THE FRANCHISING CONTRACT

Examination of the terms of franchising contracts

(Secretariat memorandum)

Rome, March 1989
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INTRODUCTION</strong></td>
<td>1</td>
</tr>
<tr>
<td>I. EXAMINATION OF THE TERMS OF THE CONTRACTS RECEIVED</td>
<td>8</td>
</tr>
<tr>
<td>1. Trademarks, tradenames, copyright and patents</td>
<td>8</td>
</tr>
<tr>
<td>2. Product exclusivity</td>
<td>9</td>
</tr>
<tr>
<td>3. Territorial exclusivity</td>
<td>9</td>
</tr>
<tr>
<td>4. Price restrictions</td>
<td>10</td>
</tr>
<tr>
<td>5. Fees and financial investment</td>
<td>10</td>
</tr>
<tr>
<td>6. Premises</td>
<td>11</td>
</tr>
<tr>
<td>7. Control of the franchisor</td>
<td>13</td>
</tr>
<tr>
<td>8. Independence of the franchisee vis-à-vis the franchisor</td>
<td>15</td>
</tr>
<tr>
<td>9. Termination of the contract</td>
<td>18</td>
</tr>
<tr>
<td>10. Consequences of termination</td>
<td>20</td>
</tr>
<tr>
<td>11. Jurisdiction and applicable law</td>
<td>21</td>
</tr>
<tr>
<td><strong>II. SWEDEN: DEVELOPMENTS REGARDING THE DRAFT LAW ON FRANCHISING</strong></td>
<td>21</td>
</tr>
<tr>
<td><strong>III. EUROPEAN COMMUNITIES: ADOPTION OF A BLOCK EXEMPTION FOR</strong></td>
<td>22</td>
</tr>
<tr>
<td>FRANCHISING</td>
<td></td>
</tr>
<tr>
<td><strong>CONCLUSION</strong></td>
<td>22</td>
</tr>
</tbody>
</table>

INTRODUCTION

At its 64th session, held in May 1985, the Governing Council requested the Secretariat to draw up a preliminary report on the franchising contract, with a view to deciding whether the subject should be included in the Work Programme for the triennial period 1987 to 1989. This report (C.D. 65 - Doc. 12) was considered by a sub-committee of the Governing Council at its 65th session in April 1986.

The material examined in the course of the preparation of the first report consisted mainly in articles and books published on the subject and available at the time, state laws of a number of those states of the United States of America which had adopted laws and regulations with reference to franchising, as well as the Rule and Guides on Franchising and Business Opportunities of the U.S. Federal Trade Commission. A number of problems connected with franchising came to light in the preparation of the preliminary report. These ranged from the actual nature of the contract which, being of a hybrid character, is not easily equated with other more traditional contracts, to the abuses which exist and the conflicts with existing, mandatory legislation such as competition law. A large number of divergences between the different countries examined, as well as a general lack of legislation (with only a few exceptions), were encountered. The different solutions experimented with in certain countries, such as the full disclosure procedures of the United States Full Disclosure Act (1979), were considered, as also was their suitability as providing elements for an international instrument.

The divergences encountered concerned:

- the nature of the agreement (whether it is a distribution, production, collaboration, association, or licensing contract or a particular business agreement);
- the parties to the contract (which may be either producer/wholesale dealer, producer/retailer or wholesale dealer/retailer but not two wholesale dealers);
- the bargaining strength of the parties - one is generally stronger than the other - which at times leads to abuses and to unequal contract terms;
- the form of the contract, whether it is express or implied and whether or not it has to be in writing;
- the nature of the goods or services offered or supplied by the franchisor, which should include know-how, and may include training, the method and/or organisation of the business to be followed, and advertising;
- what it is the franchisee is to exploit, i.e. a trademark or tradename, an emblem, a procedure, a formula or trade secret;
- the conditions under which the franchisee has the right of exploita-
tion, which may include set procedures, the franchisor's control (continuing interest), a fixed period of time and mutual exclusiveness (which is mostly territorial);
- the franchise fees and financial investment, which may be either substantial or small, and may comprise an entrance fee and/or royalties;
- the financial independence of the franchisee from the franchisor, i.e., they must not take the form of a holding company and its subsidiary, nor should they be subsidiaries of the same holding company;
- the organisational dependence or independence of the franchisee vis-à-vis the franchisor, whether they are part of a distribution network or are an association of equal companies.

Other elements the importance of which was stressed by the sources consulted were: the originality of the invention or product owned by the franchisor, the necessity of the goods or procedures having been previously experimented by the franchisor in pioneer establishments (stressed particularly in French literature), the necessity of continuously up-dating know-how, the problems associated with abuses and the termination of the contract (the fate of stock, non-competition clauses, the "indemnité de clientèle") and, as mentioned above, conflicts with anti-trust legislation.

While recognizing that franchising raised a wide variety of legal problems, some of which it might not be feasible to regulate at international level, the sub-committee of the Governing Council recommended that the subject be included in the new Work Programme. This recommendation was endorsed by the Governing Council which requested the Secretariat to submit the preliminary report, together with a questionnaire designed to elicit further information, to Governments, professional circles and recognized experts in the field.

Answers were received from: the Governments of Australia, Austria, Canada, Chile, Denmark, the Federal Republic of Germany, Italy, Japan, Luxembourg, Mexico, South Africa, Sweden, Switzerland, the United Kingdom and Venezuela. The Government of the United States of America indicated that the answers of the American based International Franchise Association should be taken as representing the position of the United States; Directorate-General IV, Competition, of the Commission of the European Communities; professional associations from Australia, Italy, the Netherlands, Sweden, the United Kingdom and the United States of America; and individuals (including corresponding collaborators) from Argentina, Canada, France, Italy, Morocco, Sweden, Thailand, the United Kingdom, the United States of America, Venezuela and Yugoslavia.

The points raised in the questionnaire concerned the following:
- the incidence of the different forms of franchising (including a specification in percentages) and the possible difference in incidence between national and international franchising;
- the existence, or non-existence, of legislation, whether aimed at
franchising in general, at the protection of the franchisee's rights against arbitrary rescission of the franchising contract or resale of the franchise by the franchisor, or at other problems which are of importance also to franchising — which may assume particular importance when it is considered that there is a general lack of legislation specifically on franchising;
- any other legal principles applied by the courts;
- cases decided on franchising, and the abuses which occur most frequently;
- the fees the franchisee pays the franchisor and their calculation;
- the codes of ethics and their importance;
- the particular difficulties encountered in international franchising as against purely national franchising, and differences between the two, such as differences in the obligations of the parties;
- the need for individual treatment for the different forms of franchising, or the possibility to cater for them all in one instrument;
- the form most fitting for an international instrument on franchising.

At its 67th session the Governing Council was seized of a survey of the answers to the questionnaire (C/D. 67 - Doc. 9), the findings of which may be summarised as follows:

- the frequency of different forms of franchising was indicated as being, in order: distribution, service, production, conventional, trademark licensing and business opportunity ventures, industrial, itinerant, capitalisation and lastly other combinations of franchising. Most answers indicated that there was no great difference between national and international franchising; however, several answers gave the frequency of the occurrence of franchising in different trade sectors and not by form of franchising; some, notably the British Franchise Association, contested the validity of the different forms indicated, speaking instead of "generations" of franchising with the business format franchise as the most recent development;
- it was confirmed that there was hardly any legislation specifically on franchising, while the legislation which might affect franchising concerned, inter alia, trademarks, patents, know-how and competition law. The question of the relevance of labour law legislation was also discussed in a few answers;
- other legal principles applied by courts were those on good faith and fair dealing;
- decisions by courts on or relevant to franchising were cited by answers received from Australia, Canada, France, the Federal Republic of Germany, Italy, Japan, Sweden and the United States of America;
- as concerned abuses, some answers indicated abuses both on the part of the franchisor and on the part of the franchisee. The most common abuses on the part of the franchisor were indicated as being misrepresentation, imposition of unfair or unduly restrictive terms, abuse of a dominant position (including arbitrary termination), discrimination between franchisees, unfair balance in performances between franchisor and franchisee and insufficient assistance on the part of the franchisor.
The most common abuses on the part of the franchisee were indicated as being failure to make payments, inadequate performance of obligations and objections to commitments in terms of commissions after serving apprenticeship and having come to "know it all";
- as regards fees, a variety of combinations of the different fees possible were given, some answers even indicating which was the most common in the different sectors. Some answers indicated a limit in the percentage allowed. Where criteria for the determination of the fees were given, they varied from a general indication of it being strictly a matter of agreement between the parties, to their being determined following market conditions and to a general requirement for their being conscionable;
- the importance given to the codes of ethics of the franchise associations varied greatly, ranging from "vital" to "marginal" - most answers considered them to be important mainly for specific purposes (such as, for example, the setting of standards);
- as regards particular difficulties encountered in international franchising, while some answers indicated that the problems encountered did not differ from those of any other form of international business, others indicated that the problems concerned the determination of the applicable law, jurisdiction and problems of recourse in a foreign jurisdiction, the divergences existing between the different national systems (which some indicated as enhancing the importance of the choice-of-law clauses), the failure to adapt the system to the foreign country or, alternatively, an excessive adaptation, the lack of trademark or tradename recognition, currency control restrictions, language problems, problems in the interpretation of the contract, problems for anti-trust disciplines and contrasts between internal and international anti-trust disciplines (notably in the EEC member States) and problems of training and control;
- with reference to a possible need for different treatment for different forms of franchising, the overwhelming majority of answers received considered that the different forms of franchising could be dealt with by the same instrument; and
- as regards the form for an international instrument, the majority of the answers indicated guidelines as the most suitable one. Several did, however, suggest uniform legislation, often in combination with a model law. However, the arguments put forward against uniform legislation, and even the adoption of a model law or model contract, appeared to be quite convincing.

In view of the answers received and of the developments expected both nationally and internationally, particularly the envisaged adoption firstly of the Draft Commission Regulation (EEC) on the application of Article 85(3) of the Treaty of Rome to categories of franchising agreements and secondly of the proposed draft law prepared by the Swedish Parliamentary Commission on franchising, the Governing Council decided to postpone any decision on future work on franchising contracts. The Secretariat was asked to submit a paper to the 68th session of the Governing Council, which would primarily examine the
actual terms used in franchising agreements and decisions of courts in different countries, and which would also consider the developments expected, particularly in the EEC.

Following this decision the Secretariat requested copies of franchising contracts from franchisors all over the world, guaranteeing confidential treatment of the material received.

At the time of writing (early March 1989) a total of sixty agreements (plus a model agreement by a professional association) have been received from 12 different countries: Austria (1), Belgium (1), France (1), the Federal Republic of Germany (6), Italy (22), Luxembourg (1), South Africa (1), Spain (2), Sweden (1), United Kingdom (16), United States (6) and Zambia (2). The model contract received was sent by the Netherlands Franchise Association and is to be found in a brochure on franchising published by the Coordinating Institute for Small and Medium Sized Businesses (Coördinerend Instituut Midden- en Kleinbedrijf). Furthermore, the information brochures given to prospective franchisees were sent by two franchisors (one from the United Kingdom and one from the Federal Republic of Germany) who did not send their contracts. Lastly, publications were received from four banks in the United Kingdom (National Westminster Bank, Midland Bank, Barclays Bank and The Royal Bank of Scotland) relating to the franchise information packs they offer prospective franchisees and franchisors. The Scottish Development Agency, which is active in the promotion of franchising, also sent a few of their information publications.

Of the sixty agreements received, 25 concern what could be considered service franchises, whereas 35 refer to distribution franchises. A few combine certain elements of both, and it is then their predominant feature which has determined their classification for the purposes of this report. The sectors concerned are as follows: distribution: clothing (9), electrical and connected equipment (7), food consumption (3), informatics (2), stationery (2), shoes (2), furniture (2), framing (2), maternity and child care (1), gift shops (1), bags and accessories (1), textiles (1), cosmetics (1) and homewares of food (1); services: cleaning services (6), window repair services (2), hotels (2), language/perfectioning schools (2), beauty centres of different kinds (2), publicity services (1), financial operators (1), travel agencies (1), drainage services (1), carwash services (1), employment agencies (1), printing (1), express couriers (1), thatching (1), production of chemicals (1) and breweries (1). The majority of agreements received concern domestic and not international franchising, although often the companies concerned originate abroad.

Despite the great variety of sectors concerned, as well as of the number of different countries from which these contracts originate, an examination of the agreements leads to the conclusion that in general the differences existing between them do not necessarily depend on sector or even country. A greater detail and clearer definition of the
contents of the franchising agreement is to be found in those countries where the phenomenon has existed for a greater length of time – not surprisingly, the longest contracts are those coming from the United States, where franchising started, and where several states have legislation containing disclosure requirements (one contract, annexes included, runs into some 200 pages or more). On the other hand, there are contracts from countries where the phenomenon is only now developing, or where it in truth has yet to develop, which can hardly be considered franchising agreements at all, being more similar to other forms of distribution or service contracts.

A certain difficulty was found in the retrieval of the addresses of franchisors. The franchise associations were contacted and five responded sending the list of their members (the Austrian, Australian, British, Italian and Swedish franchise associations – a list of members is also expected from the US based International Franchise Association). Furthermore, lists of franchisors to be found in published sources, such as the booklet "Fare afferi con il franchising" annexed to the November 1988 issue of the monthly economic periodical "Espansione", were also used. The result is that while the contracts from Austria, Sweden and the United Kingdom come from franchisors who subscribe to the ethical principles of their associations, this is not the case of the contracts received from franchisors in, for example, Italy, where only five of the twenty-two received come from franchisors members of Assofranchising (the membership, or non-membership, of franchise associations of some franchisors from other countries is not known, as not all membership lists are available to the Secretariat).

The relevance of the above observation in this context is perceived when one considers that while franchise associations are pushing for a general adoption of certain ethical standards (the activities of the British Franchise Association have been particularly successful in this respect) not all franchisors are members of their national associations and consequently not all feel committed to the ethical standards promoted by the associations. Statistics of the European Franchising Federation (which however exclude sales of automobiles, trucks, petrol, softdrink bottlers and hotels) indicate that in Italy there were in 1987 162 franchisors, whereas the Italian franchising association, Assofranchising, registered 29 full members and 12 potential members in 1988. Similarly, in the United Kingdom (EFF statistics limited to Business Format Franchises) the number of franchisors in 1987 was 244, whereas the British Franchise Association listed 89 members and 29 associates in 1988. Also in Sweden the figures are about half: 44 franchisors in 1987 as against 23 members of the Swedish Franchise Association and 11 applicants for membership. These elements should be carefully weighed when the desirability of a uniform regulation of the phenomenon is considered, particularly as the activities of the franchise association and the codes of ethics they have adopted are often proposed as an adequate substitute for regulation at whatever level, although the importance and long term effects of the
initiatives of the franchise associations should also not be under-estimated: while large franchisors in particular simply cannot afford to disregard the ethical standards proposed by their associations, one wonders whether the same holds true for smaller franchisors.

In the present report particular relevance will be given to points raised by the examination of the contracts received and which would require further consideration before any definitive judgment on the suitability of franchising for action on the part of the Institute can be formed.

Considerations of time have not permitted any extensive review of decisions of courts, and consequently the examination of purported abuses on the part of the franchisor, or for that matter on the part of the franchisee, has perforce to be deferred.

The description of the phenomenon attempted in the first study should be borne in mind when considering this report, i.e. that in essence, franchising may be considered a system for marketing a product or service. It is a contract between one party (the franchisor) and a second party (the franchisee) by which the former permits the latter to market a certain product or service under his trademark, tradename or symbol, against the payment of an entrance fee or royalty, or both. It is, however, the franchisee that makes the investment necessary to the business - he is a businessman in his own right and not an employee of the franchisor. Characteristic of a franchise is the transfer of know-how - this takes the form of an obligation for the franchisor to train the franchisee in the conduct of the business, in the organisation of the shop and work, with the franchisee in turn having to follow the instructions he has received and to act in conformity with his training.

Certain considerations of a general nature are here in order. Franchising is based on the renown of the tradename/trademark of the franchisor; thus all places of business using that tradename/trademark must, for the good reputation of all those concerned, meet the standards set for the business. In order to ensure this a certain amount of control on the part of the franchisor is essential (not to mention the fact that the trademark/tradename is the property of the franchisor and it would appear to be justified to allow him to control how his property is being used by other people). The question is the extent of this control and its nature. Similarly, the closeness of the relationship between the franchisor and the franchisees, as manifested in such aspects of the contract as the continued assistance offered to the franchisee by franchisor, may also give rise to doubts on the real independence of the franchisee vis-à-vis the franchisor, although, again, this closeness might be essential for the success of the system. Furthermore, as the idea is to promote the sale of a product or service, it would appear to be logical to permit a certain planning on the part of the franchisor as regards the location of the places of business concerned; however, any
such planning may be interpreted as being restrictive in terms of competition between enterprises and may therefore not be permitted.

It is not always easy to draw a distinction between those terms which, while to a certain extent being restrictive are yet permissible, and those which are not. The problem is how to guarantee the franchisor the control he needs over the business in order to make it a successful operation for all parties, while at the same time ensuring that the independence of the franchisee is not curtailed to the extent that he becomes an agent or a branch of the franchisor.

I. EXAMINATION OF THE TERMS OF THE CONTRACTS RECEIVED

1. Trademarks, tradenames, copyright and patents

The trademark, tradename, copyright or patent which characterises the franchise is the property of the franchisor. Thus, all actions to protect it are to be undertaken by the franchisor and not by the franchisee. Most of the contracts examined provide for a general duty of the franchisee to inform the franchisor of any infringements of these rights and it is then up to the franchisor to take action. A few contracts provide that the franchisee may take action on his own behalf if the franchisor does nothing, and the franchisor must then support him. Others indicate that the franchisor can request the franchisee to act on his behalf and at his expense - the only limitation being that if the franchisee takes independent legal advice he will have to pay for it himself. Although the franchisee is not the owner of the trademark, tradename, copyright or patent, he can often be registered as an authorised user of this right and some contracts provide for this possibility. Practically all the contracts examined provide that the franchisee may not use the trademark or tradename in his own corporate or firm name.

Similarly to these intellectual property rights, the goodwill of the enterprise also is considered to be the property of the franchisor, this being specifically stated in several contracts. Only one contract provides that on termination the franchisee is to be compensated for building up the system.

Several contracts refer to improvements to the system made by the franchisee. While most of them provide for a duty of the franchisee to communicate to the franchisor any improvements to the system he may have devised, giving the franchisor the right to introduce these improvements without paying the franchisee any compensation, only one contract gives the franchisee the right to use the improvements he has devised after termination of the contract, although this right is limited to such improvements as are not inseparable from the system as a whole.
2. Product exclusivity

Franchising is a system specifically devised to promote the sale of the products or services of the franchisor. He therefore clearly does not have an interest in selling the products of any one else. Most contracts thus contain an obligation of the franchisee to sell only products of the franchisor. Some contracts do, however, provide that the franchisee may sell products of other producers subject to the prior consent of the franchisor.

Similarly, most service franchise contracts provide for an obligation of the franchisee to acquire his supplies directly from the franchisor or from suppliers authorised by him. Only in a few of the contracts does the franchisor permit a franchisee to obtain products from other suppliers, and then if he demonstrates that the alternative supplier has consistently lower prices for products of the same quality.

It is interesting to note that some contracts allow the franchisor to vary the quantity or quality of the goods the franchisee has ordered from him, without the franchisee having any right to complain.

A new development increasingly to be found is that of what is termed a "combination franchise", or a franchise within a franchise, where a franchisor sells products and/or services within the unit of another franchisor. No data is, however, as yet available with reference to this development.

3. Territorial exclusivity

Most contracts provide for territorial exclusivity for the franchise, although a variety of limitations to this exclusivity are encountered in the different contracts: a limitation consisting in the franchisor having the right to open branches himself; a right for the franchisor to modify the territorial limits, or to permit another franchisee to open a unit, if the sales of the franchisee are a certain percentage below the target for a certain length of time; a right for the franchisor to conclude contracts to provide services of national importance and, if the franchisee is not up to providing the extra service required of him, to entrust another franchisee with the service or to carry it out himself, and, finally, in the case of an itinerant franchise, the right for the franchisor to open his own branches or to grant franchises with permanent premises.

It is to be noted that territorial exclusivity is one of the issues by which franchising might conflict with competition law (see, however, Commission Regulation (EEC) No 4067/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements annexed to this report). In fact, several contracts specifically exclude territorial exclusivity, providing instead for a
privileged position of the franchisee in the territory concerned.

4. **Price restrictions**

Another issue which is very controversial as it is considered to restrict competition, is that of the fixing of prices. Here, practice varies somewhat from country to country. While the majority of the Italian contracts quite happily state that the franchisee is to sell the products of the franchisor only at the retail prices indicated by the franchisor, which is quite permissible as there is as yet no anti-trust regulation in Italy, contracts from the United Kingdom often limit themselves to stating that the franchisee should consult with the franchisor as to the scale and level of charges to be levied on customers. At the other extreme, contracts in the United States will often specifically state that franchisees are free to fix prices.

Connected with provisions restricting a franchisee's liberty to fix the prices of the products he is selling, is the practice of restricting the franchisee's ability to hold promotional sales or end of season sales. Not only do several contracts provide for restrictions as regards the period when such events are to be permitted to take place, often specifying the days of the month when they are allowed, restrictions also refer to the prices which can be charged for the goods, and to what items of their stock can be sold - some franchisors even provide for a particular stock which is to be sold on sales and which can be requested by the franchisees.

5. **Fees and financial investment**

One of the main features of a franchise, and one which was stressed in the description we gave above, is that the franchisee is an independent entrepreneur, that he invests his own money and bears all the financial risks of the operation. In general, the European franchising contracts examined do not refer to the investment needed to open and run the franchise - at times this information is provided in the information brochures describing the business which franchisors give franchisees. The situation is of course different for American contracts, as franchisors in the United States have to comply with the disclosure requirements of the applicable law, meaning that a considerable amount of financial information is provided in the documents annexed to the actual contract. This includes audited financial statements in addition to information on the financial investment which the franchisee would be required to make. It is interesting to note that one British contract specifically states it as a duty of the franchisee to ensure that he has adequate financing to enable him to perform his obligations and by way of working capital.
Certain differences again exist between contracts originating in
different countries as regards the fees the franchisee is required to
pay. While in Italy it is rare for a franchisor to charge an entrance
fee, royalties in general being preferred, in other countries both
entrance fees and royalties are of the order. One interesting point is
that whereas in the civil law countries renewal of the contract is
almost always automatic unless notice for termination is given, in the
common law countries the franchising contracts are mostly renewed
following a notice to the franchisor of the intention of the franchisee
to continue in the relationship. It is not, however, a simple renewal,
as a new contract is signed between the parties, which is the fran-
chising contract offered by the franchisor also to new franchisees at
the time of renewal, the difference being that the entrance fee charged
new franchisees is either not to be paid or only to be paid in part.

Royalties are the most common of the fees charged franchisees, and
usually take the form of management services fees which are supposed to
cover the expenses incurred by the franchisor for his continued
assistance to the franchisee during the term of the contract.

Royalties may or may not include a fee charged for the advertising
conducted by the franchisor on behalf of his franchisees. Normally both
the royalties and the advertising fee are expressed in terms of a
percentage of gross sales (plus V.A.T.). It is interesting to note that
some contracts provide for a duty of the franchisor to prepare an
audited statement of his expenditure on publicity, and to supply the
franchisee with this statement should he request it. If it is found that
the franchisor has over- or underspent an adjustment will be made in the
following year.

Normally the fees due are paid by the franchisee to the franchisor
within a time-limit which is specified in the contract. In at least one
instance, however, the reverse was provided for, i.e. all payments from
the clients of the franchisee went into a special account managed by the
franchisor, or directly to the franchisor, who then, after having
deducted the sums due to him, paid the franchisee - which is an
arrangement which raises doubts as to the independence of the franchisee
vis-à-vis the franchisor.

6. Premises

As the franchisee is an independent entrepreneur it is only
logical that he should provide for the premises of the business he
proposes to undertake. There are, however, certain restrictions attached
to this. Firstly, a majority of the contracts provide that the
franchisor must approve the premises, although some merely provide for
advice to be given by the franchisor, stating that it is then up to the
franchisee to decide, and that the franchisor takes no responsibility
for the consequences. Several contracts not only provide for advice to
be given by the franchisor in the selection of the premises, they also
provide for locational studies to be prepared by the franchisor and his
experts, including such matters as the density of the population, the
competition in the area, the needs of the local population etc.

One aspect concerning the premises which a correspondent has
indicated might be worthy of deeper consideration when examining the
ties between franchisee and franchisor is that of the leasing of the
premises and/or equipment. Our correspondent indicated that there were,
to his knowledge, instances of franchisors who leased premises and/or
equipment they owned to franchisees. This in itself might indeed be
considered more of a facilitation for the franchisee than an onus, if it
were not for the fact that often the terms of the lease were such that
it gradually became too expensive for the franchisee to keep the
business going. In other words, the franchisee was forced out of
business and had to be thankful to the franchisor who agreed to release
him from the contract. Our correspondent stated that most of the gain of
the franchisors did not come from the fees collected, but rather from
the leases. A different view expressed by another correspondent was that
a franchisee should be no worse off if the franchisor is his landlord
than if he were not, in view of the restraints which can be imposed on a
franchisee on and immediately after termination of the contract. He
pointed out that in some cases landlords will only grant leases to
franchisors who have greater financial strength than franchisees, and
that this might be the only route into business for a franchisee. With
reference to the leasing of equipment, he pointed out that franchisors
will usually only grant leases of equipment where the equipment is
patented or is such a vital component of the franchise operation that
they would not want the equipment to remain with the franchisee on the
termination of the franchise agreement.

Only a few of the contracts examined make any reference at all to
leasing, be it of premises or equipment. A few provide that the
franchisee must ensure that the leasing contract for the premises
includes the option for the franchisor to take the place of the
franchisee in the rental contract if the franchise relationship were to
terminate. Similarly, others provide for two distinct possibilities:
either the franchisor takes out the lease, or the franchisee takes out
the lease in his own name but enters into a deed of option in the
franchisor's favour - the franchisee must, however, obtain the consent
of the franchisor for terms and conditions of any lease to be granted or
assigned to the franchisee. On the other hand, in one instance the
contract specifically requires that the franchisee make it absolutely
clear in the leasing agreement that he and he only is the tenant and
that the franchisor does not have any obligations with respect to the
landlord. Clearly, the information offered by the contracts examined is
not sufficient to bear out the view of either of our correspondents —
any cases brought on this point would have to be examined, and the
experience of former franchisees would have to be heard for an objective
opinion to be formed on this matter.
A last point to be raised in connection with the premises concerns their re-fitting for the purposes of the activity to which they have been destined. The majority of the contracts examined provide that the premises are to be re-fitted following the instructions of the franchisor, and that the unit is not to become operative until the franchisor has approved it. Whether or not the franchisor provides assistance for the re-decorating, sends over his architects and experts, varies from contract to contract. Often it is not the franchisor himself who has this technical expertise at his disposal; instead he has agreements with professional firms. He then advises the franchisee on whom to contact, and the franchisee pays for both the actual expert opinions received and for the work to be undertaken - in the first case the franchisor will in most cases provide the advice free of charge. Furthermore, often the franchisor has special arrangements, or collective-type agreements, with construction firms which undertake re-fitting and re-decorating of premises, to which the franchisee can turn for, presumably, better conditions.

A curious feature of some contracts is the provision regarding the telephone of the franchised unit. While most contracts limit themselves to providing that on termination the franchisee must arrange for such changes to be made in the registration of the 'phone and entries in 'phone books as to take care of the changed situation; there are some contracts which specifically state that the contract with the telephone company should be made in the name of the franchisor and that the use of the 'phone by the franchisee (or his employees) is to be strictly limited to business calls.

7. Control of the franchisor

As indicated above, it is of paramount importance for the franchisor, indeed also for franchisees, to be able to count on performances of uniform quality on the part of all members of the chain. The first step towards ensuring a certain degree of uniformity is that of providing for the training of the prospective franchisees. Most contracts in fact do this, some also indicating the availability of additional training and of periodical up-dating on new developments. The difference often lies in the fact that, whereas the first training is supplied free by the franchisor (or is calculated as being included in the entrance fee) only the current expenses of attendance being on the franchisee, for any subsequent training it is in most cases the franchisee who has to pay for everything - course included. The contracts often, but by no means always, provide that attendance at the training courses is mandatory, as is also the conducting of the business in conformity with the training received. A few contracts further place an obligation upon the franchisee to provide training for his employees.

Most of the contracts provide for a duty of the franchisor of continued assistance to the franchisee. This continued assistance takes
a great variety of forms, although the details do not seem to depend on any objective factor such as the trade concerned. The most common form is that of ensuring that the franchisee has continued access to personnel of the franchisor able to help him out if he has any problems. Furthermore, counselling on matters such as the selection of stock is provided for. One form of continued assistance which might border on too close a relationship is that of the franchisor sending in his own personnel to assist with the administration or management of the franchised unit when sales fall too low. Furthermore, assistance is at times offered in the negotiating of contracts, which might again be considered to indicate too close a relationship.

An important factor in the control the franchisor has over the activities of the franchisee is clearly that of the reporting system: the preponderant majority of the contracts examined provide for reports of one type or another being made periodically to the franchisor. These include monthly balance sheets and profit and loss accounts, audited annual financial statements, copies of monthly V.A.T. returns, accounts on spending on advertising and promotional activities, state of stock reports, copies of insurance policies taken out and of the receipts for the premiums paid, copies of tax declarations of the franchisee and, where the franchisee is a corporate body, of its directors, and copies of the orders placed by customers and of the receipts and invoices for all goods sold. At times a mere general indication of the franchisee having to furnish the franchisor with the information he needs on the activities of the unit suffices to cover all possible combinations of the above and more thereto.

All the statements furnished by the franchisee are normally subject to verification by the franchisor. Most contracts give the franchisor, or his agents, the faculty to enter the premises of the franchisee (at times this faculty is restricted to the opening hours of the unit, at times there is no restriction as to when the franchisor and his agents may enter) and to inspect the ledgers of the franchisee and all his documentation, at times also to make copies of the documents and to take them away for control - in one case the franchisor was allowed to remove the books themselves, not only the copies he had made. One wonders whether the franchisor, having this extensive power of supervision over the books of the franchisee, could not be held liable for any irregularities subsequently found by the authorities in the franchisee's accounts.

To this right to enter the premises of the franchisee to inspect his books, must be added the faculty of the franchisor to enter the premises of the franchisee to inspect the premises themselves, to check that the franchisee conducts the business in conformity with the instructions he has received, and even to speak or write to customers of the franchisee to control the performance of the franchisee.
8. Independence of the franchisee vis-à-vis the franchisor

Closely connected with the reporting system is the whole question of the independence of the franchisee vis-à-vis the franchisor, of the closeness of the links between them. A couple of points have already been indicated as possible moot points in this respect, and there are several more. In each case, a potential conflict can be perceived between the interests of the franchisor and the franchisee; on one hand and the need to guarantee the franchisee's independence, and thereby also the characteristic of a franchise constituting a form of collaboration between two independent entrepreneurs, on the other.

An indication also to the public of the essentially separate identity of franchisee and franchisor is required in several contracts, some specifying the words the franchisee should use on placards and invoices to indicate that his business is a franchise. Furthermore, several contracts specifically require the franchisee to be registered in such commercial registers as national legislation requires, as well as in those other official registers in which he must be entered in order to conduct his business, e.g. in Britain H.M. Customs and Excise (for V.A.T.). Any permits required for the carrying on of the business concerned on those particular premises have also to be obtained by the franchisee (e.g. for the locating of a fast food franchise in a place of great cultural interest).

The contracts as a rule merely touch upon the thorny question of labour law, stating that the franchisee and franchisor are independent businessmen, and that nothing in the contract is to be construed so as to indicate that the franchisee is an employee, agent or representative of the franchisor. A specific prohibition for the franchisee in any way to make out that he is the franchisor, or represents the franchisor, is usually also added.

Certain indications are, however, contained in some contracts as regards the employees of the franchisee, and there are those which might give rise to objections - a couple of the contracts actually go so far as to state that the franchisee is only to hire personnel approved by the franchisor. Others limit the prerogative of the franchisee by stating that the franchisee should not hire anyone who was an employee of the franchisor, or of other franchisees of the franchisor, for a certain period of time after they have left their employment. This latter restriction might, however, be understandable from the point of view of internal competition in the chain, and the risk of franchisees enticing employees from each other - in fact, the provision incorporating this restriction usually also prohibits the inducing of such persons to leave their jobs.

Also, other aspects of the conducting of the business are subject to regulation in the contracts. In a couple of cases even the holidays of the franchisee are decided by the franchisor, which does not appear
to be reconcilable with the franchisee being an independent entrepreneur. The same holds true when the franchisor decides on the opening hours of the unit, although there are cases where the whole point of the business is to have very particular opening hours (e.g. convenience stores). Again, the providing of a centralised service by the franchisor for the procurement of business, the invoicing of clients, the collection of payments for services rendered by his franchisees and for the payment of the money due to the franchised units might raise doubts. As indicated above, some contracts provide for the possibility for the franchisor to step in and to take over the administration or management of the franchised unit if sales fall short of the target for a certain, specified length of time. The same possibility is given in some contracts in the case of the death or incapacity of the franchisee, when the representatives of the franchisee, or his heirs, may request the franchisor to take over until the question of what is to be done with the franchise has been settled. Usually, when the franchisor does take over, it is for a limited period of time, and at the franchisee's expense.

As mentioned when considering the situation of the premises, the franchisor gives instructions on the re-fitting of the premises, on their interior decorating, etc. and the franchisee must follow these instructions. What can here be added, is that there are contracts which not only subject the commencing of the operations to the approval of the premises by the franchisor, but also give the franchisor the right to remove any material or other thing whatsoever which in his reasonable opinion does not conform with the uniformly high standards associated with the tradename.

The franchise contracts examined as a rule subject the right of the franchisee to sell the franchise to the fulfilling of certain conditions (the prospective buyer must be prepared to enter into the same type of contract, must offer the same guarantees as the original franchisee etc.). On the other hand, several contracts contain a provision stating that the franchisor has the right to assign his business without the franchisee having any say in the matter. It could clearly be argued that it is only fair, considering that the enterprise belongs to the franchisor, although the special links which exist between them would call for some form of consultation (which, indeed, is provided for in one contract).

The franchisor's written consent must, according to some contracts, be obtained also when a franchisee desires to form a corporation in which he owns the controlling interest, and wishes to transfer the franchise to this corporation. In such cases the contracts provide that the franchisor's consent will not be withheld if the franchisee gives certain guarantees, e.g. he personally guarantees the performance of the contract by the corporation and also remains personally liable and guarantees all credits etc.
One point which illustrates the close ties existing between franchisor and franchisee is that of the insurance policies the franchisee has to take out. Several contracts provide that the franchisor should be listed as beneficiary of the insurance, some that the franchisor’s interest should be noted on the policies, while others instead provide that the insurance should be taken out in the joint names of the franchisee and the franchisor. Again, several contracts provide that the franchisee should arrange with his insurers that no policy is terminated or cancelled, for whatever reason, unless the franchisor has received a certain period of time’s notice of the intention of the insurers. Others again provide that the insurers of the franchisee should inform the franchisor of any premiums which the franchisee has not paid.

Specifically as regards the goods, there are contracts in which the franchisor reserves title in the goods until they have been fully paid by the franchisee, and some contracts subject their sale and delivery to the franchisee to the franchisor’s standard terms of trade, which are usually annexed to the contract. However, these contracts often also contain a provision to the effect that the franchisor may modify these standard terms from time to time, and that they are to be applied in their new, revised version, after a certain number of days of their having been communicated to the franchisee, the franchisee having no right to make any objections to the proposed modifications.

Franchisor and franchisee are also closely linked in the advertising of their products. Considering that they are part of a network, this is hardly surprising and can clearly be justified by policy considerations. The tendency of most of the contracts examined is for the franchisee to pay a fee each month to the franchisor who then uses the funds he receives to advertise and to promote the business at a national level. Usually the franchisee is responsible for local advertising, although he must always obtain the approval of the franchisor for any publicity campaigns he intends to embark upon, so as to ensure that they conform to the general promotional policy of the business. Often the franchisor provides all the publicity material that the franchisee is to use. One case deviates from this, in that the franchisees do not pay the franchisor, but pay their fees into a bank account which all the franchisees administer together, the utilisation of the funds thus being decided by the franchisees in concert.

A few contracts go along these same lines as regards the general policy of the franchise network, by providing for a council of franchisees to consult together with the franchisor on such matters as publicity campaigns, the introduction of modifications into the system and the general approach to be followed.

Lastly, reference must here be made to the non-competition clauses the great majority of the contracts contain. Not unnaturally, a first non-competition clause refers to the period of the duration of the
contract: the franchisee is required not to engage in businesses competing with that of the franchise. The non-competition clauses which refer to the period after the termination of the contract are usually more detailed, some containing not only a specific time-limit, but also territorial limitations (within his old territory, within the territories of the franchisor and of other franchisees), differentiating between the different territories. Furthermore, certain differences exist as regards the type of competing business, and as regards the type of interest the former franchisee has in the other activity (shareholder, partner, whether or not he has any control over the policy of the other business etc.). Again, provisions of this nature must be considered also from the point of view of the possibility of their conflicting with competition law.

9. Termination of the contract

The arbitrary termination of the franchising contract by the franchisor was one of the points indicated as an abuse by the answers to the questionnaire the Secretariat submitted to Governments, professional associations and experts on franchising. The provisions which refer to termination in the contracts examined are, with few exceptions, very detailed indeed. Again with few exceptions, they refer almost exclusively to the franchisor's right to terminate the contract. Only a few of them contain any details on when the franchisee is allowed to terminate the contract, and only one is close to granting the two equal rights.

A point of interest is that a few of the contracts contain a provision which is common in certain countries for consumer transactions, i.e. the buyer (in this case the franchisee) is allowed a certain period of time, usually seven days, to regret his acquisition (what in Swedish is termed an "ängervecka"). The majority of the contracts, however, instead provide for possibilities for the franchisor to terminate the contract before it has truly become operative. Thus, several state that if, during the training courses, it becomes apparent that the franchisee is not suited for the task, the franchisor is allowed to terminate the contract. In such cases the franchisor is normally to return the entrance fee the franchisee has paid, minus a certain sum as indemnity for the costs the franchisor has incurred. A right to terminate the contract is often also provided for the franchisor if the franchisee does not begin operating his unit within a certain period of time after the conclusion of the contract, if he does not obtain all the permits necessary for the operation of the business from the premises selected, if the premises are no longer available, or if the entrance fee is not paid within a certain amount of time after the conclusion of the contract.

The grounds on which the franchisor is allowed to terminate the contract do not differ that much from one contract to another; there are
simply more or less of them. The most common include the following: breach of any obligation under the contract; breach of the duty of confidentiality; breach of the obligation to sell only the products of the franchisor; non-compliance with the instructions given for the re-fitting of the premises; delay in the payment of the fees; non-keeping of the standards required; non-compliance with the obligations related to the hiring and training of the personnel; failure to display the publicity material of the franchisor; non-compliance with the fixing of the prices by the franchisor; non-observance of any territorial limitations set for the activity of the franchisee; delay or non-payment of the suppliers; non-compliance with the insurance coverage requirements; misuse of the intellectual property of the franchisor; not turning to the authorised leasing company; non-observance of the non-competition clause; non-compliance with the directives on the management of the unit; withdrawal of the licences required; termination of the lease for the premises; giving false information in the reports submitted to the franchisor; turnover not reaching the target for a specified period of time; a change in the active leadership of the franchisee (several contracts specify that the franchise is granted intuitu personae, because of the confidence the franchisor has in the franchisee, which is also given as a reason for any sale of the franchise by the franchisee having to be approved by the franchisor); failure by the franchisee, within a certain period of time after notice by the franchisor, to remedy a breach which can be remedied; discrepancies in the auditing of the franchise; the franchisee copying the Operations Manual supplied by the franchisor (which several contracts state is the property of the franchisor and of which the franchisor holds the copyright); prolonged illness or inability of the franchisee; the franchisee being convicted of an offence directly related to the business conducted; insolvency; bankruptcy; winding up of the business; the franchisee entering into voluntary or compulsory liquidation; appointment of a receiver; and if the franchisee questions, disputes or attacks the validity, right, title or interest of the franchisor as to the franchisor's intellectual property.

Other, more unexpected grounds for termination on the part of the franchisor include the franchisee becoming of an unsound mind, the franchisee having misrepresented facts which, if properly presented, would have caused the franchisor not to have entered into the contract—which is normally something one would have expected from the other side, as misrepresentation on the part of the franchisor is one of the abuses usually associated with franchising.

Two provisions found are particularly interesting. One refers to the exclusion of contract terms which are found to be illicit by the courts, or which become so following legislative provisions taken at some time in the future. Where these are terms the exclusion of which would adversely affect the franchisor’s right to receive payment of the fees and of any other sums due for the supply of goods or services to the franchisee, or would materially adversely affect the intellectual
property and the know-how of the franchisee, the contracts concerned provide for a right of the franchisee to terminate the contract. The second provision is a force majeure clause which provides that both parties shall be released from their obligations in the event of war, national calamity etc., adding, however, that the clause shall only have effect at the discretion of the franchisee, except when such an event renders performance impossible for a continuous period of twelve months.

Grounds for termination on the part of the franchisee are not often provided, and when they are, they are usually limited to the breach of any substantial provision of the contract, and to the franchisee going bankrupt or becoming insolvent.

It may be added that in general franchising contracts are renewed automatically unless notice for termination is given by one of the parties, the exception being the United Kingdom where the rule appears to be the reverse, i.e. notice has to be given by the franchisee if he wants to renew the contract, and then it will only be renewed subject to the conditions specified in the contract.

10. Consequences of termination

A majority of the contracts examined contain provisions regulating the obligations of the parties after the termination of the contract. One of these obligations has already been mentioned, viz. the obligation placed on the franchisee not to compete with the franchisor and his system. Other obligations include the returning of the Operations Manual furnished by the franchisor and the removal of all signs and symbols which may link the former franchisee with the franchisor. Several contracts grant the franchisor the right to enter the premises of the franchisee to make such modifications of the premises as are required if the franchisee has not done so within a certain amount of time, and this at the franchisee's expense.

The problem of the remaining stock is one which is addressed in only a minority of the contracts - most of the contracts say absolutely nothing about this. Of those that do consider the question, the majority give the franchisor the faculty to buy the stock back from the franchisee - at reduced price and on certain conditions (the goods must still be in their original packing, etc.). In one instance the franchisee is granted the right to hold sales of the goods he has left over.

An option for the franchisor to buy back material he has furnished the franchisee is at times also provided as regards the promotional material. Only in one of the contracts examined is the franchisee granted an indemnity for having contributed to the building up of the system, and in only one other instance is the franchisee granted the return of a proportion of his capital investment. As indicated above, there is also only one instance in which the franchisee is permitted to
use improvements he himself has made to the system - on condition that these improvements are not too closely linked with the system itself.

11. Jurisdiction and applicable law

Two possible other problem areas indicated by one of the correspondents are those of jurisdiction and applicable law. As regards the first, he considers that if the parties agree on arbitration, then the rights of any third parties might be endangered. As a matter of fact, the majority of the contracts examined normally state that the court at the place of business of the head office of the franchisor is to be competent for any disputes arising under the contract; surprisingly few select arbitration. The fear expressed by this correspondent is not shared by another, who does not appear to see any particular dangers for third parties. He reflects instead on the fact that there are differing views as regards the suitability of franchise agreements for arbitration. A certain advantage in arbitration might, he states, be seen in the swiftness of the procedure (although this might be questioned with reference to international arbitration) and in the fact that it is likely to be less expensive. He does, however, see the fact that immediate relief, in the form of an injunction, cannot be obtained using arbitration as a deterrent for franchisors choosing arbitration. He considers the question of the choice of applicable law to be more interesting, although he concludes that the problems involved are not limited to franchising.

Linked with the above is the question of the taxation of royalties and of the exportation of currency which, the second correspondent states, is an issue which is only likely to cause problems if it is not taken into consideration at the time of the drawing up of the contract. He further points out that any problems would probably effectively be dealt with by the double taxation agreements which exist. The first correspondent, however, considers the question of taxation to be one of the most important ones for franchising in the future, and goes so far as to state that any international instrument on franchising would, to be worthwhile, have to deal with this question.

II. SWEDEN: DEVELOPMENTS REGARDING THE DRAFT LAW ON FRANCHISING

The draft law on franchising prepared by the Swedish Parliamentary Commission on franchising was expected to be adopted by Parliament in the course of 1988 and to enter into force on 1 January 1989. As it happens, this has not occurred. The draft has been severely criticised and is opposed by the interests concerned. It has not, however, been abandoned. The Minister of Justice has, in accordance with the legislative procedure in Sweden, invited the bodies usually consulted
for such drafts to give their opinion and these opinions are still arriving at the Ministry. Exactly when any definitive steps will be taken is not, as yet, known.

III. EUROPEAN COMMUNITIES: ADOPTION OF A BLOCK EXEMPTION FOR FRANCHISING

On 30 November 1988 the Commission of the European Communities adopted a Regulation on the application of Article 85(3) of the Treaty of Rome to categories of franchise agreements (Regulation No 4087/88 published in the Official Journal of the European Communities No L 359 of 28 December 1988, p. 46 et seq.), the text of which is annexed to this report. It is a revised version of the Draft Regulation annexed to the Secretariat report submitted to the Governing Council at its 67th session. No official or authoritative comments on the Regulation as adopted have as yet been published. Careful consideration should be given to this Regulation and to its implications for the future of franchising. It is proposed that this be attempted for the next session of the Governing Council, should the Governing Council decide that franchising is a subject the study of which should be continued.

CONCLUSION

The examination of franchising contracts undertaken by the Secretariat, the results of which have been presented in this paper, does not furnish sufficient material to permit a definitive view on the suitability of franchising for regulation by an international instrument. As the examination progressed, the Secretariat became increasingly convinced that actual disputes which have arisen between franchisors and franchisees would have to be examined in order to evaluate the importance of factors indicated by the answers to the questionnaire as forming abuses (notably misrepresentation on the part of franchisors). While it certainly is true that the great majority of the contracts provide for very close ties indeed between franchisor and franchisee, often the nature of the business concerned is such that close ties are not only justified but essential. As indicated in the Introduction, it is a question of degree, and it can be very difficult indeed to draw a distinction between those terms which are justifiably restrictive and those which are not. Furthermore, franchising combines aspects of a large number of distinct areas already subject to legislation and/or international agreements. Any action on the part of the Institute should thus be carefully considered.
COMMISSION REGULATION (EEC) No 4087/88
of 30 November 1988
on the application of Article 85 (3) of the Treaty to categories of franchise agreements

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Regulation No 19/65/EEC of 2 March 1965 on the application of Article 85 (3) of the Treaty to certain categories of agreements and concerted practices (1), as last amended by the Act of Accession of Spain and Portugal, and in particular Article 1 thereof,

Having published a draft of this Regulation (2),

Having consulted the Advisory Committee on Restrictive Practices and Dominant Positions,

Whereas:

(1) Regulation No 19/65/EEC empowers the Commission to apply Article 85 (3) of the Treaty by Regulation to certain categories of bilateral exclusive agreements falling within the scope of Article 85 (1) which either have as their object the exclusive distribution or exclusive purchase of goods, or include restrictions imposed in relation to the assignment or use of industrial property rights.

(2) Franchise agreements consist essentially of licences of industrial or intellectual property rights relating to trade marks or signs and know-how, which can be combined with restrictions relating to supply or purchase of goods.

(3) Several types of franchise can be distinguished according to their object: industrial franchise concerns the manufacturing of goods; distribution franchise concerns the sale of goods; and service franchise concerns the supply of services.

(4) It is possible on the basis of the experience of the Commission to define categories of franchise agreements which fall under Article 85 (1) but can normally by regarded as satisfying the conditions laid down in Article 85 (3). This is the case for franchise agreements whereby one of the parties supplies goods or provides services to end users. On the other hand, industrial franchise agreements should not be covered by this Regulation. Such agreements, which usually govern relationships between producers, present different characteristics than the other types of franchise. They consist of manufacturing licences based on patents and/or technical know-how, combined with trade-mark licences. Some of them may benefit from other block exemptions if they fulfil the necessary conditions.

(5) This Regulation covers franchise agreements between two undertakings, the franchisor and the franchisee, for the retailing of goods or the provision of services to end users, or a combination of these activities, such as the processing or adaptation of goods to fit specific needs of their customers. It also covers cases where the relationship between franchisor and franchisees is made through a third undertaking, the master franchisee. It does not cover wholesale franchise agreements because of the lack of experience of the Commission in that field.

(6) Franchise agreements as defined in this Regulation can fall under Article 85 (1). They may in particular affect intra-Community trade where they are concluded between undertakings from different Member States or where they form the basis of a network which extends beyond the boundaries of a single Member State.

(7) Franchise agreements as defined in this Regulation normally improve the distribution of goods and/or the provision of services as they give franchisors the possibility of establishing a uniform network with limited investments, which may assist the entry of new competitors on the market, particularly in the case of small and medium-sized undertakings, thus increasing interbrand competition. They also allow independent traders to set up outlets more rapidly and with higher chance of success than if they had to do so without the franchisor's experience and assistance. They have therefore the possibility of competing more efficiently with large distribution undertakings.

(1) OJ No 16, 6. 3. 1965, p. 533/65.
(2) OJ No C 229, 27. 8. 1987, p. 3.
(8) As a rule, franchise agreements also allow consumers and other end users a fair share of the resulting benefit, as they combine the advantage of a uniform network with the existence of traders personally interested in the efficient operation of their business. The homogeneity of the network and the constant cooperation between the franchisor and the franchisees ensures a constant quality of the products and services. The favourable effect of franchising on interbrand competition and the fact that consumers are free to deal with any franchisee in the network guarantees that a reasonable part of the resulting benefits will be passed on to the consumers.

(9) This Regulation must define the obligations restrictive of competition which may be included in franchise agreements. This is the case in particular for the granting of an exclusive territory to the franchisees combined with the prohibition on actively seeking customers outside that territory, which allows them to concentrate their efforts on their allotted territory. The same applies to the granting of an exclusive territory to a master franchisee combined with the obligation not to conclude franchise agreements with third parties outside that territory. Where the franchisees sell or use in the process of providing services, goods manufactured by the franchisor or according to its instructions and or bearing its trade mark, an obligation on the franchisees not to sell, or use in the process of the provision of services, competing goods, makes it possible to establish a coherent network which is identified with the franchised goods. However, this obligation should only be accepted with respect to the goods which form the essential subject-matter of the franchise. It should notably not relate to accessories or spare parts for these goods.

(10) The obligations referred to above thus do not impose restrictions which are not necessary for the attainment of the abovementioned objectives. In particular, the limited territorial protection granted to the franchisees is indispensable to protect their investment.

(11) It is desirable to list in the Regulation a number of obligations that are commonly found in franchise agreements and are normally not restrictive of competition and to provide that if, because of the particular economic or legal circumstances, they fail under Article 85 (1), they are also covered by the exemption. This list, which is not exhaustive, includes in particular clauses which are essential either to preserve the common identity and reputation of the network or to prevent the know-how made available and the assistance given by the franchisor from benefiting competitors.

(12) The Regulation must specify the conditions which must be satisfied for the exemption to apply. To guarantee that competition is not eliminated for a substantial part of the goods which are the subject of the franchise, it is necessary that parallel imports remain possible. Therefore, cross deliveries between franchisees should always be possible. Furthermore, where a franchise network is combined with another distribution system, franchisees should be free to obtain supplies from authorized distributors. To better inform consumers, whereby helping to ensure that they receive a fair share of the resulting benefits, it must be provided that the franchisee shall be obliged to indicate its status as an independent undertaking, by any appropriate means which does not jeopardize the common identity of the franchised network. Furthermore, where the franchisees have to honour guarantees for the franchisor's goods, this obligation should also apply to goods supplied by the franchisor, other franchisees or other agreed dealers.

(13) The Regulation must also specify restrictions which may not be included in franchise agreements if these are to benefit from the exemption granted by the Regulation, by virtue of the fact that such provisions are restrictions falling under Article 85 (1) for which there is no general presumption that they will lead to the positive effects required by Article 85 (3). This applies in particular to market sharing between competing manufacturers, to clauses unduly limiting the franchisee's choice of suppliers or customers, and to cases where the franchisee is restricted in determining its prices. However, the franchisor should be free to recommend prices to the franchisees, where is it not prohibited by national laws and to the extent that it does not lead to concerted practices for the effective application of these prices.

(14) Agreements which are not automatically covered by the exemption because they contain provisions that are not expressly exempted by the Regulation and not expressly excluded from exemption may nonetheless generally be presumed to be eligible for application of Article 85 (3). It will be possible for the Commission rapidly to establish whether
this is the case for a particular agreement. Such agreements should therefore be deemed to be covered by the exemption provided for in this Regulation where they are notified to the Commission and the Commission does not oppose the application of the exemption within a specified period of time.

(15) If individual agreements exempted by this Regulation nevertheless, have effects which are incompatible with Article 85 (3), in particular as interpreted by the administrative practice of the Commission and the case law of the Court of Justice, the Commission may withdraw the benefit of the block exemption. This applies in particular where competition is significantly restricted because of the structure of the relevant market.

(16) Agreements which are automatically exempted pursuant to this Regulation need not be notified. Undertakings may nevertheless in a particular case request a decision pursuant to Council Regulation No 1777/75 as last amended by the Act of Accession of Spain and Portugal.

(17) Agreements may benefit from the provisions either of this Regulation or of another Regulation, according to their particular nature and provided that they fulfill the necessary conditions of application. Theys may not benefit from a combination of the provisions of this Regulation with those of another block exemption Regulation, to the relationship between franchisor and master franchisee and between master franchisee and franchisee.

3. For the purposes of this Regulation:

(a) 'franchise' means a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users;

(b) 'franchise agreement' means an agreement whereby one undertaking, the franchisor, grants the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified types of goods and/or services; it includes at least obligations relating to:

- the use of a common name or shop sign and a uniform presentation of contract premises and/or means of transport;
- the communication by the franchisor to the franchisee of know-how,
- the continuing provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement;

(c) 'master franchise agreement' means an agreement whereby one undertaking, the franchisor, grants the other, the master franchisee, in exchange of direct or indirect financial consideration, the right to exploit a franchise for the purposes of concluding franchise agreements with third parties, the franchisees;

(d) 'franchisor's goods' means goods produced by the franchisor or according to its instructions, and/or bearing the franchisor's name or trade mark;

(e) 'contract premises' means the premises used for the exploitation of the franchise or, when the franchise is exploited outside those premises, the base from which the franchisee operates the means of transport used for the exploitation of the franchise (contract means of transport);

(f) 'know-how' means a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified;

(g) 'secret' means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; it is not limited in the narrow sense that each individual component of the know-how should be totally unknown or unobtainable outside the franchisor's business;
(h) 'substantial' means that the know-how includes information which is of importance for the sale of goods or the provision of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection which the provision of services, methods of dealing with customers, and administration and financial management; the know-how must be useful for the franchisee by being capable, at the date of conclusion of the agreement, of improving the competitive position of the franchisee, in particular by improving the franchisee’s performance or helping it to enter a new market;

(i) 'identified' means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfills the criteria of secrecy and substantiality; the description of the know-how can either be set out in the franchise agreement or in a separate document or recorded in any other appropriate form.

Article 2

The exemption provided for in Article 1 shall apply to the following restrictions of competition:

(a) an obligation on the franchisor, in a defined area of the common market, the contract territory, not to:
   — grant the right to exploit all or part of the franchise to third parties,
   — itself exploit the franchise, or itself market the goods or services which are the subject-matter of the franchise under a similar formula,
   — itself supply the franchisor’s goods to third parties;

(b) an obligation on the master franchisee not to conclude franchise agreement with third parties outside its contract territory;

(c) an obligation on the franchisee to exploit the franchise only from the contract premises;

(d) an obligation on the franchisee to refrain, outside the contract territory, from seeking customers for the goods or the services which are the subject-matter of the franchise;

(e) an obligation on the franchisee not to manufacture, sell or use in the course of the provision of services, goods competing with the franchisor’s goods which are the subject-matter of the franchise; where the subject-matter of the franchise is the sale or use in the course of the provision of services both certain types of goods and spare parts or accessories therefor, that obligation may not be imposed in respect of these spare parts or accessories.

Article 3

1. Article 1 shall apply notwithstanding the presence of any of the following obligations on the franchisee, in so far as they are necessary to protect the franchisor’s industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network:

(a) to sell, or use in the course of the provision of services, exclusively goods matching minimum objective quality specifications laid down by the franchisor;

(b) to sell, or use in the course of the provision of services, goods which are manufactured only by the franchisor or by third parties designed by it, where it is impracticable, owing to the nature of the goods which are the subject-matter of the franchise, to apply objective quality specifications;

(c) not to engage, directly or indirectly, in any similar business in a territory where it would compete with a member of the franchised network, including the franchisor; the franchisee may be held to this obligation after termination of the agreement, for a reasonable period which may not exceed one year, in the territory where it has exploited the franchise;

(d) not to acquire financial interests in the capital of a competing undertaking, which would give the franchisee the power to influence the economic conduct of such undertaking;

(e) to sell the goods which are the subject-matter of the franchise only to end users, to other franchisees and to resellers within other channels of distribution supplied by the manufacturer of these goods or with its consent;

(f) to use its best endeavours to sell the goods or provide the services that are the subject-matter of the franchise; to offer for sale a minimum range of goods, achieve a minimum turnover, plan its orders in advance, keep minimum stocks and provide customer and warranty services;

(g) to pay to the franchisor a specified proportion of its revenue for advertising and itself carry out advertising for the nature of which it shall obtain the franchisor’s approval.

2. Article 1 shall apply notwithstanding the presence of any of the following obligations on the franchisee:

(a) not to disclose to third parties the know-how provided by the franchisor; the franchisee may be held to this obligation after termination of the agreement;

(b) to communicate to the franchisor any experience gained in exploiting the franchise and to grant it, and other franchisees, a non-exclusive licence for the know-how resulting from that experience;
(c) to inform the franchisor of infringements of licensed industrial or intellectual property rights, to take legal action against infringers or to assist the franchisor in any legal actions against infringers;

(d) not to use know-how licensed by the franchisor for purposes other than the exploitation of the franchise; the franchisee may be held to this obligation after termination of the agreement;

(e) to attend or have its staff attend training courses arranged by the franchisor;

(f) to apply the commercial methods devised by the franchisor, including any subsequent modification thereof, and use the licensed industrial or intellectual property rights;

(g) to comply with the franchisor's standards for the equipment and presentation of the contract premises and/or means of transport;

(h) to allow the franchisor to carry out checks of the contract premises and/or means of transport, including the goods sold and the services provided, and the inventory and accounts of the franchisee;

(i) not without the franchisor's consent to change the location of the contract premises;

(j) not without the franchisor's consent to assign the rights and obligations under the franchise agreement.

3. In the event that, because of particular circumstances, obligations referred to in paragraph 2 fall within the scope of Article 85 (1), they shall also be exempted even if they are not accompanied by any of the obligations exempted by Article 1.

Article 4

The exemption provided for in Article 1 shall apply on condition that:

(a) the franchisee is free to obtain the goods that are the subject-matter of the franchise from other franchisees; where such goods are also distributed through another network of authorized distributors, the franchisee must be free to obtain the goods from the latter;

(b) where the franchisor obliges the franchisee to honour guarantees for the franchisee's goods, that obligation shall apply in respect of such goods supplied by any member of the franchised network or other distributors which give a similar guarantee, in the common market;

(c) the franchisee is obliged to indicate its status as an independent undertaking; this indication shall however not interfere with the common identity of the franchised network resulting in particular from the common name or shop sign and uniform appearance of the contract premises and/or means of transport.

Article 5

The exemption granted by Article 1 shall not apply where:

(a) undertakings producing goods or providing services which are identical or are considered by users as equivalent in view of their characteristics, price and intended use, enter into franchise agreements in respect of such goods or services;

(b) without prejudice to Article 2 (e) and Article 3 (1) (b), the franchisee is prevented from obtaining supplies of goods of a quality equivalent to those offered by the franchisor;

(c) without prejudice to Article 2 (e), the franchisee is obliged to sell, or use in the process of providing services, goods manufactured by the franchisor or third parties designated by the franchisor and the franchisor refuses, for reasons other than protecting the franchisor's industrial or intellectual property rights, or maintaining the common identity and reputation of the franchised network, to designate as authorized manufacturers third parties proposed by the franchisee;

(d) the franchisee is prevented from continuing to use the licensed know-how after termination of the agreement where the know-how has become generally known or easily accessible, other than by breach of an obligation by the franchisee;

(e) the franchisee is restricted by the franchisor, directly or indirectly, in the determination of sale prices for the goods or services which are the subject-matter of the franchise, without prejudice to the possibility for the franchisor of recommending sale prices;

(f) the franchisor prohibits the franchisee from challenging the validity of the industrial or intellectual property rights which form part of the franchise, without prejudice to the possibility for the franchisor of terminating the agreement in such a case;

(g) franchisees are obliged not to supply within the common market the goods or services which are the subject-matter of the franchise to end users because of their place of residence.

Article 6

1. The exemption provided for in Article 1 shall also apply to franchise agreements which fulfill the conditions laid down in Article 4 and include obligations restrictive of competition which are not covered by Articles 2 and 3 (3) and do not not fall within the scope of Article 5, on condition that the agreements in question are notified to the Commission in accordance with the provisions of Commission Regulation No 27 (1) and that the Commission does not oppose such exemption within a period of six months.

(1) OJ No 35, 10. 5. 1962, p. 1118/62.
2. The period of six months shall run from the date on which the notification is received by the Commission. Where, however, the notification is made by registered post, the period shall run from the date shown on the postmark of the place of posting.

3. Paragraph 1 shall apply only if:

(a) express reference is made to this Article in the notification or in a communication accompanying it; and

(b) the information furnished with the notification is complete and in accordance with the facts.

4. The benefit of paragraph 1 can be claimed for agreements notified before the entry into force of this Regulation by submitting a communication to the Commission referring expressly to this Article and to the notification. Paragraphs 2 and 3 (b) shall apply mutatis mutandis.

5. The Commission may oppose exemption. It shall oppose exemption if it receives a request to do so from a Member State within three months of the forwarding to the Member State of the notification referred to in paragraph 1 or the communication referred to in paragraph 4. This request must be justified on the basis of considerations relating to the competition rules of the Treaty.

6. The Commission may withdraw its opposition to the exemption at any time. However, where that opposition was raised at the request of a Member State, it may be withdrawn only after consultation of the advisory Committee on Restrictive Practices and Dominant Positions.

7. If the opposition is withdrawn because the undertakings concerned have shown that the conditions of Article 85 (3) are fulfilled, the exemption shall apply from the date of the notification.

8. If the opposition is withdrawn because the undertakings concerned have amended the agreement so that the conditions of Article 85 (3) are fulfilled, the exemption shall apply from the date on which the amendments take effect.

9. If the Commission opposes exemption and its opposition is not withdrawn, the effects of the notification shall be governed by the provisions of Regulation No 17.

Article 7

1. Information acquired pursuant to Article 6 shall be used only for the purposes of this Regulation.

2. The Commission and the authorities of the Member States, their officials and other servants shall not disclose information acquired by them pursuant to this Regulation of a kind that is covered by the obligation of professional secrecy.

3. Paragraphs 1 and 2 shall not prevent publication of general information or surveys which do not contain information relating to particular undertakings or associations of undertakings.

Article 8

The Commission may withdraw the benefit of this Regulation, pursuant to Article 7 of Regulation No 19/65/EEC, where it finds in a particular case that an agreement exempted by this Regulation nevertheless has certain effects which are incompatible with the conditions laid down in Article 85 (3) of the EEC Treaty, and in particular where territorial protection is awarded to the franchise and:

(a) access to the relevant market or competition therein is significantly restricted by the cumulative effect of parallel networks of similar agreements established by competing manufacturers or distributors;

(b) the goods or services which are the subject-matter of the franchise do not face, in a substantial part of the common market, effective competition from goods or services which are identical or considered by users as equivalent in view of their characteristics, price and intended use;

(c) the parties, or one of them, prevent end users, because of their place of residence, from obtaining, directly or through intermediaries, the goods or services which are the subject-matter of the franchise within the common market, or use differences in specifications concerning those goods or services in different Member States, to isolate markets;

(d) franchisees engage in concerted practices relating to the sale prices of the goods or services which are the subject-matter of the franchise;

(e) the franchisor uses its right to check the contract premises and means of transport, or refuses its agreement to requests by the franchisee to move the contract premises or assign its rights and obligations under the franchise agreement, for reasons other than protecting the franchisor's industrial or intellectual property rights, maintaining the common identity and reputation of the franchised network or verifying that the franchisee abides by its obligations under the agreement.

Article 9

This Regulation shall enter into force on 1 February 1989.

It shall remain in force until 31 December 1999.
This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 30 November 1988.

For the Commission
Peter SUTHERLAND
Member of the Commission