The Draft Common Frame of Reference (DCFR): Model Law for Future Common Regulation of Franchise Agreements?

Проектът на обща референтна рамка (DCFR): образец на Закона за бъдещото общо регулиране на споразуменията за франчайз?

Kristina Stefanova[1]

SUMMARY

Business-format franchise has well pervaded every part of Europe for the last few decades. Nevertheless, it is still unknown to the better part of the European legislature. Even where it is a nominate contract, its true nature and features are yet to be understood by legal professionals. The different approach taken by each state results in unequal treatment of the parties and significant differences when deciding upon similar cases. These impediments for the spread of the franchise agreement in Europe have inspired the current article, in the search for an adequate solution, to consider the proposed regulation of franchising in the DCFR. The article aims to evaluate the suitability of its provisions regarding franchising and to recommend further consideration where necessary.

[1] Faculty of Law, University of National and World Economy, Sofia, Bulgaria, kristina.st.stefanova@gmail.com

KEY WORDS

Draft Common Frame of Reference (DCFR); Franchising, Model Law; Franchise Regulation

Introduction

Business-format franchise has already reached every corner of Europe.[2] These networks have been present in the European market for years. Franchise business model has proven to help both franchisors and franchisees. In is known for its effectiveness to attract new capital for the franchisor and at the same time it eases the brand establishment increasing the number of its outlets operating under the same name. It is also a suitable to enter into new markets ensuring good management of the outlets because the franchisees themselves invest in the business, as well. On the other hand, franchisees have the opportunity to start a brand-new enterprise with a world know reputation using the license of the trademark they got and instantly gaining business experience under the guidance and support of the franchisor. In brief, franchising is a business method which could equally help big, well-known companies, and new, small, or medium-sized enterprises, sole traders, who struggle to grow or to start their own activity. Hence, this form of business should get some encouragement in all EU member-states, either developing, or developed, for the advantages it brings to the companies and the individuals in each of them. However, under the current legal environment within the EU, this is hard to achieve.

The problem of our study is the complete discrepancy in the legal framework of the franchise agreement in the EU and the adoption of a common regulation[3] as a possible solution to this dilemma. The

[2] Statistical data about the number of franchise brands, outlets and their turnover and employment rates can be found on the web site of the European Franchise Federation at <http://www.eff-franchise.com/Data/Franchise%20Statistics%20-%20Europe%20-%20source-EFF.pdf> (last visited on 21 August 2017).

[3] In this article 'regulation' shall be understood and examined in its broader sense, ie as adoption of mandatory and dispositive legal norms, enforceable through litigation at the discretion of the parties. We choose this approach for

importance of such reform on the EU-level was already seen by the drafters of the DCFR. They dedicated to it Book IV, Part E, Chapter 4 of the DCFR[4] which sets provisions regulating the franchise agreement forth.

So, our first aim is to analyse the proposed provisions on the franchise agreement in the DCFR, which could give a basis for a future common regulation. Thus, the study might assess how drafted articles should satisfy the needs of the business and the jurists dealing with franchise. The second, is to give some recommendations considering the investigation results to both national and supranational bodies for improving the specific draft franchise-regulation and to maximize their positive outcome. Therefore, we examine:

1. The need of a common regulation of franchise agreements at EU level (Section 2) is shown by some examples found in recent legal practice.

2. The DCFR as a suitable basis for a future franchise regulation at national or supranational level (Section 3).

3. Some provisions of the DCFR, namely: the proposed definition of a franchise agreement (Section 4.1.), franchisor's obligations (Section 4.2.), franchisee's obligations (Section 4.3.).

4. Some recommendations resolving the current uncertainty (Section 5), and we suggest amending the proposed regulation of the pre-contractual disclosure and IP rights.

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two reasons. Firstly, the DCFR was created with the intention of becoming a European Civil Code – regulation in the broader sense; secondly, as every state has taken different approach with regard to franchise agreements, common regulation in its narrower sense through specialised bodies to supervise and guarantee the compliance with certain legal norms could hardly be imagined for the time being.

[4] A simple definition of the DCFR that we could give is a compilation of model law based on European legal principles and practice, created as part of the preparation of common European Civil Code. More on the development of the DCFR: E. Ritaine, 'The Common Frame of Reference (CFR) and the Principles of European Law on Commercial Agency, Franchise and Distribution Contracts'. ERA Forum, 4, 8 (2007), pp. 563 – 584, and F. Emmert, The Draft Common Frame of Reference (DCFR) – The Most Interesting Development in Contract Law Since the Code Civil and the BGB. Indiana University Robert H. McKinney School of Law Research Paper, 8 (2012), [online] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2025265 [access 09.06.2020].

1. The Need of a Common Franchise Regulation

The first question is whether there is a need for common franchise regulation. The answer could be nothing but affirmative.

The only EU legislation, which currently regulates the franchise agreement, is in the field of competition law.[5] Hence, unless competition is concerned, the Member States and the other European countries have been solving the problems generated by franchise agreements in their own genuine and so remarkably diverse manner.

Today only nine member-states implement franchise-specific statutes or statutory provisions.[6] All of them set forth their own definitions of a franchise agreement. Each member-state has markedly different approach. Six of EU members with franchise legislation focus the pre-contractual disclosure. Two countries require registration of the franchise agreements and the other relevant documents. It is to cite the French model who does not even mention the word „franchising". The two of the statutes that do not require pre-contractual disclosure are more concerned with the attempt to define a franchise and the rights and obligations it gives rise to.[7]

The legal drafting approach and techniques differ significantly, thus, now we see even more impediments for the necessary protection of the contractual parties. The trend seems to be that every country adopts a separate national regulation, each with its own peculiarities, which would hardly help the cross-border franchising. On the contrary, it would deter it and lead to loss or diminishing of

[5] Currently Commission Regulation (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices [2010] OJ L102/1 is in force. It grants block exemption from Art. 101(3) TFEU to vertical agreements, among which is also the franchise agreement, provided the clauses of the agreements meet certain requirements.

[6] M. Abell, *The Law and Regulation of Franchising in the EU. Cheltenham, Edward Elgar. 2013.* The eight member states examined in the cited book are France, Spain, Italy, Sweden, Belgium, Romania, Estonia and Lithuania. However, with the adoption of a new Hungarian Civil Code, which entered into effect in March 2014, franchising is regulated in Hungary as well under Chapter LI: License (Franchise) Agreements.

[7] *Ibid.,* 63.

profitable industry within various European countries. On the other hand, one uniform regulation within the EU would create more security for both franchisors and franchisees and encourage its development.

In most of the countries, the franchise agreement is still an innominate contract. The lack of clear definition is the first reason for misunderstandings of the nature and idiosyncrasy of the franchise agreement. As franchise agreements are quite new to most of the European countries and considering the lack of definitions and of clear limits of the rights and obligations of the parties particular for the franchise one easily see why the practitioners, the judges and even the academia fail to examine and understand its complexity.

Furthermore, in each EU state some differences in the agreement application of and the court practice appear. Even its definition is not clear and unified across the Europe. This brings uncertainty about the suitable statutory provisions. Some judges apply general private law principles, other, the analogy. So, some conditions for agency, distribution or even go for the franchising.[8] Many EU jurisdictions struggle with its concept. They find it hard to reconcile the obligation of a franchisee to follow the franchisor's system and directions with the independence of a standalone business. Therefore, they use aspects of Employment law to protect franchisees.[9] In these cases, the judges consider the franchisee's obligations closer to those of an employee rather than of an independent entity. The other striking example is the application of Agency law to franchises. In the German practice the courts increasingly grant the franchisees with rights, typical of the agency – and of the distribution agreements.[10] Even 'the [German] Courts always stress that each contract is individual, and all circumstances of the individual case must be considered.'[11] There is no sign that this trend of diverse national approach will change and so the impediments for franchises will grow across the EU. It is to mention the expenses for examination and consultation due to these obstacles should not

[8] Examples of cases where employment law and commercial agency law is applied to franchise agreements in various European countries are presented by Abell (2013), pp. 145 – 53.
[9] *Ibid.,* 145.
[10] *Ibid.,* 147 – 50.
[11] *Ibid.,* 146.

be underestimated. Hence, considerable number of franchisors and other investors, would choose to refrain from entering EU markets.[12]

At the opposite end of the spectrum, the complete lack of regulation often leads to abusive practices or opportunistic behaviour by one of the parties towards the other as the essence of the franchise agreement, in fact, consists of completely opposing interests of the parties. The franchisor and franchisee are separate, independent merchants; however, the judge can be easily misled to imply the freedom of contract (the unconditional *pacta sunt servanda*) principle. Nonetheless in these agreements, often the franchisees cede the power and the control to franchisors voluntarily and thus, bearing on mind the lengthy term of the relationships itself, we see the need for the franchisee-franchisor contracts to be sufficiently flexible. They must allow the franchisor to adapt the franchise to meet new market conditions, but sometimes an incomplete contracting is the best to achieve. In fact, the result (especially where a contract is little negotiated) is that the drafter (the franchisor) could act opportunistically.[13] The truth is that even in the pre-contractual stage, the bargaining power is extremely one-sided[14], often leaving no other options for prospective franchisees but a 'take it or leave it" contract. Even afterwards, the success of the franchise network depends on the control for quality and uniformity by franchisees. What is unique to the franchising is the franchisee's dependence on

[12] There are hardly any examinations or data available about EU franchise businesses and their relations with member state regulations. We found only one question in a survey, presented in Abell, (*Ibid.* 160), where franchisors are asked what the main barriers are for expanding into other EU member states. Their main concern is 'finding a suitable master franchisee', followed by 'the extra burden created by each Member State having different franchise regulation.' These were placed before problems like language, costs and different market conditions. The rest of the survey shows that most of the interviewed franchisors are in favour of franchise-specific regulation at an EU level.

[13] Atwell C., J. J. Buchan. 'The Franchise Fulcrum: The Legal System's Contributions to Research about Power and Control in Business Format Franchising'. *Journal of Marketing Channels*, 21 (2014), pp. 180 – 195, 187.

[14] A generous list of examples of malfunctioning franchise networks as given by Abell (2013), p. 61, n. 5. Control power creates the temptation to abuse and many cases including in Europe prove it. 'These incidents seriously damaged the public image of franchising and led the authorities to consider regulating franchise agreements.' One carefully drafted common regulation of the franchise agreement would facilitate our understanding of the idiosyncrasies this agreement has.

the franchisor with respect to the franchisor's control over the commercial identity of the franchisee's business. It is this reliance of the franchisee upon the franchisor's system that supplies the franchisees with the necessary regulatory protection.[15]

To sum up, the franchise agreement is such a contract that needs a deep understanding of its nature and complexity. The current legislation of the EU member-states gives no appropriate framework to encourage its development. What is more, the fragmented and diverse legal provisions or court practices in different member states could do more harm than good to both franchisors and franchisees. Hence, a common regulation at EU level is necessary to ensure a proper and uniform treatment of franchise agreements across the EU.

2. The DCFR as a First Step Towards a Common Franchise Regulation

The idea of common international or European private law is not a new one. The DCFR follows the UNIDROIT Principles of International Commercial Contracts (PICC), the Principles of European Contract Law (PECL) and an extensive study on possible European Civil Code.[16] The Common Civil Code adoption proved to be a challenging task, partly because of some legal institutes as the Law of

[15] E. Spencer. „An exploration of the legal meaning of franchising". – *Journal of Marketing Channels*, 1/2, 20 (2013), pp. 25 – 51.

[16] The Commission on European Contract Law, which created PECL, and whose work has been continued by several working groups in order to create DCFR, was founded in 1982. 'The work of the Amsterdam working group within the Study Group on a European Civil Code has led to the formulation of European principles regarding commercial agency, franchise and distribution contracts' (Bueno Díaz, O. *Franchising in European contract law a comparison between the main obligations of the contracting parties in the Principles of European Law on Commercial Agency, Franchise and Distribution Contracts (PEL CAFDC), French and Spanish law.* München, Sellier European Law Publications, 2008, which were incorporated in the DCFR. More on the history behind the DCFR and the work on the harmonization of the European private law, see A.-I. Opritoiu, 'Introduction to DCFR'. *Journal of Law and Administrative Sciences*, 3 (2015), pp. 98 – 104.

sales[17], or contracts' conclusion and performance, developed and interpreted differently in each country's laws and court practices. Although, they are all similar in civil law jurisdictions, they still have their peculiarities.[18]

Adversely, the Franchise regulation does not have a long tradition in most of the member-states. Therefore, we may assume that: first, the adoption of Common Franchise Regulation is still possible, and it would prevent some significant differences in future treatment of the parties; and second, such an order has to be adopted before the different countries could reach some national resolution of the problems caused by franchise agreements in its own way.[19] The DCFR is a soft law[20] instrument and a result of meticulous research and work of many experts studding the European legal jurisdictions and practices. It offers a model law for franchise regulation. We examine it as a basis for a future common European Regu-

[17] A Proposal for a Common European Sales Law was adopted by the European Commission in 2011 and withdrawn in 2014.

[18] Similar view has been taken in Note from Directorate-General for Internal Policies, 'From the DCFR to the Current EU Contract Law Debate', (2010), 19, where it is stated that '[a] 'toolbox" (…) does not help very much when EU law 'intrudes' into some classical areas of private law where the Member States have and most probably will maintain rather different concepts and systems. Transplants from EU law may be alien and be understood in a quite different way. Even the concept of contract, which plays a central role and shapes the current field of activity of the EU legislator, often varies in the different legal systems.'

[19] The truth is that adoption of such common regulation would only provide legal obligations for the parties and remedies to indemnify the party not in breach. More protection could be achieved only by creating regulation in the strict sense of the word, ie mandatory registration, filing documents and/or creating agencies to observe the compliance with the relevant statutory obligations. However, such step at community level is currently unimaginable. Still, common mandatory regulation in the broad sense would ensure at a satisfactory level at least some security for the parties.

[20] To our research the term 'soft law' is understood as 'rules of conduct which, in principle, have no legally binding force but which nevertheless may have practical effects and also legal effects.' This definition was laid down by Snyder during the Sixth International Workshop for Young Scholars, 'The Evolution of European Courts: Institutional Change and Continuity' Dublin 16 – 17 November 2007, cited by O. Stefan, 'European Union Soft Law: New Developments Concerning the Divide between Legally Binding Force and Legal Effects', *The Modern Law Review*, 75, 5 (2012), pp. 879 – 893, p. 879, as the most frequently quoted definition of soft law.

lation or Directive not only because of this, but also because it is the only supranational model law, covering every aspect of the franchise agreement. It could be a model-law for national legislators when preparing bills for franchise-specific laws or provisions.

Considering it as soft law we cannot neglect UNIDROIT valuable model-laws, namely the Guide to International Master Franchising Arrangements (1998, rev. 2007) and the Model Franchising Disclosure Law (2002). They are results of extensive research and propose good definitions and ideas about the regulation of franchising, helping us to understand the nature of the franchise relationship. Nevertheless, they present only partial solutions covering the legislative gap concerning franchise statutes.

On the other hand, the exhaustive regulation DCFR of franchise agreement unique in the aspect of its comprehensive supranational approach, which was mentioned already in the literature.

> *„The DCFR is in fact the first European coherent, systematized and sufficiently detailed franchise law with rules tailor-made for this peculiar hybrid transaction."*[21]

Other soft law instruments about the franchising are the Internal rules of the Franchise associations, the so-called Codes of Ethics.[22] Although they set some examples of contract provisions and good faith practices, they cannot always have regulatory power as they can get their force only by voluntary compliance. So, none of them dispose of full range of legal means to guarantee the parties' rights, or to impose respective obligations.

Furthermore, the choice of future modification of the regulative regime by adopting a Common Instrument on international or EU level is more a political question than a legal one. So, it is not enough for drafted adoption to have a good legal product. It must be a common denominator of the different jurisdictions of the participating states. This shows another advantage of the DCFR, its design to encompass the European legal mind, laws, and practices.

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[21] T. Tajti, *sub-chapter D2 on franchise. Systemic and Topical Mapping of the Relationship of the Draft Common Frame of Reference and Arbitration.* Kazimieras Simonavičius University, Vilnius, 2013, p. 84.

[22] Probably the best example is the European Code of Ethics of the European Franchise Federation, available at <http://www.eff-franchise.com/77/regulation.html>(last visited 21 August 2017).

The theorists define the DCFR as 'a set of non-binding guidelines to be used by lawmakers at Community level on a voluntary basis as a common source of inspiration or reference in the law-making process.'[23] In other words, 'the Council sees the EU legislator as the addressee of the CFR'[24] and thus of the DCFR as well. The DCFR was designated as 'a tool for better law-making targeted at Community law-makers'. Likewise, it has been emphasised multiple times that the CFR 'could be a 'toolbox' for European legislators and possibly for domestic legislators'[25] and 'would be used to provide clear definitions of legal terms, fundamental principles and coherent modern rules of contract law when revising existing and preparing new sectorial legislation'.[26] The possibility of domestic legislators using it as a 'toolbox' gives us another good reason to scrutinize it and give our recommendations.

There is one more reason that makes us believe the DCFR franchise provisions could become an enforceable instrument adopted by EU or national legislators. It does not introduce any excessive novelties or obligations and includes the traditional and essential rights and obligations for the parties of a franchise agreement. Thus, it is easy for the EU and national legislative bodies to accept and implement it. It supplies clarity, security, minimum standard protection and most importantly – unification of the basic franchise rules. The extensive commentary to the DCFR also eases the understanding of the rationale behind its norms and their proper interpretation.

Last but not least, we would like to emphasize that besides 'content and method-wise being the close kin of Continental European civil codes'[27], the DCFR has another significant advantage: 'it does not aim to protect only one of the contractual parties – rather it strives to strike a balance though taking note of asymmetry.'[28] We

[23] Council of the European Union, Press Release: 2863rd Council meeting, Justice and Home Affairs, Luxembourg, 18th April 2008 (8397/08), 18.
[24] S. Vogenauer. Common Frame of Reference and UNIDROIT Principles of International Commercial Contracts: Coexistence, Competition, or Overkill of Soft Law?' *European Review of Contract Law*, 6, 2, (2010), pp. 1 – 47, p. 153.
[25] Note from the Presidency to the Council of the European Union on the Common Frame of Reference for European Contract Law, Doc. 8548/07, 17.04.2007, 2.
[26] Second Progress Report of the European Commission of 25 July 2007 cited by Ritaine (2007), p. 565.
[27] Tajti (2013), p. 75.
[28] Tajti (2013), 75.

could call it 'an attempt to find a proper balance for the inherently contradicting interests of franchisors and franchisees.'[29] What is meant by these words?

The franchise agreement is roughly a legal relationship between two independent undertakings under which the franchisor supplies its trademark, business know-how, ongoing assistance and guidance to the franchisee in exchange for initial lump sum payment and/or periodic payments. Beneath the surface of this simple definition, there are complex relations between the parties, consisting of battle for quality and conformity control, mixed with prevention from opportunism and unexpected or hidden costs. The franchisors need have enough freedom to control the franchisees as the uniformity of quality, prices and service is crucial for the success of the whole chain. On the other hand, the possibility to control and monitor could (and practice has proved that many times it does) tempt the franchisor to take advantage of its dominant position and abuse. Balance is the key to the healthy and beneficial relationship for both parties. However, practices in countries where franchising has been known and practiced for decades teach us that balance usually cannot be achieved by the business self-regulation and without legislative intervention.

Another reason for optimism, mentioned in the literature, is that DCFR is superior to what many European systems possess now as far as completeness, maturity and balance is concerned'.[30] If we take a look at the few European national statutes regulating the franchise agreement would see that it should be nominated (regulated) contract in the strict sense. However, a person who is not aware of the franchise relation idiosyncrasies would fail to notice that such a statutory regulation is in most cases unsatisfactory, to say the least. A simple definition of the franchise-relation nature and of its main obligations could not even approach the practical reason for its regulated. It is not necessary because the parties are not certain about their obligations or functions, but the success of the whole franchise network comprises of imposition of set rules for the franchisee to follow and the franchisor to control. It could result in an uneven position of the contractual parties. 'We suggest power and control are enablers of opportunistic behavior, and cata-

[29] *Ibid.,* 75.
[30] *Ibid.,* 76.

lysts for instability in the franchise relationship'[31] and abuse. Moreover, the franchisor is usually the economically stronger party in the negotiations and afterwards. This entails asymmetry of the whole agreement as many times the franchisor dictates all the conditions. This is what has called for the need of legislative intervention in the states with longer tradition and experience with franchising.

On the other hand, too much freedom and trust in the franchisee's good faith and lack of proper control by the franchisor could also leave space for the temptation of free riding by the franchisee. Especially given the fact that the success of a single franchisee depends more on the successful operation of the whole network. The problem is that bad operation of one franchise outlet also affects the whole network. This interrelation is what makes the uniformity within the franchise network so important. The 'uniformity that cannot be achieved without giving strong powers to the franchisor to efficiently protect his business model along with his intellectual property rights'.[32] Nevertheless, 'there is much more to this relationship than franchisor domination. Franchisees have the power to damage brand image, investor perceptions, and overall quality of the branded product or service.'[33] This is why finding the fine line between the necessary and healthy control of compliance, uniformity and quality and prevention of control abuse is crucial for the success of any franchise system.

In the light of all the above, the DCFR has every prospect of being used as a base for future common franchise regulation at Community level. The reasons include: the exhaustive regulation of every aspect of the franchise relationship; the fact that it mirrors the European laws and practices and was drafted by European scholars from various jurisdictions; the first designation of the proposed franchise regulation was to be incorporated in common European private law, etc. However, the DCFR's biggest advantage is that its clauses touch on the typical franchise features, thus drawing the attention of legislators, judges and jurists to the complicated issues that arise from the franchise relationship. Its most significant advantage is the understanding of the subject matter, incorporated in

[31] Atwell, Buchan (2014), p. 181.
[32] Tajti (2013), p. 91.
[33] Atwell, Buchan (2014), p. 183.

the articles. Precisely the regulation of understanding of franchise agreements must be careful in the search for the perfect balance between power, control and independence and the aim to protect both parties' best interests, are what make Book IV, Part E, Chapter 4 of the DCFR suitable base as a first step for a common European regulation of the franchise agreements.

All the above leads us to the conclusion that the DCFR is currently the only available model law instrument to use as a base for future uniform regulation in Europe or as an example of franchise regulation for national legislators. This requires that we examine its provisions in detail, and to evaluate its positive sides and drawbacks, hoping that this common regime will serve as a starting point for future adjustment of EU- or National instruments.

In the rest of this paper, we will try to highlight the positive aspects of the rules and to recommend some improvements.

3. Advantages of the Franchise Provisions in the DCFR

3.1. Definition

The definition of a specific contract finds the normative characteristics of legal relationship. As we mentioned above, the lack of a uniform definition and understanding of the franchise agreement raises problems in both international and domestic contracts. So, other rules (typical for similar contracts) are applied in the practice. To make matters worse, sometimes the parties, and even the judges cannot decide in advance which type of contract rules would be applied in each case. This happens when the courts have the practice to interpret the franchise-agreements according to the type of specific nominated contract they resemble.[34] Such an unclear ap-

[34] An example of such practice is a Hungarian case 8.Pf.21.065/2007/5. In this case the first instance court found that rules for three different contracts (transfer of rights, commission contract and undertaking contract) are applicable to the franchise agreement in question, but the appellate court found that 'the elements of the commission contract dominate the agreement; hence, the rules of the latter are to be applied." S. Messmann, T. Tajti. *The Case Law of Central and Eastern Europe – Enforcement of Contracts. Bochum, European*

proach brings insecurity for the parties and in fact, they never know what statutory norms regulate their relationships and agreements.

The DCFR, Article IV.E.–4:101, gives us a definition. The franchisor grants the franchisee in exchange for remuneration with the right to do business and to supply products on the its own behalf, but within the franchisor's business network and under the franchisor's trademark and other intellectual property. This definition seems to be in line with the European legislation. The first definition of the franchise agreement is given in Regulation No 4087/88 of 30 November 1988 on the application of Article 85 (3) of the Treaty concerning its categories. It covers almost the same features as the DCFR.[35] The only characteristic that is omitted in the DCFR is the 'assistance' as the drafters' aimed to encompass 'a broader range of franchise agreements.' The Guidelines on Vertical Restraints[36] also focus on licensing of IP rights, ongoing aid by the franchisor and the franchise fee he receives in exchange. Although mentioning that the result is a 'uniform network for the distribution of its prod-

University Press, 2009, pp. 290 – 291. Franchise agreement is not an innominate contract in Hungary anymore, but the practice to apply rules of other contracts by analogy depending on the dominating elements of the franchise agreement subject to court trial is still widespread in many European countries where no explicit rules regulate the franchise agreement.

[35] The Regulation followed the famous Case 161/84 *Pronuptia de Paris GmbH v Pronuptia de Paris Irmgard Schillgallis* [1985] ECR-353, which laid the foundation of franchising regulation in the competition law. It entered into force on 1 February 1989 and remained in force until 31 December 1999. Art. 1, paragraph 3 (a) defined franchise as a package of industrial or intellectual property rights relating to trademarks, 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. Art. 1, paragraph 3 (b) defines the franchise agreement as 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.

[36] European Commission, Guidelines on Vertical Restraints, Commission Notice, Brussels, 10.5.2010 SEC (2010) 411 final, para 189.

ucts',[37] it is not examined how this is achieved. These definitions are not surprising considering that the EU legislation only focus the competition clauses of this agreement.

To see whether Article IV.E.–4:101 includes all basic features of franchise agreements, we could use as a benchmark the definition, provided by the FTC of the USA as one of the countries with the longest experience in both developing and regulating franchising. Under the Federal law a commercial agreement is 'franchise' if it has at least three basic elements. Namely, franchisor must: 1) provide a trademark or other commercial symbol; 2) to exercise significant control or provide significant assistance in the operation of the business; 3) require a minimum payment of at least $500 during the first six months of operations.[38] This definition covers both business format and product franchises.

The difference between FTC of the USA, the DCFR and the European competition law is only one element – the control, which the franchisor exercises over the franchisees to guarantee the uniformity of the whole network. It may be insignificant at first glance but it is, in fact, crucial for this agreement. The uniformity is what distinguishes the franchising from any other type of business and what makes it successful. However, the power to control and guarantee such uniformity is what leaves a wide-open door for abuse by the franchisor. This is what creates the need for regulation and at the same time makes it extremely hard to regulate.

The UNIDROIT's Model franchise disclosure law also recognizes the importance of the control as an essential part of the franchise definition. Under article 2 the franchise agreement is an accord granting something to franchisee. So, the franchise means the rights granted by the franchisor in exchange for financial compensation, authorizing and requiring the franchisee to engage in the business of selling goods or services on its own behalf under a system designated by the franchisor. It includes know-how and assistance and prescribes in substantial part the way the franchised business is to be operated, including significant and continuing operational control by the franchisor. This is associated with a trademark, service mark, trade name or logotype designated by the fran-

[37] *Ibid.,* para 189.

[38] Franchise rule 16 C.F.R. Part 436, May 2008, COMPLIANCE GUIDE, FTC.

chisor. As we see, the supervision and control, exercised by the franchisor over the franchisee is not omitted.

It is important to include the control, as it would draw the attention to the inherited power imbalance in the franchise agreement. The parties are independent entities concluding the franchise agreement but by doing so, one of these entities voluntarily gives up his independence. For this reason, the law and the court must be aware of this subordination and seek for the right balance between the aims of the agreement and the granted rights. Hence, we recommend the inclusion of the control, which the franchisor exercises over the franchisee, as a basic feature of the definition of the franchise agreement in any future franchise regulation.

3.2. Franchisor's Obligations

The most valuable feature of the proposed regulation is the attempt, and successful we would say, not to favour one party at the expense of the other. Overprotectiveness is no better than the lack of protection because it serves as a deterrent for the other party.

Although the aim of PEL CAFDC (incorporated into DCFR) is not to offer protection, they nevertheless impose more obligations on the franchisor than on the franchisee. The dependent situation of franchisees towards franchisors due to the information asymmetry and unequal bargaining power between the parties made it necessary to devote special attention to the contractual interests of franchisees. Franchisors are considered to be able to take care of themselves, as they typically have the bargaining power and hence the power to impose the terms in franchise agreements.[39]

The DCFR considers the usual problems and collision of interests that occur between the parties and manages to supply rational and fair solutions without excessive or undeserved protection for any of the parties.

[39] Díaz (n 18) 25.

3.2.1. Obligation for Assistance, Supply and Good Reputation

Good examples of the statement above are Articles IV.E.–4:203 „Assistance" and IV.E.–4:204 „Supply". Both provisions concern problems, typical for a franchise relationship.

Significant part of the franchise fees, especially the entrance one, are paid by the franchisees in exchange for the assistance and the guidance during the establishment of the outlet as well as throughout their business activity. The assistance degree is what distinguishes the franchise agreement from other similar contracts such as agency and distribution. In many cases, it is also the primary reason for an entrepreneur to choose to invest in a franchise outlet instead of his own business. The assistance is promoted as one of the keys for the success of franchise businesses. Therefore, it is interesting that this obligation of the franchisor is a default rule, which could be excluded by the parties. In most jurisdictions, the assistance is among the key features, which define the contract as a franchise agreement.[40] We presume in some types of business such as distribution franchise assistance is not of such importance and could be excluded in exchange for other benefits for the franchisee such as lower fee or royalties. However, as the franchisor has the bargaining power, the court it has to observe whether giving up assistance is beneficial for the franchisee as well or assistance is in fact necessary for the success of the undertaking.

On the other hand, paragraph (2) of Article IV.E.–4:203 „Assistance" is an example of the fact that the DCFR protects the franchisee but it, nonetheless, pays attention to the other side of the coin – the possibility of abusive or opportunistic behaviour of the franchisee. This article is an attempt to limit the rights of the franchisees within reasonable limits.

However, the extent to which the franchisor is obliged to supply free assistance and when the franchisee crosses the line, so fairness requires the assistance to be paid is unclear. This depends on the type of franchised business and the agreement. The best solution the parties could adopt is an explicit and extensive description of the assistance owed to the franchisee under the franchise agreement and the exact costs for additional assistance. Otherwise, there is a possibility for disputes and abuse by both sides.

[40] The USA, France, Spain to name a few.

The next provisions (IV.E.–4:204: „Supply“ and IV.E.–4:206: „Warning of decreased supply capacity“) are of particular importance as they catch the essence of the franchise agreement. Due to the uniformity requirements, usually the franchisee agrees to get the supplies exclusively from the franchisor or a third party, chosen by it. The grounds for such obligation are not questionable. The uniformity attracts clientele and is the only way to maintain the quality standards high enough within the whole franchise network. For this reason, the compliance with such requirement could prevent from another problem, typical for the franchise agreement. 'An adequate supply (…) prevents temptations, on the side of the franchisee, to purchase competing products in order to fulfil its need for supply.'[41] Any supply by different, unauthorized supplier is considered a breach of the franchise agreement. This could lead to financial sanctions or even termination.

However, if the supplier – regardless of whether this is the franchisor or a third party – delays the agreed supply, the need can urge the franchisee to buy goods from another supplier. Usually this is considered as a breach of the agreement even though the franchisee may have no other choice, but to take the least harmful actions. If the supplies are not bought by the franchisor, it could claim to be a third party to the supply contract. Thus, the franchisee could face a situation where it cannot hold the franchisor liable for third party's obligations under the supply contract and cannot buy the goods from another supplier as having no protection in case of contract breach.

The aim of Article IV.E.–4:204 is to release the franchisee from liability, if the goods are not prompt provided and at the same time imposes an obligation on the franchisor to ensure such duly provision even when this is delegated to third parties. This obligation is essential because otherwise, the franchisee could be left with no defence while the franchisor has only the benefits, but he does not bear the risk. As the drafters put it, '[the] rationale of this rule is that when the franchisee grants exclusivity to the franchisor, the former should obtain some advantage in return.'[42] Again, the aim is the balance of the interests, and it is achieved by adding the 'rea-

[41] Comment B of the DCFR Comments to Article IV.E.–4:204, 1090.
[42] *Ibid.*

sonable' requirement to protect the franchisor from opportunistic behaviour.

The rationale behind Article IV.E.–4:206: "Warning of decreased supply capacity", is the same. It aims to provide the franchisee with some protection in the hypothesis where its supply comes exclusively from the franchisor or third party defined by the franchisor.

What we already said about the importance of the franchisor's assistance is hold true about the reputation of the franchise brand, as well. They both are the primary motives the franchisees to give up their independence and to enter the franchise network. Article IV.E.-4:207 captures this essential feature. The well-established reputation of the network brand and the good advertising and marketing strategies are the other main impetus for the franchisee to buy the license of the trademark, and thus, the franchisee buys the reputation of the products. The reputation, however, must be constantly kept and improved. This is franchisor's obligation as he has the power and the control of the quality standards, organising marketing strategies and advertising. This is part of the price, paid by the franchisees.

3.2.2. Unilateral Determination by the Party

The obligation of the franchisee to pay the franchisor regularly according to the agreed under Article IV.E.–4:301 is usual. What attracts the attention is paragraph (2) of that same article. It considers cases where payments are to be unilaterally decided by the franchisor. Sometimes this is unavoidable.

It often to say that the franchise agreements are unfair and loaded in favour of the franchisor. By its nature, however, the arrangement must allow the franchisor to determine and give directions which the franchisee may consider to be unfair.[43]

Article IV.E.–4:301, paragraph (2) considers that 'the unreasonable unilateral determination of fees is one of the most recurrent problems in franchise relationships.'[44] According to most of the jurisdictions, it is the parties' will to govern the legal relation. Hence, 'the law must closely monitor the use which the franchisor makes of such a discretionary power, especially in the case of franchise con-

[43] Martin Mendelson & Robin Bynoe, *Franchising* (1995), 321.
[44] Comment C of the DCFR Comments to Article IV.E.–4:301, 1098.

tracts where the franchisee is frequently heavily dependent (as a result of extensive investments) on the continuity of the contractual relationship.'[45] When such a clause providing the franchisor with the power to determine unilaterally the price has been agreed, it cannot be avoided as it would intervene too deeply into the individuals' autonomy and freedom of contract. The DCFR proposes a reasonable solution in cases where the franchisor has taken unfair advantage of such contract provision. It refers to Article II. –9:105, which provides to substitute the unilaterally determined 'grossly unreasonable' price or other term with the reasonable one. We regard this solution as the most harmless, but still fair, as the agreement termination or avoidance of the clause might be unacceptable or radical given the parties' significant investments and the peculiarities of the various industries. On the other side, there are defence means at franchisee's disposal. Given the diversity of franchise businesses and the usages, the 'reasonable' price could only be decided on case-by-case basis.

3.2.3. Termination of the Franchise Agreement

The termination of the franchise agreement is regulated by the rules of Book IV, Part E, Chapter 2 – General provisions, applicable to agency and distribution as well.

When read for the first time, these articles leave the impression of being broad and too descriptive, even cumbersome at times. Nevertheless, they lay a solid foundation for the regulation of those agreements where the parties invest a lot of time, money, and personal efforts, hence, a sudden termination can cause significant losses. More importantly, it touches on the core reason for most of the disputes in cases of unilateral termination of franchise agreements.

For that reason, Article IV.E.-2:302 is of interest to our research. It protects parties' sunk costs by obliging both franchisors and franchisees to give notice with 'reasonable length' before ending the agreement. The rationale behind this provision is the significant input of the parties to develop a profitable establishment. Each 'party may have made important investments which will only see a return after a period of many years. (…) Therefore, this party may

[45] *Ibid.*

be economically very dependent on the continuation of the contractual relationship.'[46] Both parties make huge investments, as this contract, like distribution and agency agreements, is intended to continue for years. The parties put too many resources, and in cases of franchisees – normally all their resources – to set up and develop the business. Besides, often the franchise establishment is the only source of income for the franchisee. Hence, one of the necessary protection measures is at least sufficient time before the termination so that the other party could reorganize its resources accordingly and ensure its future business activities.

Huge benefit from the DCFR is paragraph (4) of Article IV.E.-2:302. It stipulates explicitly the minimum period of notice for termination of franchise agreements. So far, such minimal periods are obligatory only for agency contracts within the EU under Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents. Unlike agents, the franchisees currently can count only on the franchise agreement provisions and the general protection of contractual parties granted by the jurisdiction whose law is applicable. However, such statutes usually do not take into consideration the key features of the franchise agreement. We already mentioned the sunk costs and the expectation that the franchise relationship will continue for years. Besides, the trust that is usually built between the parties after years of co-operation is also a significant factor. The time periods said seem just, reasonable and do not impose unequal standards for the parties. This provision is supposed to be mandatory, and it must be so. Paragraph (6) of the same article additionally draws the attention towards the frequent imbalance of bargaining power and excludes the possibility of unequal terms. It aims to balance the contradictory interests of the parties and it succeeds to do so in the most rational way possible.

As we already underlined, the DCFR strives to strike the right balance between the parties without burdening the franchisor more than necessary but treating the parties as equals if this is possible. Another example of this is found in the commentary to Article IV.E.-2:302: this [the period of notice] does not mean that in establishing what notice period would be reasonable in the circumstances, only the interests of the aggrieved party should be taken into

[46] Comment B of the DCFR Comments to Article IV.E.–4:303, 1041.

account. Not only can the facts of the case relating to each of the facts point to a shorter period of notice (e.g., the absence of investments by the aggrieved party, of a post-contractual competition clause, of difficulties in finding an alternative etc.), but also in the case of facts which point towards a longer period, these factors must be weighed against the interest of the party which wished to end the relationship.[47]

The Paragraph 3 states the most important factors to be taken into account when deciding on the reasonableness of the termination and the notice period. As explicitly said in the commentary[48], the list is not exhaustive, but it provides good examples of important factors to be examined in cases of disputes.

The DCFR model law supplies also an option to terminate the contract without the notice period discussed above. This comes at a price equal to the losses 'effectively suffered by the aggrieved party'. In other words, if the reasonable period of notice is not met, the termination is effective, but compensation must be paid to the other party. Article IV.E.-2:303: Damages aims to place the aggrieved party 'as far as possible, in the position in which it would have been if a notice of reasonable length had been provided.'[49] The general formula for calculation of the damages, set forth in the article, tries to fairly provide protection and compensation without over-protecting any of the parties. It allows termination with the proper and adequate sanction and reasonable balance between parties' colliding interests. It also imposes uniform criteria when deciding upon the damages.

Another factor that general statutes fail to recognize is the malicious practice that some franchisors may adopt to terminate the agreement for the slightest incompliance or discrepancy with the agreement, business method or manual they can find. The reasons for such behaviour vary: could be because franchisors profit from the entrance fees of new franchisees or because they aim to take over the outlet if it is profitable.[50] The important conclusion is that

[47] Comment B of the DCFR Comments to Article IV.E.–4:303, 1041.
[48] *Ibid.*, 1040.
[49] *Ibid.*, 1045.
[50] 'Opportunistic franchisees buy-back schemes where franchisors attempt to buy back successful franchisees are an example of franchisor selfishness. A number of cases in the Australian jurisdiction have centred on franchisors

when judging on termination of franchise agreements, it is of utmost importance to weigh up the reason for the termination against the overall investments and performance of the parties.

We believe this is what urged the drafters to include Article IV.E.-2:304: Termination for non-performance, which prohibits the termination of a contract for non-performance, unless the non-performance is fundamental. This provision exists most probably in the general rules of different jurisdictions. Nevertheless, given the already discussed above significant investments and reliance of the parties on the lasting contract, in cases of franchise agreements the termination may cause problems. An explicit statement of this provision in the legislature would minimize the opportunistic behaviour and the damage it causes.

For a franchise contract to be terminated, a breach by one of the parties is not sufficient. The breach must be fundamental. The understanding of the words 'fundamental non-performance' comes from Annex 1. This is 'non-performance of a contractual obligation' that (a) substantially deprives the creditor of what the creditor was entitled to expect under the contract, as applied to the whole or relevant part of the performance, unless at the time of conclusion of the contract the debtor did not foresee and could not reasonably be expected to have foreseen that result or (b) it is intentional or reckless and gives the creditor reason to believe that the debtor's future performance cannot be relied on.

The provided definition is too cumbersome. It is much better explained and summarized in comment A to Article IV.E.-2:304: these long-term commercial relationships may be terminated for non-performance if indeed (i) the non-performance is intentional or reckless and gives the aggrieved party reason to believe that it cannot rely on the other party's future performance, or (ii) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract.

Article IV.E.-2:305: Indemnity for goodwill is also a novelty for the traditional contract legislation. In the sense of this article under 'goodwill' is understood primarily 'clientele'. With regard to the franchise agreement 'the goodwill is rarely the goodwill of the franchisee since typically, clients are attracted by the image of the

deliberately targeting high-performing outlets, or even master and area franchisees, to regain control of them.' – *See* Atwell, Buchan (2014), p. 183, n. 14.

brand and the network."[51] Nevertheless, it could still be relevant where a party, as a result of a valid post-contractual non-competition clause, is not allowed to compete with its former principal, franchisor or supplier, and if, as a result clients who would have moved to it had it started a competing activity now move to its former principal or franchisor or supplier, the combined effect of termination and the post-contractual non-competition clause may be a transfer of goodwill in the sense of this Article, which gives rise to a right to be indemnified.[52]

In brief, application is possible even in cases of termination of franchise agreements, especially if it is unilateral, and the franchisee could claim the damages.

3.2.4. Stock, Spare Parts and Materials

Article IV.E.-2:306 takes into consideration the franchisee's position after the termination of the franchise agreement. The uniformity requirement imposes on the franchisees to buy specific machines or furniture with unique design. They are a significant investment and cannot be used outside the franchise network due to their impracticability or restrictions of the franchise agreement. If the contract has been terminated before the goods are used or depreciated, the franchisee is left with a significant non-returnable investment.

Especially as with the termination the agent, franchisee or distributor may even have lost the right to use or resell them (especially in the case of a valid post-contractual non-competition clause). On the other hand, the excess stock, spare parts, and materials will normally still be useful to the principal, franchisor or supplier which can either use them itself or sell them to the new or other agents, franchisees, or distributors.[53]

According to the rule of the article, this is applicable only if the materials are not useful for the franchisee and he cannot resell them himself. It is true that this repurchase is a widespread practice but there are cases where the franchisor would have particular benefit not to do so. For instance, if he receives a commission from the pro-

[51] Comment D of the DCFR Comments to Article IV.E.–4:303, 1049.
[52] *Ibid.*, 1050.
[53] *Ibid.*, 1051.

ducer or he himself is the producer of the goods/materials/parts. Point E of the commentary to the article in question once again proves that the DCFR aims to impose balance based on reason and fairness instead of favouring one party over the other. It stipulates that as long as the franchisee has the possibility or is given the right to sell the remaining stock or materials, no repurchase is required. The mere aim of the drafters is not to burden the franchisor but to restore an imbalance coming from the agreement itself.

3.3. Franchisee's obligations

The balance in the franchise relationship is very fragile. Any behaviour or intent in bad faith could impair that balance, regardless of which party is taking advantage of the other. In other words, if too much freedom and trust reposed in the franchisee, then it might be the one abusing the franchisor. The drafters of the DCFR have considered this and respectively they have settled some requirements for the franchisee to protect the franchisor's interests.[54]

Business method, instructions, and inspection

Such obligations that deserve our attention are set forth under the Article IV.E.-4:303: „Business method and instructions" and the Article IV.E.-4:304: „Inspection". They capture another essential feature of the franchise agreement. 'Although it is in the franchisee's own interests to ensure the reputation of the franchise network, this provision stresses the importance for the welfare of the franchise network to avoid any misbehavior on the part of franchisees which may result in damaging the image of the franchise system.'[55] Why is that so?

As we already highlighted, the franchisee could also adopt opportunistic behaviour and exploit the franchisor and the franchise net-

[54] As it is well described by the authors: 'In the growth phase, franchisees may be naïve to the fact that the franchisor has expended considerable amounts of time, effort, and money in developing the concept and recruiting franchisees. Once the franchisor breaks even, the balance of power then changes its equilibrium, and it then arguably swings back and forth until the decline of the franchisor or the end of the franchisee's license.' See Atwell, Buchan (2014), p. 183.

[55] Comment D of the DCFR Comments to Article IV.E.–4:303, 1100.

work. The biggest benefit an individual franchisee can obtain from the franchising is the good reputation based on well-established business and service practices. In other words, while a new business, brand or merchant has to establish a good reputation and attract a clientele, the franchisee, from the very beginning of his business, already has a number of clients and guaranteed customers. „[I]t is the consistency of the system's operation, service, and product quality that attracts customers and induces loyalty: customers become loyal if the experiences they enjoy at diverse units of these chains routinely meet their expectations.“[56]

This is not so easy to achieve, and it sets the scene for one of the classical examples of opportunistic behaviour by the franchisee. One franchisee's ignorance and disobedience to the operation manual and quality standards does more harm to the whole network than to his own outlet. He still has clients due to the good reputation of the trademark, but it is losing clients and reputation because of the inferior quality of service by that one franchisee. A perfect example we can take is a business activity or outlet, where clients do not usually recur to the same place. Let us imagine a shop or fast-food restaurant at the station: because of the location, the number of clients will not change, but the clients who were not satisfied with the service have some bad impression of the brand. Such behaviour harms the overall reputation and damages the whole franchise network. The truth is that 'individual franchisee's incentives are not aligned with those of its franchisor: the profit-maximizing behavior of an individual franchisee can have adverse external effects on the franchisor and other franchisees as well.'[57]

This complicated interrelation is unique for the franchising, and its importance could hardly be captured by the general obligations of parties to follow the contract provisions. As 'the maintenance of the quality standards and uniformity of the franchise network may not be attainable unless the franchisee follows such instructions', the franchisor needs to have the necessary legal instruments to ensure his business method and instructions are met. This is one hypothesis where the franchisor needs protection by the law. Because 'protection of the network is essential, both for franchisors and franchisees, who depend on the economic strength of the trademark

[56] R. Blair, F. Lafontaine. *The Economics of Franchising* (2005), 117.
[57] R. Blair, F. Lafontaine (2005), 118.

and who share a common interest in protecting the image and reputation of the franchise network.'[58] That is why we consider that an obligation for 'reasonable efforts' of the franchisee to follow the business method and instructions is not enough to achieve the purposes of the franchise agreement. Presuming that the pre-disclosure obligation of the franchisor has been fulfilled, and the franchisee was aware of the liabilities he has undertaken with the franchise agreement, we could safely impose on the franchisee the obligation of full compliance with the business method, instructions and manuals, provided that they are 'reasonable'.

The franchisor's right of access to the franchisee's premises and inspection is a logical consequence of the franchisee's obligation to follow the business method and instructions.

Inspection is an effective method for the franchisor to check whether the franchisee manages the franchise business by the guidelines which are provided by the franchisor and to which all franchisees must adhere in order to maintain the common image and reputation of the network.[59]

The right of inspection 'provided, however, that it is carried out within the limits imposed by the independent status of franchisees'[60] is the only way the franchisor can provide and ensure conformity with the common standards as one of the essential features of the franchise contract.

4. Recommendations

The drafters undisputedly tried to create comprehensive rules on franchising and certainly succeeded in their endeavour. Still, this is not to say that their work is impeccable and could be explicitly implemented or adopted without any revisions.

[58] Comment B of the DCFR Comments to Article IV.E.–4:303. 1100.
[59] *Ibid.*, 1101.
[60] *Ibid.*

4.1. Pre-disclosure

The truth is that in any business the parties have interest in keeping some of the information for themselves. On one side, not all the information presents them in positive light, and, on the other side, it is often their trade secret or inside information. Hardly would an experienced and clever businessman show all his key information in the negotiations and the bargaining process. This is how negotiations work. However, when it comes to franchise agreements, even though we have separate persons or entities, there is scarcely any negotiation process going on. The bargaining power is one-sided, and the prospect franchisees can hardly have any leverage against the franchisors. The practice has proved that in most cases the franchisor is the one who drafts the agreement and dictates the rules. As we know, „[a]ny rational person will create a contract that is in their best interests. When this motivation for the franchisor to protect its own interests is combined with the incoming franchisees' often limited experience and their acceptance of the standard form nature of the contract, the foundations for conflict are laid."[61]

For this reason, the first step in regulating franchising, and many countries have already taken it, is imposing on the franchisor the obligation to disclose information. This information is relevant and important for the prospective franchisee's choice whether to enter the franchise agreement or not. The importance of this information is undisputed as widely recognized by many states all over the world and by some model law organisations and private franchise associations.[62] It is important to introduce mandatory rules as the information is crucial when deciding whether to enter the relationship and there is no other way to obtain it except through its voluntary provision – otherwise due diligence is beyond the financial and professional possibilities of the franchisee.

The DCFR drafters did not overlook the franchisor's duty to disclose information. They correctly saw and noted that whilst the franchisor actively asks the prospective franchisee to show the nec-

[61] Atwell, Buchan (2014), p. 187.

[62] Such examples are the US Federal Law, Australian franchise-specific law, UNIDROIT's model franchise law, European Franchise Federation's Code of Ethics, etc.

essary information by questionnaires, the prospective franchisee is usually not in a position to direct similar questionnaires to the franchisor (…). The unilateral imposition of standard clauses which can only be accepted on a 'take it or leave it' basis by the franchisee justifies the latter receiving prior information about such terms.[63]

The dynamics of control in a franchise are multifaceted and encompass everything from monitoring, finding constraints, surveillance, and motivation to forecasting. By defining the limits of control and discretion prior to entering into the franchise agreement the parties' interests can be reconciled to provide each with the commitment necessary to justify entering the franchise relationship.[64]

The contents of the obligation of pre-contractual disclosure for franchisors under the Principles [Principles of European Law on Commercial Agency, Franchise and Distribution Contracts incorporated into the DCFR – author's note] are the result of a combination of Articles IV. E. – 2:101 and IV. E. – 4:102."[65] While the general rule of Article IV. E.–2:101 provides for the common obligation of the parties to negotiate and disclose relevant information in good faith, the special norm of Article IV.E. – 4:102 supplements Article IV.E.–2:101 and addresses all the facts and terms that must be disclosed.

The information that must be disclosed before concluding a franchise contract, according to Article IV.E.–4:102, is of key importance for the parties. In fact, if both parties are acting in good faith, such an obligation helps them both. The franchisor needs to identify franchisees who would be able to fulfil all the requirements, obligations, costs of the whole business in a uniform way with the whole franchise network. Unsuccessful franchisees will damage the image if they fail. Even if they do not go bankrupt, an improperly managed franchise establishment – lower quality, incompliance with the manual, bad service, etc., damages the whole franchise network and the trade name in general. Thus, a franchisor has a crucial interest in finding such franchisees who may not be capable of fulfilling the contract requirements. Hence, a full disclosure of all key elements is

[63] Comment B of the DCFR Comments to Article IV.E. – 4:102, 1081.
[64] Atwell, Buchan (2014), p. 186.
[65] Díaz, (n 18) 59.

the first step of this process. The franchisees can better decide for themselves whether they can undertake such responsibility, but they must be aware of what they are undertaking.

In compliance with Article IV.E –2:101, the information has to be provided 'a reasonable time before the contract is concluded' and has to 'enable the other party to decide on a reasonably informed basis's whether to sign or not. The information has to be provided within 'a reasonable time' according to Article IV.E.–2:101 and 'timely' according to Article IV. E.–4:102.

We find that 'reasonable' does not cover the needs of a franchise contract. For starters, whether the information supplied a reasonable time in advance would be decided only in case of court or arbitration dispute. Besides, it would be decided on case-by-case basis. The official commentary also proposes too broad and unclear solution, saying that '[i]n assessing whether the pre-contractual information is given within reasonable time criteria such as the circumstances of the case or any applicable usage will fall to be taken into consideration.'[66] It is true that circumstances of every case should be takes into account. What else should be considered is the high number of franchise agreements, their extensive and complicated texts, and the significant investment in terms of money and time that franchisees make under such an agreement. Moreover, negotiations and changes in the first drafts of the agreements are rare practice. Hence, the least a franchisee could do to protect his interests is to be aware of the obligations and to consider carefully the input required by them in the form of both money and efforts before they undertake the franchise.

The DCFR states only: 'adequate and timely information'. The lack of specific minimum of time for the franchisee to examine the agreement and consult with a specialist is a precondition for further conflicts between the parties. The obligation for disclosure usually includes a minimum time period before the signing of the agreement in order to provide the franchisee with sufficient time to examine the agreement. The established practice is that the franchisor is the one to prepare the whole contract, along with the detailed manual to which the franchisee will be obliged to adhere. It is unnecessary to explain in detail why is the careful examination of a long-term contract important, as this is true not only for the

[66] Comment D of the DCFR Comments to Article IV.E.–2:101, 1032.

franchise agreement. It suffices only to remind that strict compliance is required by the franchisee and even the smallest divergence could be used as a reason to end the agreement. Hence, we find more suitable the approach of setting a minimal period. The usual obligatory period is between 14 to 30 days.[67] We recommend a period of at least 30 days. Hardly would 16 more days impede the business dynamics, but it would significantly increase the opportunity for a prospective franchisee to consult with an attorney or another expert in this field as well as compare offers of other franchisors.

Another weakness to be noted is the list of issues to be disclosed before the conclusion of the agreement. The DCFR, as well as UNIDROIT Model disclose law and US law cover almost the same topics of information that must be provided to the franchisee in advance.

However, the wording of the DCFR provision is much broader and too general about the data to be disclosed. For example, 'relevant intellectual property rights' hardly suffices all the information that is important for the franchisee to decide, especially given the fact that the license of the intellectual property rights is the leading feature and enticement of the franchise agreement. A comparison with the UNIDROIT model law on the exact list of data to be disclosed with regard to IP rights[68] gives an example how to achieve more certainty and stability when the franchise agreement is to be signed.

Another example is the requirement of the franchisor to provide information about the franchise network. In our understanding, this should include the number and location of other franchisees as well as contacts of former franchisees. The information, which other

[67] In Europe where disclosure is mandatory the time period is between 14 to 30 days before concluding the agreement. (see. Abell, (n 5) 64-6). In the USA FRANCHISE RULE 16 C.F.R. Part 436, May 2008, COMPLIANCE GUIDE, FTC requires a time period of 14 calendar days before signing the agreement.

[68] Art. 6 (1) (L) the following information regarding the franchisor's intellectual property to be licensed to the franchisee, in particular trademarks, patents, copyright and software: (i) the registration and/or the application for registration, if any; (ii) the name of the owner of the intellectual property rights and/or the name of the applicant, if any; (iii) the date on which the registration of the intellectual property rights licensed expires; and (iv) litigation or other legal proceedings, if any, which could have a material effect on the franchisee's legal right, exclusive or nonexclusive, to use the intellectual property under the franchise agreement in the State in which the franchised business is to be operated.

franchisees and former franchisees would provide, could be crucial for the prospective franchisee's decision. That is why maybe not all of the franchise network information would be disclosed, as the wording of '(f) structure and extent of the franchise network' leaves a good opportunity for the franchisor not to provide all the facts as opposed to paragraphs (I), (J) and (K) of UNIDROIT Model franchise disclosure law.[69]

Another paragraph of the same article that deserves criticism is '(g) the fees, royalties or any other periodical payments.' It is an attempt to demand clear information on the expected expenses of the franchisee throughout the duration of the agreement but an unsuccessful one. The notions are too broad and unclear and leave wide space for interpretation and circumvention of the rule. Even though the effort to make the requirements simple and understandable is appreciated, we recommend a more extensive provision, explicitly stating that all due expenses for the duration of the contract shall be disclosed in a clear way, and no unexpected costs could be imposed on the franchisee.

Another information that no franchisor would voluntarily disclose concerns any pending or resolved court trials, especially those where the franchisor is a defendant and is sued by franchisees (former or not) or third parties challenging his ownership of the IP rights. Such information is very indicative of the franchisor and its business. Its disclosure must be explicitly required by the legislator.

[69] (I) the total number of franchisees and company-owned outlets of the franchisor and of affiliates of the franchisor granting franchises under substantially the same trade name;
(J) the names, business addresses and business phone numbers of the franchisees, and of the franchisees of any affiliates of the franchisor which are granting franchises under substantially the same trade name whose outlets are located nearest to the proposed outlet of the prospective franchisee, but in any event of not more than [X] franchisees, in the State of the franchisee and/or contiguous States, or, if there are no contiguous States, the State of the franchisor;
(K) information about the franchisees of the franchisor and about franchisees of affiliates of the franchisor that grant franchises under substantially the same trade name that have ceased to be franchisees during the three fiscal years before the one during which the franchise agreement is entered into, with an indication of the reasons for which the franchisees have ceased to be franchisees of the franchisor.

Even more valuable information that must be disclosed but is omitted by the drafters of the DCFR is regarding any exclusivity clauses with respect to territory or clients. Such exclusivity is a frequent practice in franchise networks. Nevertheless, it is a double-edged sword for the franchisees. If a franchisee has exclusivity in a profitable territory, his clientele is guaranteed. Unfortunately, this is not always the case. Sometimes the territory granted as exclusive could be impossible to bring enough profits for various reasons (the size is too limited, the brand is unknown, etc.) or there are already too many outlets of the franchise network within the designated territory. These factors could have a significant effect on the decision of the franchisee. That is why any exclusivity or limitations of clientele or territory must be explicitly stated as mandatory information to be disclosed.

As already said above, the drafters of DCFR drew a solid base of model law concerning the franchise agreement. Notwithstanding, with respect to the disclosure requirement we recommend a more extensive and exhaustive enumeration of all the facts and data to be provided in advance to the franchisee. As the UNIDROIT Model franchise disclosure law was entirely focused on disclosure, it would serve a better model law for future legislative acts.

4.2. Intellectual Property Rights

One more article which drew our attention is Article IV.E.–4:201: Intellectual property rights. According to paragraph (1) the franchisor must guarantee the undisturbed and continuous use of the IP rights. The highest value of the franchise package, these are the IP rights – the trademark, the know-how, patents, manuals, etc. which in fact make the business method successful.

'Most franchise contracts begin with a grant of a right, usually in the form of license. This grant lies at the heart of the franchise relationship.'[70] It is even part of the commonly accepted definition of the franchise agreement. As the drafters themselves state, the licensing of intellectual and industrial property rights is the cornerstone in the proper functioning of the franchise business method.

[70] Spencer (2013), p. 36.

(…) In fact, this is the main reason for franchisees to be attracted by the franchisor's system of doing business.[71]

The DCFR explicitly defines in Article IV.E.-4:101 that 'the franchisee has the right *and the obligation* to use the franchisor's tradename or trademark or other intellectual property rights, know-how and business method (emphasis added).' Hence, the franchisee must have a guarantee that he would be able to use them. However, 'paragraph (2) merely obliges the franchisor to observe due diligence in providing an adequate response when there is an action, claim or proceeding brought or threatened by a third party concerning such intellectual property rights.'[72]

Usually, the franchisor is the owner, and he is the one to manage the IP rights. Unless something different is explicitly agreed, which is not the usual practice, in fact the franchisee is not able to protect himself without the franchisor's assistance as 'the franchisee is to be identified as a mere licensee of such rights.'[73] The franchisee is unable to take any legal actions as he is just a licensee and has the right only to use the IP. Thus, if the franchisor claims he has done all the reasonable efforts, the franchisee will have tied hands. His business might be hampered, or he may even be unable to work for the duration of a whole trial while proving whether the franchisor has done all reasonable efforts. The franchisee buys a product, and this purchase should not be different from any other where full responsibility of the seller would be required.

Another point to consider is that even in case of bad faith on behalf of third parties, the franchisor is the one who can file a claim and protect his IP rights. He has the legal grounds and the resources. Otherwise, the franchisee is left with no protection against behaviour of third parties, regardless of whether their behaviour is fraudulent or not.

To sum up, we believe that to ensure undisturbed and continuous use of the licensed IP rights, the franchisor must provide not only reasonable efforts but a result, consisting of such care according to the agreed in the franchise agreement.

[71] Comment B of the DCFR Comments to Article IV.E.–4:201, 1084.
[72] *Ibid.*, 1084.
[73] *Ibid.*, 1085.

Conclusion

In the current paper, we discussed the urgent need of common regulation of franchising at Community level, as this would secure better legal environment for both parties. However, common regulation per se is not a guarantee for successful development of franchising. Such a common regulation must set forth rules, which are fair and protect both parties, to encourage them and to minimize possible sources of abuse and legal disputes.

As the DCFR is the first attempt to create a complete franchise regulation, we recommend changes in some articles, namely:

1. Control to be included as part of the definition of the franchise agreement.

2. A mandatory pre-contractual disclosure period of 30 days to be included in Article IV.E. – 4:102.

3. A more detailed description of the information to be disclosed by the franchisor prior to the conclusion of the franchise agreement, especially regarding financial obligation, IP rights, past and pending trials, franchise network and exclusivity.

4. An obligation for the franchisor to ensure the undisturbed and continuous use of the IP rights granted the franchise agreement.

The overall impression is that the DCFR takes into consideration the idiosyncrasies of the franchise agreement and aims to neutralize all possible sources of abusive or opportunistic behaviour. We believe the biggest asset of this model law is precisely the attempt not to over-protect any of the parties but to strike the right balance between their personal interests and the common interest they have in establishing and developing the franchise relationship. For this reason, we consider that Book IV, Part E, Chapter 4 of the DCFR is suitable to be used as a base for further elaboration and adoption of either national franchise-specific provisions or, even better, a common European franchise regulation.

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