects of franchising and in particular disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of master franchise agreements on sub-franchise agreements. The Study Group was also requested to make proposals to the Council regarding any other aspects of franchising that might lend themselves to further action by the Institute and, as soon as practicably possible, indicate the form of any instrument or instruments which might be envisaged.

Reference documents for the session were:

Study LXVIII - Doc. 7 (Further consideration of the areas amenable to treatment at international level)

Study LXVIII - Doc. 8 (Collection of materials relating to franchising)

Study LXVIII - (SG) Misc. 1 (Comments submitted by Mr Martin Mendelsohn, Jaques & Lewis, London) and

Study LXVIII - (SG) Misc. 2 (Comments submitted by the European Franchise Federation).

Background documents were:

Study LXVIII - Doc. 5 (Examination of areas amenable to treatment at international level) and

Study LXVIII - Doc. 6 (Examination of the answers to the questionnaire prepared by the Committee on International Franchising of the International Bar Association in consultation with Unidroit).

The President of Unidroit, **Mr Riccardo Monaco**, welcomed the participants in the session. He stressed the importance of the Study Group which would provide the fundamental scientific basis on which work would proceed. It was a source of great satisfaction for the Institute to proceed with this instrument of international trade after the adoption of the *Ottawa Conventions on International Financial Leasing and International Factoring*, and he was sure that under the expert guidance of the Chairman of the Study Group, Mr Leif Sevón, Justice of the Supreme Court of Finland, President of the EFTA Court and Member of the Unidroit Governing Council, the Group would achieve important results.

Mr Sevón referred to the meeting of the Unidroit Governing Council which had taken place the preceding week. There had been a fairly short discussion on franchising and the terms of reference of the Study Group which had been decided at the 72nd session had not been modified. The fact that franchising was growing in importance had been stressed by representatives of both developing countries and countries in transition to a market economy. There had been an indication that national legislators in different parts of the world saw an increasing interest in franchising, and that there might therefore be a certain urgency to determine the direction the Study Group should take. The feeling had been that the Study Group should consider the possibility of producing different kinds of instruments (convention, uniform law, model law or other instruments). There had furthermore been a discussion as to whether the Study Group should embark on questions of conflicts of law and jurisdiction and the parameters laid down were that if any such exercise were to be undertaken it should be done in very close co-operation with the Hague Conference on Private International Law. Mr Sevón recalled that while the Study Group was requested to examine whether, and if so what,

work should be done in relation to franchising, the final decision was the prerogative of the Governing Council which would at its next session revert to this item on the basis of the report of the Study Group and take such decisions as it would deem appropriate at that time.

There was a general consensus that before embarking upon detailed discussion of specific aspects of the franchise relationship, it was essential to reach agreement as to the specific commercial vehicle under consideration. There was a very strong tendency in the international community to include within the definition of franchising many other types of distribution agreements, particularly licence agreements and transfer of technology agreements. There were in addition certain forms of distribution which were sometimes included under the term "franchising", such as soft drink bottlers or automobile distributors, and the Group must decide whether such forms of distribution should also be covered in its discussion, or whether it would instead consider mainly what was known as business format franchising. The Group agreed that what was primarily under consideration was business format franchising.

It was pointed out that at the heart of a franchise relationship was a trademark or service mark licence, associated with which was a greater or lesser degree of control or assistance. Beyond and associated with that there could be a range of other relationships which existed in some systems and not in others, such as, for example, the sale of goods by the franchisor to the franchisee, or a landlord and tenant relationship. There were some systems in which the franchisor lent money to the franchisee or guaranteed the franchisee's obligations to a third person, in which case the franchisee would have a debtor relationship to the franchisor. It was observed that there was one area of law which had however not yet been covered that was causing many problems. This was the nature of the relationship that existed between the franchisor and the franchisee and the obligations that flowed from that relationship. In the United States of America courts had classified the relationship in a variety of ways, for example as joint ventures, trusts, and as fiduciary relationships, but it was considered that such classifications were misleading and inappropriate.

There was agreement that the main reasons which led to the failure of many international franchise ventures included the fact that the sub-franchisor was under-capitalised, a lack of knowledge and experience on the part of the sub-franchisor as to how to act as franchisor, and also a clash of personalities: in seeking out a sub-franchisor the franchisor was seeking an entrepreneur who was his mirror-image while at the same time asking that same sub-franchisor to follow the system, and these two qualities did not always go together. There was also often inadequate market research, unacceptability of the product or service offered, or even of the trademarks, and also the use of the wrong commercial vehicle which did not lend itself to franchising. In many cases there were unrealistic expectations on both sides. Another reason was a lack of knowledge on the part of the legal profession as to what it was doing and what it was seeking to achieve. In many cases there were impediments to franchising within the foreign country and these were not always sufficiently analysed in advance. It was however pointed out that these reasons for the failure of franchises were not unique to franchising and that the same factors led to failure in business generally, at both domestic and international level. It was true that expectations were higher in franchising than in other forms of business, as some people thought that franchising was a vehicle that protected them from these general inadequacies of business, and there was a higher sense of confidence that a business that was franchised would succeed, as in franchising the sub-franchisor and sub-franchisee paid money for that which the franchisor sold as a well-proven concept. More was therefore expected from franchising and the disappointment was greater when it did not work.

The importance of a healthy commercial law environment was stressed repeatedly throughout the session. The need to consider whether what was needed was franchise legislation or a set of laws that would permit franchising to flourish was deemed to be of paramount importance. A prerequisite for franchising being able to function effectively was the existence of a general legislation on commercial contracts. Questions which should be addressed in this context were whether there existed an adequate company law, whether there were sufficient notions of joint ventures, whether intellectual property rights were properly set forth and whether companies could rely on ownership of trademarks and know-how and on confidentiality agreements.

It was observed that there was a tendency on the part of developing countries in particular to associate the success of franchising in the United States with the existence of franchise legislation. There was, however, nothing which could prove or disprove this. There was no demonstrable evidence that regulation as it existed in the United States had had a positive effect and many argued that its effect had been negative in terms of adding burdens and costs to the ability to franchise. Compliance with those laws required a lot of time and entailed high legal fees and these costs were ultimately passed on from the franchisor to the franchisee and then to the consumer.

In the United States there were two types of regulation. One concerned the relationship between the parties after the franchise had been initiated and that existed only at state level and then only in some fifteen states. The other regulated the offer and sale of the franchise and that existed in two forms: at federal level in the form of the *1979 Federal Trade Commission (FTC) Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures* and at state level in the form of state legislation in some fifteen states. The difference was that in the first case it was necessary to go through a process of registration and examination by state administrators, whereas in the second, if a party was not in one of the fifteen states with specific legislation, this was not necessary as there was no federal government agency with which to file the disclosure document. There was no private right of action. Whereas it was agreed that the laws which required registration substantially added to the costs of the franchise systems, one view was that despite this it was not an undue burden to require small franchise systems to comply with the disclosure regulations, or even with some of the registration requirements. Another view was that compliance with the franchise legislation represented a barrier to entry to smaller franchisors as the costs represented a large percentage of their available capital.

In Canada only the province of Alberta had enacted legislation on franchising and that was considered to be particularly draconian. It was observed that no one had as yet proved that there were fewer abuses of franchising in the province of Alberta than in other Canadian provinces and no one had as yet demonstrated that more people were dishonest about their disclosure in the rest of Canada than they were in the province of Alberta. No one could prove any benefit that franchise legislation had brought to the province of Alberta; on the contrary it was suggested that franchisors tended to avoid Alberta.

In France legislation appeared instead to have brought benefits, as there were fewer bankruptcies and some felt that this was due to the law that had recently been introduced. The law was observed, as there were heavy sanctions for non-compliance. Cases of fraud did not occur as often as they had before and franchising had become more healthy.

It was suggested that most legislators considered the franchisee as a consumer that had to be protected, and that there might be something in this. Franchisees paid good money for a concept and

then thought that they were perfect business people and that their enterprise would work, only to find later that something was wrong. It was observed that considering what was happening in certain countries, especially when franchising was booming, greater protection might be needed, whatever that protection might be.

Despite the consideration of the costs involved in compliance with franchise legislation in the United States and despite the apparently negative impact of legislation in Alberta, the view was expressed that it was possible that legislation could promote confidence in business and support successful business expansion. The Study Group should therefore consider whether some kind of legislation would promote confidence and success in franchising as a business vehicle and whether it might promote integrity and fairness in franchising. The view was also expressed that legislation might create greater certainty for franchisors entering other countries as they would know what to expect. It was however suggested that there was a considerable lack of knowledge and informed debate, and that at both international and domestic level there was a need for education. When Unidroit considered whether legislation was needed, it should have at the forefront of its thinking an understanding that there was a great deal of misperception and ignorance which needed to be addressed and that if the Study Group decided to move in the direction of an international instrument it had to serve as much the purpose of on-going education as that of laying down specific standards.

The Study Group was informed of initiatives undertaken by other organisations, both intergovernmental and non-governmental. The *World Intellectual Property Organization (WIPO)* was working on a guide to franchising for developing countries, but this was an elementary publication which explained the general principles of the subject so that whoever was confronted with the phenomenon in a developing country would know what it was. It was designed with a view to the hypothetical case of a particular franchise which was used as an illustration for points that were being made. The Group preparing this guide had decided not to draw up a model contract and to abstain from legislative discussion altogether. The *International Labour Organization (ILO)* was also preparing a similar report addressed to developing countries but with an emphasis on how franchising could be used as a tool for economic development. The *International Chamber of Commerce (ICC)* had set up a group entrusted with the preparation of a model contract for franchising, which related not to master franchise agreements but to unit franchise agreements, the intention being not to produce a guide, but rather to produce a contract with a short introduction. There was further a group in Ljubljana called the "*International Centre for Public Enterprise*" that had met twice to consider the role of franchising in transitional economies, focusing specifically upon Central and Eastern Europe, and which had examined how franchising could be used as an effective tool for, for example, the privatisation of State-owned enterprises, as well as other ways in which it could be used to promote economic growth. In the United States a voluntary consortium had been created in 1993 which now comprised thirty major franchise companies that had committed themselves to a programme of voluntary mediation of disputes: for a two-year period those in the programme had committed themselves to bringing any dispute between a franchisor and a franchisee to non-binding mediation, not just before going to litigation, but even before going to arbitration. This scheme appeared to be successful. National franchise associations were also increasingly active in the promotion of ethical standards.

As regards the Unidroit initiative, the mandate of the Study Group was to examine different aspects of franchising and in particular disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of master franchise agreements on sub-franchise agreements, as well as to make proposals to the Council regarding any other aspects of

franchising that might lend themselves to further action by the Institute and, as soon as practicably possible, the form of any instrument or instruments which might be envisaged.

Mr Sen indicated that in India it had been suggested that Unidroit could consider the possibility of adopting some form of regulation or guidelines for international aspects of franchising. It could, in fact, consider two possibilities. The first was the preparation of norms, standards or guidelines so as to indicate the necessity of disclosure. This would in the future prevent franchisees from seeking to avoid liability, for example, for defective quality in the goods or services they offered by claiming that there had not been adequate disclosure on the part of the franchisor. Secondly, Unidroit could produce model legislation which would enable countries examining the possibility of introducing legislation to consider whether in fact they should opt for legislation or, if not, whether any of their existing laws needed amendment.

Before discussing the direction that future work should take within Unidroit, it was decided that a general discussion first on international, or cross-border, franchising, and then on domestic, or non-cross-border, franchising should take place.

INTERNATIONAL FRANCHISING

It was suggested that there were essentially five ways to franchise internationally: direct franchising, franchising through a branch or subsidiary, master franchising, franchising by means of a joint venture and area development agreements. While these forms of franchising were here being considered for international franchising, it was noted that they were also used for domestic franchising.

In direct franchising the franchisor itself granted franchises to individual franchisees in the foreign country. In this case there was an international contract to which the franchisor and the franchisee were parties. It was observed that this form of franchising was not used frequently in international franchising and that in any case it was a simple international agreement. There was a consensus that direct franchising was not of interest for the purposes of the Study Group's investigation of international franchising.

Where the franchisor established a subsidiary or branch office in a foreign country it was this subsidiary or branch office which would act as franchisor for the purpose of granting franchises. This form of franchising was of no interest to the Study Group as any issues which might arise would concern the relationship between the parent company and the subsidiary, which no one would construe as a franchise agreement. Whether or not a franchisor chose to create a branch or subsidiary was a management and tax decision and not a franchise decision. Furthermore, the relationships between the branch or subsidiary and its franchisees were domestic franchise relationships.

In a master franchise agreement the franchisor granted a sub-franchisor the exclusive right within a certain territory (such as a country) to open franchise outlets itself and/or to grant franchises to sub-franchisees. The sub-franchisor in other words acted as franchisor in the foreign country. In this case two agreements were involved: an international agreement between the franchisor and the sub-franchisor, and a domestic franchise agreement between the sub-franchisor and the sub-franchisees.

It was agreed that master franchise agreements were at the heart of the exercise and that in the first instance it was this form of franchising which should be examined.

The fourth way to franchise internationally was by means of joint ventures. What normally happened in these cases was that the franchisor and a local partner created a joint venture. This joint venture then entered into a master franchise agreement with the franchisor, and proceeded to open franchise outlets and to grant sub-franchises in the same way as would a normal sub-franchisor. The Group felt that the question of joint ventures was also outside the scope of the exercise because it involved problems of a nature which would not lend themselves to the kind of considerations the Study Group was making. Whether or not a franchisor elected to participate in a joint venture in connection with the grant of a franchise was a managerial, a use of capital, decision which in some cases would be dictated by the laws of the country. It was not a franchise decision.

In the case of area development agreements two approaches were possible. Either the developer was given the right to open a multiple number of outlets in accordance with a predetermined schedule and within a given area, or it was given a right to establish under a predetermined schedule and within a given area a combination of its own outlets and sub-franchised outlets. Area development agreements, which until recently were not common in international franchising, were now receiving increased prominence in countries which were far away from the country of the franchisor. The evolution of these forms of agreement had now become a reality with their own special problems within an international context that did not necessarily exist within a national context. It was however felt that also these agreements were outside the scope of the discussion on international franchising.

It was observed that new forms of agreements were continually evolving. Bare-bones licence agreements and hybrid licence franchise agreements also merited consideration as instruments which were increasingly used by the community.

I. MASTER FRANCHISE AGREEMENTS

A number of aspects of master franchise agreements were considered. These included the nature of the relationship between the master franchise agreement and sub-franchise agreements, applicable law and jurisdiction, settlement of disputes, problems associated with the tripartite nature of the relationship between franchisor, sub-franchisor and sub-franchisees, particularly in relation to termination, and disclosure.

a. The nature of the relationship between master franchise agreement and sub-franchise agreements

The nature of the relationship between the master franchise agreement and sub-franchise agreements was considered from the point of view of the influence that the master franchise agreement had on sub-franchise agreements. The typical arrangement in a master franchise agreement between the franchisor (A) in one country, the sub-franchisor (B) in another country and the sub-franchisee (C) in the same country as B, was that the contract between B and C referred to the contract between A and B, and made it subject to the contract between A and B to the extent that the law of that country so permitted. It frequently incorporated the contract between A and B by reference and in some variations there would be a tripartite contract in which A, B and C were all parties to the contract, thus giving A direct rights and obligations in relation to C. In other cases there

would be two separate contracts, one between A and B and the other between B and C. In some countries third party beneficiary arrangements were possible. Where this possibility existed, an attempt was made for one of the contracts to create a third party beneficiary arrangement in the other. In any event an effort would be made to impose the controls over the quality and the nature of the operations of C by virtue of, for example, the principal standards and trademark controls which arose from A. What A tried to do was to make B his *alter ego* in the country where B and C were located, so that B performed as much as was feasible the obligations to C that A would otherwise have (training, supervision, etc.). From a financial point of view, what usually happened was that the payments which C would make for the right to do business under this system, instead of going to A as if it were a two-party system, would be divided between A and B in relation to their relative contributions to the process. When there were two contracts, one between A and B and the other between B and C, the latter would be governed purely by domestic law and all of the possible additional situations which could be envisaged, whether it be lease, anti-trust or whatever, would arise between the sub-franchisor and the sub-franchisee and would be governed by domestic law.

It was in fact suggested that the only issue was whether or not there was a contract between B and C. Any A who wished to deal with a C in another country there must be a figure such as B. It was not feasible for A to make every visit or to undertake every supervision, so that must be entrusted to B. B could be an employee of A, an employee of a branch or of a subsidiary of A, or an independent broker or contractor who simply had to identify prospective persons with whom A might decide to enter into a relationship. B could be an independent contractor who received a delegation or authority from A to perform on A's behalf vis-à-vis C whatever obligations A would have to C, while maintaining a direct relationship between A and C since A could not divest itself of its obligations to C by appointing B. A might also decide that B should be more than an employee and rather be an intermediate, separate tier entity enjoying a separate contractual relationship with C. It was in this latter case that one spoke of a master franchise relationship which had infinitely more complexities than simple cross-border franchising.

It was observed that when the master franchise agreement had a relatively long term there was always the question of the time until which the sub-franchisor could grant sub-franchises. There was usually a separation between the term of the master franchise agreement itself and the development term during which the sub-franchisor could grant sub-franchises. The development term usually ran for only two-thirds of the term, leaving enough time at the end for the sub-franchise agreements to run. A properly drafted sub-franchise agreement would deal with the question of the degree to which the sub-franchisor had the right to grant sub-franchises, for how long in relation to the term of the master franchise agreement and under which circumstances this would be altered if there were a change in the conditions of the franchisor or the sub-franchisor. The problem was that there were few properly drafted contracts and it was typical to have the term of a unit agreement last longer than that of the master franchise agreement.

One question raised with reference to the relationship between the parties in master franchising was that of direct actions being brought by the various sub-franchisees against the franchisor. It was observed that there would be no master franchising unless B was completely independent of A. The question was whether C had direct recourse against A or whether recourse was limited to B, considering also the doctrine of privity of contract. If C were to have recourse directly against A, in some legal systems it would be necessary to conclude a three-party contract with A making a direct commitment towards C. It was however observed that such provisions were becoming increasingly

rare, as franchisors began to realise that they were not able to fulfil the obligations they assumed by entering into such a three-party contract.

In general terms it was observed that in the case of master franchising it was important that there be an understanding between the parties of each other's business cultures. What also was of paramount importance was the commitment of the franchisor as reflected in the agreement: the commitment to initial training, to on-going training, to assisting in the working out of problems. The role of the sub-franchisor with regard to improvements to the system was very important and in many instances the sub-franchisor was given some liberty both to introduce improvements and to adapt the system to the realities of the foreign country.

b. Applicable law and jurisdiction

In legal practice the difficulties relating to applicable law and jurisdiction involved two issues: the difficulties of enforcement when one party was located in one country and either two or three parties in another, and conflicts of law where there was, for example, a franchisor in one country and a sub-franchisor and sub-franchisees in another country. The question then was what law would apply to the contract between the franchisor and the sub-franchisor and what law would apply to the contract between the sub-franchisor and the sub-franchisees. Furthermore, if it was a contract in which all three parties were involved, what law would then apply?

If franchising were looked at from an academic point of view, it was on the basis of any conflict rules almost inevitable that the applicable law should be that of the country in which the franchise was being exploited. It was the franchisee who had the greatest number of obligations, who bore the greatest risk, who was called upon to perform the most onerous part of the contract. There were, however, times when there were very good reasons why the franchisor should wish to have its own law apply to both the master franchise and the sub-franchise agreements. A franchisor would clearly be more prepared to live with the stability and certitude of what it knew, rather than submit to the uncertainties of other countries. There was also agreement among the practising lawyers within the Study Group that they would not wish to subject a client to the laws of a country that did not have clear laws on commercial usage and practice.

It was often considered to be an abuse on the part of the franchisor to impose its own law as the law applicable to the contract, but it was suggested that this was not necessarily the case. The view was expressed that it was a misconception automatically to consider that it was not in the franchisee's interest for foreign law to be applied. In many cases it was in fact in the franchisee's interest not to apply the local law but to apply instead, for example, United States law which was much more draconian and which gave the franchisee much greater rights. The complaint of a franchisee who perceived itself as being mistreated had a much greater hearing in the United States than in other countries. It was in a way misguided national pride which made some franchisors desire to have their own country's laws apply, but in practice this was not a good idea and franchisors were beginning to realise this. In fact, whereas there had in the past been a tendency for franchisors to seek to have their own law apply both to the master franchise agreement and to the sub-franchise agreements, this was no longer the case.

It was observed that in international franchising the use of arbitration and mediation was becoming increasingly common. In many instances the law of third countries was being applied and arbitration proceedings were being heard in a third and neutral country.

The situation where no law was chosen by the parties was also examined. There was general agreement that there was no reason to suppose that franchise agreements were somehow excluded from the normal conflict of laws rules, nor was it considered to be necessary for there to be rules specifically designed for franchising in this regard. It was noted that different international conventions might produce different results, and that problems might arise in the determination of which convention should apply, but this was not a problem which was peculiar to franchising.

c. Settlement of disputes

Linked with the question of the applicable law was that of the settlement of disputes. It was observed that an issue under debate within the European Franchise Federation was whether the Federation should create a court of arbitration. Opinions were divided within the EFF on whether international franchising should develop its own international dispute settlement system through arbitration or whether it should instead use the already known and established systems of settling disputes internationally. There was general agreement in the Study Group that no specific system for franchising was necessary, although it was considered that an increase in the knowledge of franchising of the arbitrators sitting in proceedings which dealt with franchising was called for, as most international dispute resolution organisations had no familiarity with it at all. The same was true in the mediation process, as to be creative in producing a settlement that could be acceptable to the parties a knowledge and an understanding of franchising was needed.

The Study Group in general favoured the use of mediation in franchising dispute resolution, independently of whether the ultimate resolution was by resort to arbitration or to the courts. Although arbitration was considered to offer some advantages over courts in the resolution of disputes. It was stressed that the franchise relationship was an on-going relationship and that it was of great importance that that relationship be allowed to continue, which might not be possible if the controversy were brought to a head in court proceedings. The possibility to maintain secrecy and a greater degree of confidentiality in the mediation process by keeping it less formal made it easier to maintain the relationship while the dispute was being solved.

As regards arbitration, the observation was made that it was generally much easier to enforce an arbitral award than a court judgment in another jurisdiction. It was however agreed that arbitration had its limitations in relation to injunctions or immediate relief as often arbitrators could not be appointed sufficiently rapidly to allow for that kind of relief.

d. The tripartite nature of the relationship between franchisor, sub-franchisor and sub-franchisees

There was general agreement that the most problematic area in master franchise relationships was what happened when the contract ended. A distinction had here to be drawn between the expiration of the term of the agreement and termination due to the fault of the sub-franchisor. A third question regarded the consequence of termination due to the fault of the franchisor, but it was observed that this issue had not been studied. The point at issue was the impact of these three situations not only on the relationship between the franchisor and the sub-franchisor, but even more on the relationship between the sub-franchisor and the sub-franchisees. Each of the situations envisaged needed to be tackled in a completely different manner.

The first issue was the question of term. Master franchise agreements were typically granted for a very long time. It was extremely expensive to enter into and to maintain these relationships and even

more so to terminate them. They could therefore be considered to be life-long relationships. If, nevertheless, the master franchise agreement came to an end, the question arose of what would happen to the sub-franchise agreements made on the strength of the master franchise agreement. In many jurisdictions the sub-franchise agreements would immediately fall, i.e. the expiration of the term of the master franchise agreement would automatically result in the termination of the sub-franchise agreements. This was also the case with the termination of the master franchise agreement. There were, however, ways in which the sub-franchises could be protected. One was that the master franchise agreement, notwithstanding its expiry or termination, continued in some sense to govern the terms of the sub-franchise agreements. Another was to receive a commitment from the franchisor to the sub-franchisor that it would respect the terms of the sub-franchise agreements notwithstanding expiry or termination. To the extent that after forty years the franchisor took over all of the sub-franchise agreements, the question would arise whether it should pay the sub-franchisor some compensation, also in view of the fact that for the franchisor these were essentially cash-flow agreements.

It was observed that the issues which arose with the termination of the master franchise agreement by reason of default of the sub-franchisor and the impact this termination had on sub-franchise agreements was the Achilles' heel of master franchising. Most franchise lawyers would say that the franchisor had the right to be assigned in and to the rights of the sub-franchisor with respect to those agreements. The problem was how this could be achieved. The legal profession had come up with several solutions, none of which appeared to be satisfactory and none of which had been tested. These proposed solutions included giving the franchisor a power of attorney to assign the unit agreements back to it and signing assignment agreements in advance.

What had occasionally happened but was not considered desirable was that when, for example, a sub-franchisor was not considered to deserve the grant of a new term but not bad enough to have its contract terminated, a new sub-franchisor was nominated while the old sub-franchisor was permitted to continue with its own sub-franchisees until the last sub-franchise agreement ended. The result was the existence of two parallel networks which was not considered to be a good solution. In some agreements the sub-franchises all terminated at the same time, whereas in others the parties allowed the sub-franchises to continue for their own term. In any event this had to be dealt with in all the contracts and coordinated. There was consensus that termination provisions had to take into account the interests of all three parties involved.

Another issue examined by the Study Group was what happened in the event of breach by the sub-franchisee. As the franchisor had given up all rights and duties with respect to the sub-franchise agreements to the sub-franchisor, it was the sub-franchisor who had the duty to intervene and to ensure that the breach on the part of the sub-franchisee was remedied. This would normally be provided for in the master franchise agreement. If the sub-franchisor did not do so, it would itself be in breach. The problem for the franchisor was what it would be able to do to protect its trademark if the sub-franchisor did not act, considering that it had no direct relationship with the sub-franchisee.

There was agreement that the franchisor would be able to proceed against the sub-franchisor for breach of contract. As regards instead the possibility for the franchisor to proceed against the sub-franchisee, it would not be able to do so as it had given up this right to the sub-franchisor. It might however happen that the franchisor sought in the master franchise agreement to create a direct lien between itself and the sub-franchisee, so as to permit it to act against the sub-franchisee if the sub-franchisor did not do so and this created problems. This however occurred less and less frequently, as

franchisors came to the realisation that by doing so they created a direct action of the sub-franchisees against them, which was not what they had intended. Despite this, the franchisor might occasionally still reserve a direct action in respect of certain matters, such as shop signs.

e. *Disclosure*

In the course of the discussion on disclosure the Study Group examined in particular the experience of the United States. The Study Group was informed that the disclosure required in the United States had four component parts. The first of these consisted in what was in effect a regurgitation of the actual terms of the agreement, with the additional requirement that the information be given in plain language. The reason for this was that the American legislator had been thinking of the small franchisee who was taking its life savings and changing its status from that of a dependant worker to that of a franchisee. This might however not be considered to be relevant to a master licence to take the rights to another country and this part of disclosure therefore appeared to be inapplicable to international master franchise agreements. The second part consisted of financial information concerning the franchisor, including audited financial statements. However, the overwhelming number of franchisors whom members of the Study Group had come across did not use the same company for international franchising, preferring to set up a separate company solely for international franchising, which they did for limited liability and tax purposes. The financial information about the franchisor would therefore be irrelevant as it would be the newly constituted entity which would to all intents and purposes be the franchisor. The third part of the disclosure was earnings claims, if the franchisor chose to give them: it did not have to do so, and was in fact often discouraged from doing so. If the franchisor did offer earnings claims, it had to provide historical references, footnotes, disclaimers and the like. Only about 15% of franchisors provided earnings claims. The fourth part of the disclosure required franchisors to give information on the results of the company, on how many franchisees in the United States had been terminated in the last three years, on how many companies had asked the franchisor to permit them to transfer their businesses from one location to another and whether the franchisor had accepted or refused such requests, etc. This information, which concerned unit operations in the United States, would at best be of limited value to someone in another country. In many cases the information furnished in this way was actually harmful, as it led the foreign franchisee to think that it would be one of the one thousand franchisees of the franchisor when in actual fact its future and success would be far more dependent on its own conduct than on its being part of the system, as it was not a question of simply adding one more franchise in a well-established country. The franchises which went abroad would, in fact, be carefully tailored to suit the country entered.

It was observed that many United States franchisors would nevertheless choose to make available also to prospective franchisees abroad the franchising offering circular which they used for the United States domestic market and which contained all the information which American law required to be disclosed, although according to one view this was done more as a matter of convenience as the document was available and ready for use.

In the experience of some member of the Group, in the master franchise agreement situation franchisors typically sought to disclose much more information than might actually be required by United States law: during negotiations they sought to establish a very close mutual relationship and that required exchanging a great deal of information. It required the development of detailed business plans and careful negotiation, not so much to establish rights and remedies as rather to determine the compatibility of the parties and to be sure that there was a clear understanding of what each of them expected. There was a great deal of disclosure in a well-done master relationship, and this situation

should be distinguished from the unit situation where economic considerations would not permit such a discussion and exchange of information. A master franchise agreement would speak to the exchange of improvements and later developments in technology. Information on changes in the management or the board of directors might appear if the sub-franchisor were relatively small. Information on difficulties in obtaining financing would appear less frequently, unless the joint venture vehicle was super-imposed on the master franchise.

Ultimately, the view was expressed that while disclosure would not prevent prospective franchisees from taking the wrong decisions, it did help them make up their minds, although its value at international level was questioned.

Conclusions and proposals

The terms of reference of the Study Group was to examine different aspects of franchising, in particular disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of master franchise agreements on sub-franchise agreements, and to make proposals to the Unidroit Governing Council regarding any other aspects of franchising that might lend themselves to further action by the Institute. The Group was also to indicate the form of any instrument or instruments which might be envisaged. The discussions on international franchising had concentrated on master franchise agreements and had related to the nature of the relationship between the master franchise agreement and sub-franchise agreements, applicable law and jurisdiction, settlement of disputes, problems associated with the tripartite nature of the relationship between franchisor, sub-franchisor and sub-franchisees, particularly in relation to termination, and disclosure.

The findings of the Group led to the conclusion that none of the areas which had been discussed would lend itself to being dealt with by means of an international convention. This was clearly the conclusion to be drawn from the discussion on how the agreements were concluded and on what information was requested and provided. Considering the great variety of franchise agreements and of the different options open to parties entering into franchise agreements, as well as the fact that in international franchising questions such as the term of the master franchise agreement in relation to the development term could be approached in very many different ways and the resulting agreement still be a properly drafted agreement, it appeared that it would be almost impossible to treat such questions by means of an international convention as the consequence would be to tie the hands of the parties by suggesting that the issue at hand ought to be dealt with in one specific way only, and this would be of little service to the business. The discussion on disclosure would however be taken up again with respect to domestic franchising.

Whereas a binding instrument such as an international convention was considered to be inappropriate or even harmful to international franchising, there emerged in the course of the meeting a general consensus on the opportuneness and indeed on the desirability of preparing a legal guide to international franchising, and in particular to master franchise arrangements. It was suggested that any guide should be drafted on the assumption, and stating the fact, that parties should use legal counsel and that therefore matters of a general nature would not be dealt with.

It was suggested that the guide should in the context of each chapter have a short summary at the outset which would indicate to a fast reader what that chapter dealt with, thus permitting the reader to skip that chapter if the issues presented in the summary were not ones which were relevant in the

particular case. Such a summary would also serve as a checklist of issues that should be dealt with in a contract.

A guide such as that envisaged would first describe what franchising was, and what it was not. A definition of sorts would therefore be necessary, albeit not a legal definition but rather a description that would facilitate the correct understanding of whatever followed. It would have to be based on knowledge of past, current and if possible future practice in the field, so that the questions which were discussed were of practical value to parties in the field of franchising. It would have to take up issues preferably from the point of view of what kinds of problems parties ought to consider when entering into a contract, which signified that stress must be laid on the need for an adequate commercial assessment without however going into too many details, as Unidroit would not be in the best position to give advice on matters which fell outside its specific field of competence. The guide should also deal with such questions as the kinds of clauses the parties should consider in the light of what the contract was to contain, the advantages and disadvantages of certain clauses, taking into account the fact that that must be analysed in the light of the applicable law and in that of the particular kind of contract that the parties in question were contemplating. Such a guide could to a considerable extent be a descriptive document of clauses which occurred frequently. It could contain advice as to what parties should attempt to avoid, but should probably be rather restrictive in putting forward clear recommendations to the parties, and instead function on the assumption that the parties could, on the basis of the advantages and disadvantages brought to their attention, themselves assess what kind of a contract they wished to conclude.

The guide should deal with the respective obligations of both parties to an international franchise agreement, preferably a master franchise agreement, but should probably also set out the different possibilities that were available to the parties to achieve their economic purpose, although it should not go into detail on anything other than a master franchise agreement. It would cover questions that might arise at all stages of the contract, for instance the question of the information that parties should exchange upon entering into the contract as well as during the term of the contract. The guide should also deal with the issues of the expiry or termination of the contract, in respect of which it should also describe problems that might arise from the fact that there were sub-franchise agreements in addition to the master franchise agreement, and stress that adequate obligations be placed on the sub-franchisor to ensure that the sub-franchise agreements operated in the manner provided for in the master franchise agreement.

The guide should also address disputes between the parties, and the different means which existed to settle such disagreements, stressing the fact that in principle what they had was a long-term contract which should preferably prevail and that this would require the parties to seek solutions that would not bring them into a hostile relationship with each other. This would probably involve some suggestions as to a system of conciliation or mediation before proceeding to some form of dispute settlement if the disagreements were still to persist. It would be necessary to have a text setting out all these issues in sufficient detail, but it would at the same time also be advantageous to add a checklist of issues, so that it would be possible to see at a glance whether all the items that needed to be dealt with had in fact been dealt with.

The Group agreed that it would be very helpful to have a commercial definition of what franchising was and what it was not, as well as a description of how it worked from a commercial point of view, without necessarily considering what the legal aspects of franchising were. Franchising might further be contrasted with other vehicles of international expansion such as licensing, as franchising was essentially a very elaborate licence, and with joint ventures which were often mistakenly identified

as something which had unique franchising aspects when in reality this was not the case. It was just another commercial vehicle was that in some cases coupled with franchising. Furthermore, it was considered that it would be helpful to note that a business system was often only one of the elements of the package. Many lawyers defined the grant of a franchise as a licence to use trademarks in connection with a business system, and defined the system as including certain kinds of know-how, most of which were not patented.

Specifically in relation to the proposed description of franchising, it was suggested that it would be necessary to stress the fact that the term "franchising" was understood in different ways in different countries, which explained why it was so difficult to compare statistics.

It was suggested that the preamble to the guide should stress the importance of the commercial law environment, without however going into detail. A principle focus should be whether the infrastructure of the country was adequate to support healthy franchising. That was particularly important if the main utilisers of the guide were to be found not in industrialised countries but in developing countries, because it was in those countries that this issue was of the greatest relevance. The questions which had to be considered were whether the country concerned had adequate trademark laws, adequate laws to protect trade secrets and to encourage franchisors to come into the country, because if it did not then franchising would not develop there. As to the question of whether or not something more was needed in the country besides an adequate legal infra-structure, it was proposed that an indication of the existence of codes of ethics as well as of legislation should be provided, although it was too early to determine whether any recommendations in this regard should be included. It was suggested that at most the reader should be informed of developments throughout the world and of where the source material was to be found. A discussion of the pluses and minuses could be included, although there would inevitably be different views on what was a plus or a minus. Hesitations were however expressed as to the advisability of describing existing legislative instruments and their advantages and disadvantages.

It was considered that the nature and extent of the grant should be dealt with in the guide. The principal issues were the system and the intellectual property rights that were being granted, whether the grant was or was not exclusive and which countries would be involved. The grants would contain some negative undertakings, such as the franchisor undertaking not to use the trademarks in connection with a third system. Another issue that should be addressed was alternative distribution channels, i.e. where the franchisor sold the same products outside the franchise network, whether these were or were not allowed and, to the extent that they were allowed, whether there were any limitations.

When the nature and extent of the grant of rights was considered, there should certainly be a description of the business system and of the intellectual property rights which formed part of that system as well as of any other element which might be included in the agreement. It was not a question of describing what should go into the agreement, but rather one of seeing that everything that the parties wished to include in the agreement really was there. A general description of the business system would form part of a clause of the kind envisaged, as would a description of the trademark and/or other intellectual property rights.

Another issue under the grant or nature of the grant which should be examined was the right of the sub-franchisor to own outlets as well as to sub-franchise and whether that was included in the

grant. There was a raging dispute going on under the European Community block exemption regulation as to whether or not that was possible.

The question of the applicable law would be one which would of necessity need to be considered repeatedly in the guide, so as to point out to the parties that if they did not take the applicable law into account the provisions which they drafted might function in a totally different manner from that intended, or might not even operate at all. The advantages and disadvantages for each of the parties of each of the conceivable solutions should be set out, including not only legal but also commercial factors, so as to draw the attention of the parties to the consequences of not dealing with the issue. The possible consequences of not choosing the applicable law in the case of arbitration should also be illustrated, especially if the parties had agreed on arbitration but had not clarified which law applied. It had happened that the parties to a contract simply included an arbitration clause in their contract without taking any form requirements into consideration. The arbitration court had then stated that it was not competent as the parties had not validly agreed on arbitration so they should go back to the State courts, but the parties still did not know to which.

Turning to the settlement of disputes, it was agreed that it would not be appropriate to involve franchising in a general argument on the respective advantages or disadvantages of State courts and arbitration. It would not be possible to arrive at a valid answer, because what was valid between countries A and B might not necessarily be valid between countries C and D. To give general guidelines on whether it was preferable to have recourse to State courts or to arbitration was a task which went beyond the terms of reference of the Group. The same was true of the possibility of providing guidelines as to which type of arbitration system should be chosen. The whole subject of choosing between different arbitration systems, or of choosing between State courts and arbitration, was not considered to be suitable for treatment in the guide. Similarly, instructing existing arbitration institutions on what franchising was, was considered to go beyond the mandate of the Study Group.

It was considered that what should instead be done in relation to the settlement of disputes was to point out to parties that they had to consider how disputes ought to be settled, that there were several ways in which this could be done, that in an on-going relationship mediation had certain advantages because it facilitated the continuation of the relationship, and that in the choice between arbitration and a court such and such other factors ought to be borne in mind. Among the factors enumerated would be the question of whether a judgment or an award could be enforced where enforcement was needed, in which respect it would be noted in the guide that there were enormous differences between different contracts: for example, if in a French/German dispute the question of enforceability would be quite different from that arising in the case of a United States/French dispute because in the first instance there existed a convention on the enforcement of judgments. No recommendations should necessarily be made: what should be pointed out was simply that different consequences would flow from different courses of action.

A proposal was made to meld with the guide an analysis of what approaches national Governments, national Parliaments and national systems had taken to franchising domestically. This would enable the Group to go through that analysis and indicate what was at the time of the completion of the guide the extent of intervention in each of the jurisdictions mentioned. It was however considered that this point was best dealt with only when a text was before the Group.

The use of manuals was an issue of importance in a franchising relationship as often, particularly in the franchise of an entire business format, the franchisor would use as the heart of its

system an elaborate manual which told the franchisee how to carry out each and every aspect of the business. This manual was the subject of detailed treatment in franchise agreements. In the case of international franchising the manual would have to be translated, but also adapted to the requirements of local regulations and laws. There were several issues connected with the manuals, which included those of who had the responsibility to adapt the system, copyright issues, ownership and the up dating of the manuals.

Related to the question of manuals and their use, but also to the actual presentation of the contract, was that of language. The importance of using the local language was stressed, as was the need to translate manuals which were to be used in another country. It was felt that one issue which should be addressed was the fact that if a certain language that came from a certain legal system was used, the words in that language were in some cases loaded with legal meaning that had been interpreted by hundreds of cases, statutes and regulations, and this meaning would in most cases not be clear to a person who, although he or she might speak the language perfectly well, had no knowledge of the particular way in which that terminology was used in the particular legal system. It was for example frequent for Common Lawyers to use terminology in the English language such as "consequential damages", "incidental damages" that had no meaning in Civil Law systems and yet to believe that these terms were capable of being translated when they drew up a contract with a Civil Law party.

It was observed that there were several issues which should be addressed in the context of language. The first was whether all parts of the contract should be in the same language. What, for example, would happen if the contract was in one language and additional documents in another? The second issue was that in the choice of the language when drafting a contract account should also be taken of the applicable law because that might actually affect the interpretation of the concepts used. These might in fact be interpreted in a way quite different from the intention of at least one of the parties.

Another point to be drawn to the attention of the parties was the need for home country counsel and host country counsel being able to work together to make sure that the intentions of the party they represented were already properly stated before they had the discussions with the other party as much confusion and misunderstanding could arise between people on the same team.

It was suggested that the question of quality control should be addressed as an independent heading, but although there was nothing to prevent it being given separate treatment, it was noted that typically it was dealt with in the manual. Many master franchise agreements required the sub-franchisor to own and operate the first five or ten units and therefore the basic standards, including quality control, would be covered in the master franchise agreement. This agreement would then provide that whenever sub-franchises were granted the sub-franchise agreement must contain standards that were at least as stringent as, or consistent with, the master agreement. Quality control could however be dealt with simply in a statement that the sub-franchisor agreed that all franchise units in the territory should maintain the quality control standards set forth in the manual.

The question of the importance of the international experience of the sub-franchisor was raised, as it had been suggested that a lack of such experience might give rise to problems. This was contested and the example given of franchisors who did not wish the sub-franchisor to think that it knew more than the franchisor and its system. There was however agreement that this was an issue worthy of discussion in a guide.

The preparation of a legal guide such as that under consideration was unanimously endorsed and enthusiastically greeted by the members of the Study Group. There was a consensus that an instrument such as the proposed guide would be invaluable as very often lawyers representing franchisees did not even realise the existence of problems and that there were ways of protecting their clients. This was true not only of lawyers in developing countries or developing economies, but also of lawyers in countries such as France and Germany.

Furthermore, it was felt that countries would be in a much better position to decide whether they needed laws, and if so what kind of laws, once this educational process had been undertaken. They would be able to identify areas of their country's law where something might need to be done, consider whether one impediment or another to franchising needed to be removed and whether they had to ensure that their infra-structure was adequate. Until people were aware of the kind of issues the Study Group had been examining it made little sense to speak in terms of legislation.

Doubts were however raised as to the wisdom of providing a manual to States encouraging them to consider which laws they would choose to adopt based on the understanding they had gained from this educational effort, since that might create great varieties of legislation, which would defeat the attempts of the Institute to achieve the harmonisation and unification of law. The Group could consider educating the business community as part of the many options open if that fell within the statutory aims of Unidroit, but it had also to consider whether legislation might be beneficial to promoting integrity and fairness in franchising as well perhaps as to promoting confidence and success in franchising as a vehicle for business development.

It was agreed that an outline for such a proposed guide should be examined by the Study Group and should then be presented to the Governing Council of Unidroit for approval. The outline as adopted by the Study Group is presented as Annex I to this report.

II. DOMESTIC FRANCHISING

Turning to domestic, or non-cross-border, franchising, three of the four areas discussed in relation to international franchising also merited consideration in this context. The only area which appeared not to necessitate further discussion was that of the applicable law. As long as domestic relations alone were being dealt with the only question which might arise was whether it was possible to derogate by a contractual provision from the law that would otherwise be applicable. This was however not a problem peculiar to franchising.

The information to be provided to a person contemplating becoming a party to a franchise agreement was on the other hand certainly an issue relevant also to domestic contracts, as was the information to be provided by the parties respectively during the life of the contract. The question of what happened on the termination of the master franchise agreement, or the effects of the eventual tripartite relation on domestic franchising, were also relevant, as was that of the settlement of disputes.

On the issue of pre-contractual disclosure, it was noted that where an obligation to disclose information existed, much was required of a franchisor contemplating the conclusion of a franchise agreement, that there were different types of arrangements, such as the requirement that the information be disclosed to an authority, which was however not the kind of question presently before

the Study Group. From the discussion the conclusion could be drawn that there was some doubt as to whether a statutory obligation to provide information substantially improved the situation, but the issue was whether the discussion which had taken place could be deemed to be conclusive for the purposes of the Study Group. The question was whether entering into franchise agreements today took place on the basis of sufficient and accurate information on the part of both parties and if any action to improve the present situation was desirable then what action should be foreseen.

It was pointed out that an obligation on the part of the franchisor to give full information to potential franchisees did not exclude the possibility of errors being made, although it did help the prospective franchisee to take a decision. Nor did such an obligation eliminate the risk of fraud. The necessity to create a balance between the need for prospective franchisees to receive information at the beginning of the relationship and the need of the franchisor to keep certain information confidential was also stressed.

There was agreement that parties made better decisions if they had access to all the relevant and important information bearing on their transaction, assuming that they analysed it carefully and properly. Of course that alone would not assure success, but it did enhance and promote the chances of success. Franchisors required detailed and extensive information from prospective franchisees in all their decisions. It would also behoove any prospective franchisee to obtain and to analyse carefully the information concerning the franchise system it was considering entering. The question was whether the need for that information ought to be settled by legislation or how it could be ensured that the franchisee who might not appreciate the need for this information, or might not be able to obtain it from the franchisor, could have access to it.

It was observed that, unlike any other business or trade practice, information in franchising as to the business that was being acquired was readily available: the best information was that available from other franchisees in the system from whom hand knowledge could be obtained of their experience of the franchise. Prospective franchisees had therefore access to the relevant information, but the question was whether they actively sought to acquire such information. Experience on this point varied among the members of the Group, some indicating that franchisees simply did not try to contact other franchisees in the system they were contemplating entering (this was true in Canada and the United States), while others instead indicated that when the prospective franchisees were advised to contact already existing franchisees in the system in general they did so (Germany).

The question of the liability of a franchisor for the publicity it used to sell its franchises was considered. As regards the United States, liability could arise out of such publicity, as even the franchise laws themselves could comprehend within them those types of documents, since they might constitute representations by the franchisor, they might further constitute representations which were inconsistent with what it was supposed to make, with what it was not supposed to make and with how they should be made under franchise laws. A further issue was whether franchising would be brought within the securities laws. In general this was not considered to be the case, because a security had been viewed historically as one in which the success or failure of the investment was almost entirely within the hands of the person with whom the investment was made, whereas in the case of a franchise it was clear that the success of the venture was to a significant extent in the hands of the person making the investment.

Reviewing the French experience with the *Loi Doubin*, it was observed that it was a law of mandatory application and that its non-observance could form the basis of a request by the licensee

for the annulment of the contract. In France an obligation to give information had always existed, for a seller in a sales contract in particular but also for a party granting a commercial licence (the *obligation de renseignement*). This general obligation had however not been considered to be sufficient, and this had led to the adoption of the *Loi Doubin*. In general the effects had been positive, as there were fewer bankruptcies of franchisees and there were those who felt that this was due to the law, as franchisees now had a much better idea of the effects of their entering into a franchise agreement. The cases of fraud which had previously occurred had been almost eliminated. Franchising had as a result become more healthy. It was pointed out that the *Loi Doubin*, which was mainly a law on disclosure, required the franchisor to disclose at least two years of financial information and provided for criminal sanctions for its non-observance. There was however one provision of the law which troubled United States, English and Japanese franchisors who had examined it, namely the last phrase of the second sentence of Art. 4(2): "et des perspectives de développement de ce marché". The concern was caused by the ambiguity of the language which made franchisors uncertain as to what was required of them. It was difficult for an American franchisor to tell a franchisee in perhaps a small and highly specific area within France what the prospects for the development of that market would be. That was so inconsistent with the approach taken under American law, where in most cases the franchisor was flatly prohibited from making projections or estimates to the franchisee of the likelihood of its success as a franchisee, that many franchisors were troubled by the nature of the obligation that might be imposed upon them, and by the liability they might assume by saying something which might later be described as highly optimistic estimates of the likelihood of success of the franchisee in that market place.

The Australian experience was different in that in 1980 a law with respect to petroleum franchising had been passed very much as a direct response to grassroots constituency pressure for the evening up of the bargaining position between retail service station operators and multinational oil company franchisors. That legislation was still in force. Subsequently a self-regulatory arrangement had been elaborated for the petroleum industry by three of the major franchisee organisations. This "Oil Code" had been very effective. In the mid 1980's there had been a discussion which had led to the preparation of a bill to regulate franchising separately. This had found little favour either at the level of organised franchisors, franchisees, their professional advisers or at that of the principal service providers, i.e. financial institutions. By 1986-87 it had become clear that even though a second draft of the legislation had been prepared there would not be adequate support and the Government had consequently refrained from legislating. A task force had been set up consisting of franchisors, franchisees, service providers and advisers and government officials that had inquired into the franchising industry generally. The outcome of the work of this task force had been the establishment of a Franchising Council as a limited liability company under the corporations law with as one of its principal tasks the development of what was now the *Franchising Code of Practice*. The Council had been set up and almost fully funded by the Government on the basis of a two year trial period. It was intended that by the end of the 1994 calendar year there would be a full-scale evaluation of the Franchising Code, of the degree to which franchisors had brought their franchising within the Code, of the degree to which service providers and advisers had signed up on the Code and a first attempt made to answer the question of whether or not this had led to better performance, fewer failures, and so on. About one month prior to the Study Group meeting the present Minister had concluded on advice from the Council that there had not been adequate experience and that there was not an effective majority of franchisors, service providers and advisers who had signed up on the Code for there to be a proper evaluation of its operation at the end of 1994. The Ministers had therefore agreed to extend the period to December 1995. The Code had however had a beneficial effect, and it was clear to those who paid close attention to the experiment that there was a far healthier climate now

than at any time over the last fifteen years. Although extending the trial period by another twelve months, the Government had nevertheless indicated to the franchising industry that it was prepared to look again at legislation if the majority of franchisors, of major advisers and service providers did not sign up under the Code.

The attempts at legislation and the subsequent adoption of a Code of Practice had been a response to the public disquiet at the lack of competence, judgment and morality amongst the connected group of service providers to investment generally. The outcome in the Code was something which each of the groups brought together in the task force - franchisors, franchisees, service providers, advisers and government officials - saw as being necessary to deal with the deficiencies of the recent past, but also to maintain a practical balance of what realistically business could live with.

The experience of the Canadian province of Alberta, where the stringent regulation of the franchise relationship had led franchisors to avoid entering the province, was also referred to.

As regarded ethical standards, reference was made to the Australian Code which in addition to the disclosure requirements imposed on franchisors also provided for certain disclosure requirements for advisers (i.e. lawyers and other professionals who advised on franchising) and service providers (banks and financial institutions). There was agreement within the Group that it would be most useful to extend disclosure requirements to these groups, although it was difficult to do so in view of the vested interests involved. In the United States there was a general notion that lawyers were adequately governed by the canons of ethics of their bar associations and that no special set of additional obligations should arise from the fact that their client was a franchise company instead of a real estate or manufacturing company. The issue was however not entirely settled. There were no standards in the United States as to what constituted an acceptable management consultant in franchising or outside of franchising and there were large management consultancy firms who earned enormous fees based on the authority they claimed in this area.

The *European Franchise Federation (EFF)* had adopted a *Code of Ethics* to which the associations affiliated with it adhered. In Germany the EFF Code of Ethics had not yet received a wide audience because it was not very specific on a number of issues, including pre-contractual disclosure, but courts had referred to it and to the fact that it contained a disclosure rule. It was not clear what this meant, but the courts had said that this was nevertheless a standard of the profession. The *German Franchise Association (GFA)* had made it a policy, which was not entirely shared by other members of EFF, that only members of the GFA should hand out this Code of Ethics because they adhered to it and therefore had a certain obligation to respect it, and it had attempted to prevent franchisors who were not members of the Association handing it out. Despite this, it could not be said that the Code of Ethics had had a real and considerable impact on the franchise business in Germany. In France courts had also referred to the Code and had taken it as an indicator of the standards of the profession. In the United States the *International Franchise Association (IFA)* had adopted a *Code of Principles and Standards of Conduct* which was likely to become very important, and the *Canadian Franchise Association* had recently promulgated a voluntary disclosure document.

The Chairman suggested that the Study Group should take into account the fact that in a number of countries the question was under consideration as to whether national legislation dealing with franchise contracts should be enacted. It was not certain that national legislators clearly knew at this stage what the outcome of such initiatives should be, nor were they very specific about the kinds

of franchise agreements to be dealt with. If national legislators were to pursue the matter rapidly, the consequence would presumably be that the substantive questions they would seek to deal with might vary greatly, and that the level of the legislation and how restrictive that legislation would be, would presumably also differ considerably. The Study Group should consider whether it would not be advisable to seek to develop some kind of instrument, the nature of which still had to be decided, that would set out issues of especial relevance if legislative activity were to be pursued. If that were to be the course the Study Group would choose to follow, it would have the benefit of providing advice as to those issues which were relevant and thereby offer advice as to issues which should probably not be touched upon and for which a regulation could be detrimental to franchising, the usefulness of which no one had doubted, neither in the Study Group nor in the Governing Council. Such an instrument, or paper, might in addition have the effect of ensuring some kind of a uniformity in options which national legislators might consider. The introduction to such a paper should also stress a point mentioned in the general discussion of the Study Group, i.e. that to provide legislation for franchising did not mean that all the problems had been resolved unless there was an adequate general legislation covering commercial agreements. It should also indicate that legislation directed specifically at franchising might be avoided if an adequate and well functioning general legislation for commercial contracts was in place. It should however be borne in mind that as soon as a development of importance to the economy took place which it seemed difficult to handle, it was a natural reaction to try to do so by means of legislation. The problem was that legislators also wanted to benefit from the phenomenon, but that if they adopted too far-reaching protection legislation they would not do so, and this had to be made clear.

As to the proposed role that this second instrument might have in assisting national legislators contemplating the introduction of specific legislation on franchising, it was suggested that while it was a wise policy not to recommend a specific course of action, some indication should nevertheless be given as to the ways and means available to those considering such action, and as to the areas to be considered and the methods that could be adopted. This might perhaps help ensure a certain degree of uniformity between different countries.

The increasing role of national franchise associations was also stressed in this context. The number of functioning franchise associations had increased rapidly in the last few years, particularly in the countries of Eastern Europe, Latin America and Asia. These associations were now beginning to deal with issues relating not only to codes of ethics, which they either had or were in the process of elaborating, but also with education. It was therefore suggested that the second proposed action be delayed until such time as it was possible to consider the guide to international franchising whose preparation the Study Group was proposing, and also to evaluate the results of the increasing efforts by national franchise associations and by the *World Franchise Council* which was in the process of being set up.

Hesitations were however expressed as regards the desirability of the Study Group's waiting to see what other groups might or might not do, in particular the World Franchise Council and it was therefore suggested that the Study Group should address these problems itself and consider whether it could come up with a product that was worth releasing to interested circles. One member of the Group noted that there was evidently a fear to recommend legislation in any form as that might be a burden on the franchising industry, but if some States were in any event going to adopt legislation, then it was suggested that even with codes of ethics or of conduct, if there was no harmony and uniformity among those codes, there would be an even bigger problem than before.

It was observed that a paper such as that suggested could submit a series of questions and a possible course of action for the consideration of legislators who were examining the possibility of introducing specific legislation for franchising, which would assist them in evaluating the effective need for such legislation. Those questions and the possible course of action could be the following: was there real evidence that problems existed? If there was real evidence of problems, how broad and pervasive those problems were should be determined. If there were problems, whether they were limited to particular types of industries as opposed to being industry-wide in nature should also be determined. If the problems were of this nature, then whether there were ways in which they could be resolved by resort to existing bodies of law - contract law, tort law, fraud, etc. should be determined. If they could be so resolved, then clearly whatever needed to be done to make people aware of the possibilities they had under current law should be done. If the problems could not be addressed under current law, then whether there were techniques for self-regulation which might be less intrusive and less onerous that ought to be considered should be determined. If self-regulation were considered, then an indication of the experience of other countries which had dealt with this should be given. If and only if the conclusion was reached that there was evidence of abuse which was broad, pervasive and not isolated, which was not limited to particular industries, which was not subject to being handled by existing law and which could not be handled by self-regulatory approaches and if legislation were therefore contemplated, then an indication should be given of some of the issues addressed by countries that had introduced legislation, of the problems that they had encountered and of the possible benefits obtained, etc.

There was general agreement on the advisability of the analytical approach suggested. **Mr Rose** suggested that what was necessary after this analytical approach had been followed was to give an indication of what was the best international practice being followed, i.e. the best international practice that was being followed not by other politicians in other countries, but by those who were leading the commercial professional field. The Unidroit Governing Council would be doing the wider community a disservice if it did not come up with a statement of best practice capable of evolving in response to the common law of commercial activity through the practice of the merchants of the day. It would on the other hand be doing a great service if it did produce a statement of best practice on the clear understanding, that might be expressly stated, that this was part of a rapidly evolving area of both commercial and legal activity and one in respect of which Unidroit would have to provide an after sales service on. A practical politician would be most grateful to have the analytical framework together with a statement of the world's best practice as seen through the eyes of, and as digested by, the scientific community as represented by Unidroit, but drawing very heavily on the experience of commercial practitioners and of their professional advisers.

CONCLUSION

The Unidroit Study Group on Franchising reached the conclusion that the items examined in the course of its discussion on international franchising did not lend themselves to being dealt with in an international convention. A broad consensus was reached on the fact that a guide would serve a useful purpose for international franchising and would be of invaluable assistance to both the business community and legal advisers alike. It was agreed that the outline of the proposed guide to international franchising as adopted by the Study Group should be submitted to the Governing Council for approval at its next session. If the Governing Council approved the outline, the Study Group would be responsible for the preparation of the guide.

In relation to domestic franchising it reached a lesser degree of consensus on the question of whether anything should be done in addition to the preparation of the guide for international franchising, although there was consensus on the fact that the information gathered in the process of the preparation of this legal guide would be of considerable assistance in clarifying the issues involved with a view deciding the approach to be followed. It was decided that for the time being this question should be deferred.

OUTLINE FOR THE PROPOSED GUIDE

1. Introduction

- why and how the guide was produced
- description of the guide and its basic characteristics
- franchising as understood in this guide
- distinction between franchising, licensing and distribution agreements
- distinction between franchising and other forms of technology transfer or technical cooperation
- legal environment in which such franchise agreements can function
 - specific franchise legislation
 - other legislation impacting directly on franchising

2. Options for international distribution

- description of the kinds of commercial vehicles available to the franchisor to franchise internationally
- indication the guide will deal with master franchise agreements
- considerations
 - economic environment of host country
 - attitude of host country to franchising
 - cultural communications
 - reasonableness of commercial expectations of the parties
 - assessment of market
 - knowledge and experience of the parties
 - the other party's business culture
 - the other party's international experience
 - the experience of potential sub-franchisors with franchising
 - commitment to cooperation
 - experience of potential sub-franchisors with franchising

3. General questions concerning the drafting of the agreement

- whether agreement is tripartite or not
- language of the agreement, manuals and other relevant documents
 - effects of the language chosen on the interpretation of the agreement
- general conditions and their role
- the role of the preamble to the agreement
- existence of several sub-franchisors in the same territory
- right to sub-licence trademarks and to extent sub-licensing not permitted, what options are available to the parties
- role of applicable law and choice of forum

4. Nature and extent of the grant of rights

- long-term arrangement requiring close cooperation
- description of franchise system
- description of marks, symbols and copyright
- other elements of the franchise system
- territory
- exclusivity v. non-exclusivity
- use of alternative distribution methods by franchisor
- rights retained by franchisor and not included in the grant of rights
- right of sub-franchisor to own outlets as well as to sub-franchise

5. Term of the agreement and conditions of renewal

6. Financial matters

- fees and other sources of revenue available to franchisors
 - control procedures
 - restrictions on payment of fees
 - cost of converting currency
 - initial payments for grant of franchise
 - per unit payments
 - ongoing or running royalties
 - marketing or advertising funds
- payment conditions and currency matters
- fiscal implications
- right of franchisor and/or sub-franchisor to retain allowances, discounts, etc. from suppliers to sub-franchisees
- impact on payment of fees to franchisor by sub-franchisor if sub-franchisees fail to pay fees to sub-franchisor

7. Obligations of franchisor

- training of sub-franchisor in franchise system and how to act as franchisor
- information
- assistance
 - management
 - commercial
 - technical
 - advertising material
- identifying and negotiating with suppliers of goods and services
- remedies for breach of obligations

8. Obligations of sub-franchisor

- network
- recruitment of sub-franchisees
- supervising use of franchise system

- quality control
- supervising use of trademarks
- establish offices and hire staff
- compliance with existing laws
- identifying of approving locations for sub-franchisees
- fulfilling obligations imposed on sub-franchisor in its capacity as franchisor under each sub-franchise agreement
- establishment of pilot outlet(s)
- translations of documentation
- adaptation of franchise system
- training of sub-franchisees
- confidentiality
- non-competition
- compliance with development schedule and consequences of failure by sub-franchisor to comply
- remedies for breach of obligations

9. Provision on manuals

- ownership
- updating manuals
- role of manuals

10. Advertising and control of the advertising

- award sub-franchisors existing in same territory
- apportionment of advertising fees

11. Supply of products and services

- exclusivity
- designated suppliers

12. Unit sub-franchise agreement

- parties to sub-franchise agreement
- obligation placed on one of the parties to prepare translation
- execution of agreements in different languages
- intervention by franchisor to sub-franchise agreement
- modifications to sub-franchise agreement
- amendments required to reflect transformation of unit franchise agreement to sub-franchise agreement

13. Intellectual and industrial property

- right to sub-licence
- right to bring action
- consequences of third party suit against sub-franchisor for infringement
- use of unregistered trademarks

- applications for trademarks that may not issue
- proper use of trademarks
- identification of sub-franchisor as user of trademarks
- content and limitations of the licence

14. Know-how

- identification
- clauses to protect the know-how during the contract and after its termination

15. System changes

- originated by franchisor
- originated by sub-franchisor
- ownership of system changes

16. Representations and warranties

- by franchisor
- by sub-franchisor

17. Insurance and indemnification

18. Sale, assignment or transfer of rights

- by franchisor
- by sub-franchisor

19. Expiry

- expiry of term and its consequences
 - consequences for the sub-franchisor
 - consequences for the sub-franchisee
- post-expiry arrangements

20. Termination

- termination by franchisor for default of sub-franchisor
 - consequences for sub-franchisor
 - consequences for sub-franchisee
- termination by sub-franchisor for default of franchisor
 - consequences for sub-franchisee
- post-termination arrangements
 - effect on existing sub-franchise agreements

21. Choice of law

22. Choice of forum

- Use of alternative dispute resolution
- negotiation
- mediation
- arbitration
- court proceedings
- enforcement of rights or awards

23. Ancillary documents

- commitment agreements
- option agreements
- management agreements
- combination franchises
- deposits
- escrows
- security arrangements
- collateral assignments
- equipment or inventory financing documents
- promissory notes
- leases or sub-leases
- approved supplier arrangements
- national account arrangements
- confidentiality agreements

24. Obtaining approval of agreement from regulatory authorities in host country (if necessary)

25. Use of test period arrangements

26. Other provisions

UNIDROIT STUDY GROUP ON FRANCHISING**First Session, Rome, 16 - 18 May 1994****List of Participants****MEMBERS**

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