FRANCHISE DEVELOPMENTS IN EUROPE

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Chair's Column

Times goes fast and there are a few days left to accommodate franchise agreements existing prior to May 31, 2022 to the new EU Block Exemption Regulation 2022/720 of 10 May 2022 on Vertical Agreements (VBER). The new VBER entered into force on June 1, 2022 after long discussions and EFL has been attentive and involved in this important process. Let us remind you that the new VBER has confirmed its applicability to dual distribution systems hence to franchise systems where franchisors often operate their own outlets in addition to franchising in a market. However, the flow of information between the franchisor and franchisee is now restricted in the context of dual distribution to only those exchanges of information that are "*directly related to the implementation of the agreement* " and "*necessary to improve the production or distribution of the [franchise] goods or services* (…)". However, the new VBER has brought good news for a softening approach and legal uncertainty in franchising. For instance, as concerns online sales, the use of specific online marketplaces and price comparison tools, as well as online advertising, may be restricted as long as it does not prevent the franchisee from using an entire online advertising channel; also, discrimination between online and offline sales is no longer hardcore.

As concerns our association, I am pleased to announce that following Benedikt Spiegelfeld's retirement, Dr. Johannes Aehrenthal has joined EFL as the Austrian member of the group. We welcome Johannes warmly and are convinced that his membership ensures that our clients will be best served when requiring expert legal advice for franchising in Austria.

There will be other new comers to our group soon since our Danish member, Paul Neale, and Belgium member, Pascal Hollander, have unfortunately resigned from EuroFranchise lawyers due to professional reasons.

It has been a privilege to have Benedikt, Pascal and Paul as EFL members for many years; we have benefitted from their sound knowledge and expertise in franchising matters and we thank the three of them for their enormous contribution to EuroFranchise Lawyers.

Our members continue exchanging know-how on international franchising and networking at most reputed international conferences. A number of us have just attended the 38th IBA/IFA Joint Conference in Washington this month. It has been an excellent opportunity to gather with colleagues from all over the US and other jurisdictions and keep abreast of legal developments, challenges and opportunities for international franchising. In addition, a majority of our members will attend the IDI Conference in June which this year will take place in Bologna and deal with restrictions on the freedom of contract to analyse to what extent can be expected that a franchise contract will not be reinterpreted or rebalanced by courts in Europe. Those of you attending the IDI conference are most welcome to get in touch with EFL members in advance to plan an appropriate time to meet.

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By Pascal Hollander

EXPECTED IMPROVEMENT OF THE DISCLOSURE LAW

When enacted in 2005, the Disclosure Law, requiring franchisors to prepare and submit to prospective franchisees a disclosure document and to wait for one month thereafter before actually entering into the franchise agreement, provided for the setting up of a committee in charge of monitoring its implementation and making proposals for its improvement (the "Monitoring Committee"[1]).

In its latest opinion, released on 10 June 2022, the Monitoring Committee addressed an issue in the drafting of the Disclosure Law, that has severely affected its effectiveness. According to its Article X.28, § 1, 1°, the disclosure document must set out the "*important contractual provisions*" of the contemplated franchise agreement. Under this heading, the Disclosure Law lists nine types of contractual provisions, including "*b) the obligations*" and "*c) the consequences of the non-performance of the obligations*". This requirement turned to become a headache for drafters of disclosure documents, as an incomplete description of the "obligations" could have potentially drastic consequences (*i.e.* the setting aside of any obligation which has not been mentioned). As an agreement is in essence a sequence of contractual obligations, drafters of disclosure documents often chose for security in copying the full text of the agreement (save the identity of the parties and the preamble) in the disclosure document, so as to be sure that no obligation was inadvertently omitted. The consequence thereof is that, instead of describing the most important contractual provisions and drawing the reader's specific attention thereto, disclosure documents often are fully redundant with the agreement itself and very difficult to "digest" by their reader (not to mention that they must also contain other information than the important contractual obligations, about the commercial and economic characteristics of the franchise), and are thus ineffective.

It is this issue, arisen out of the practice, that the Monitoring Committee wants to remedy by making the disclosure document a "red flag" rather than an exhaustive list of all obligations set out in the contemplated franchise agreement. With that goal in mind, the Monitoring Committee has suggested to amend the Disclosure Law, by deleting the reference to "*obligations*" and to their non-performance and by completing the already existing list of important contractual provisions. The new list would contain fifteen provisions that, if existing in the contemplated franchise agreement, will have to be set out in the disclosure document. This list would be exhaustive, so that the fact that other contractual provisions would not be set out will no longer entail a risk of these provisions being set aside. The practice of copying the full text of the franchise agreement into the disclosure document would therefore likely disappear.

If adopted, the legislative change should result in shorter and clearer, and thus more effective, disclosure documents. No timetable is currently set or known for the introduction of a bill that would amend the Disclosure Law in line with the opinion issued by the Monitoring Committee.

Italy

By Silvia Bortolotti

ABUSE OF ECONOMIC DEPENDENCE - FRANCHISE AGREEMENTS

Article 9 of law No. 192 of 18/06/1998 on subcontracting prohibits the abuse of economic dependence, i.e., the situation which exists when a party is able to determine an excessive imbalance of rights and obligations for the other party.

Namely, Art. 9 Law 192/1998 provides:

"Abuse of economic dependence

1. *The abuse by one or more undertakings of the position of economic dependence in which a customer or supplier undertaking is, in or against them, shall be prohibited. An economic dependency is a situation in which an undertaking is able to cause, in its commercial relations with another undertaking, an excessive imbalance of rights and obligations. Economic dependence shall also be assessed taking into account the real possibility for the party subject to*

[1] Its official name is "*Commission d'Arbitrage / Arbitragecommissie*", which translates into English as Arbitration Committee. However, this is a complete misnomer, since this body does not perform any arbitration-related activity, hence our preference for naming it Monitoring Committee.

abuse, to find satisfactory alternatives on the market.

2. *Abuse may also consist in a refusal to sell or a refusal to buy, the imposition of unjustifiably onerous or discriminatory contractual conditions, or the arbitrary interruption of existing commercial relations.*

3. *The pact through which the abuse of economic dependence is carried out shall be null and void. (..)"*

The competence to decide in this matter lies with the ordinary courts, but also the Italian Antitrust Authority can intervene with warnings and sanctions when it envisages, precisely, a relevance of the alleged abuse in terms of competition.

Although the above provision is included in a law dealing with subcontracting contracts, Italian case-law is in favour of a wide application to most commercial contracts and, in principle, also to franchise agreements. However, when examining the factual situation, Italian Courts have almost always excluded the existence of an economic dependence between franchisor and franchisee, mainly considering – on a case-by-case evaluation - that the franchisee had the chance to find satisfactory alternatives to the franchisor in the market, without even getting to the point of ascertaining a possible abuse.

On the contrary, recently the Italian Antitrust Authority opened investigations against some main franchisors, i.e. Benetton (on November 17, 2020 – proc. A543) McDonald's (on July 27, 2021 – proc. A546) and Original Marines (on December 3, 2021 – proc. A550) for alleged abuse of economic dependence against their franchisees. The proceedings arose from complaints brought by former franchisees of the relevant franchise networks who basically claimed the imposition by the franchisors of imbalanced contractual provisions, which potentially give rise to an abuse of economic dependence.

In the framework of those proceedings, the three franchisors agreed to amend their franchise agreements, in compliance with the requests made by the former franchisees and the indications provided by the Antitrust Authority; the Antitrust Authority accepted the franchisors' commitments to proceed with such amendments and closed the relevant proceedings respectively on June 14, 2022 (McDonald's) on July 5, 2022 (Original Marines) and on January 31, 2023 (Benetton).

Such choice is clearly understandable from the franchisor's perspective, considering its interest to avoid a possible decision of the Antitrust Authority which could affect the balance of its franchise agreements as well as possible sanctions. However, through this kind of approach the Antitrust Authority *de facto* grants itself the power to "re-balance" franchise agreements, authority it doesn't have under Italian law.

ABUSE OF ECONOMIC DEPENDENCE – DIGITAL PLATFORMS

In connection with the previous information, it is important to consider that the text of Article 9 of Law 192/1998 was recently amended (by Article 33 of Law No. 118 of August 5, 2022), introducing a presumption of economic dependence in the commercial relations between digital platforms and undertakings which use their intermediation services, under certain circumstances.

Particularly, the following sentences have been added to paragraphs 1, 2 of Article 9:

1. *(..) "Unless proven otherwise, economic dependence is presumed where an undertaking uses the intermediation services provided by a digital platform that plays a decisive role in reaching end users or suppliers, including in terms of network effects or data availability."*

2. *(..) "The abusive practices carried out by the digital platforms referred to in paragraph 1 may also consist in providing insufficient information or data on the scope or quality of the service provided and in requesting undue unilateral performances not justified by the nature or content of the activity carried out, or in adopting practices that inhibit or hinder the use of a different provider for the same service, also through the application of unilateral conditions or additional costs not provided for in the contractual agreements or existing licences."*

Competence over civil actions in this matter is now reserved to the specialised business sections ("sezioni specializzate in materia di impresa") of the ordinary Courts.

The amended rules came into effect on October 31, 2022.

COMPULSORY MEDIATION FOR FRANCHISE DISPUTES

In the framework of the revision of the procedural rules applicable to civil Court proceedings Article 5

of Law No. 28 of 4 March 2010 has been amended and now provides for the compulsory recourse to prior mediation in order to bring disputes concerning franchise agreements before Italian courts.

The amended rule will come into effect on June 30, 2023.

United Kingdom

By John Pratt

RESTRICTIVE COVENANTS AND GOOD FAITH

Two important legal issues affecting franchise agreements have recently been considered by the English courts.

A. POST TERMINATION NON COMPETE COVENANTS

After the Court of Appeal's decision in respect of a Drain Doctor franchise agreement last year, the well established position that, in the absence of unusual factors, a 12 month post-term non compete covenant, in a franchisee's allocated territory would be enforceable, no longer applies and judges now need to analyse the franchisee, the franchisor and the terms of the franchise agreement in each individual case.

The fear for franchisors is that their franchisees obtain all of the franchisor's know how and build up their business using the franchisor's brand and continuing assistance only to exit the franchise and operate their business independently once they have obtained the benefits they were looking for.

Legal Steps

UK Franchisors should immediately review their post term non compete covenants and modify the covenants for all new franchise agreements they issue in order to address the concerns expressed by the Court of Appeal. For existing franchisees, generally, any new terms cannot be introduced otherwise than on renewal. However, franchise agreements should contain a provision which enables the franchisor to reduce the scope of the post termination obligations and that could be used to introduce new Drain Doctor compliant restrictions. Another alternative may be to simply notify existing franchisees of the franchisor's wish to reduce the scope of the non compete covenant to make it fairer and less onerous on the basis that "why wouldn't a franchisee agree to that?" The danger is that a franchisor, as a result, alerts franchisees that the existing non compete covenant may be unenforceable.

Alternatives

In view of the lack of certainty concerning the enforceability of non compete covenants, there are a number of steps that a franchisor should consider:-

1. Although franchise agreements are non negotiable it may be that the post term non compete covenant is the one clause that can be negotiated to overcome the concerns of the Court of Appeal that franchisors' bargaining power was such they could impose unfair non compete provisions.

2. Consideration should be given as to whether practical alternatives to non compete covenants can be used such as the franchisor retaining ownership of all the data on a franchisee's CRM system or essential equipment, requiring franchisees to use the franchisor's booking system or requiring customer contracts to be entered into by the franchisor or providing that on termination of the franchise agreement the franchisor has an option to acquire the franchisee's business and/or premises.

3. A further approach is to make legal action less attractive for franchisees by requiring an "account of profits" if a franchisee operates a competing business and/or limiting the time period for a franchisee to bring a claim.

In addition, franchisors should learn from the mistakes made by Drain Doctor who picked a franchisee with no business experience, was willing to change its forecasts to suit the franchisee, expressed doubt about the likely success of the franchisee, took on a franchisee who would lose his house if the franchise business was not a success and according to the court treated the franchisee badly.

B. GOOD FAITH

Franchise agreements will generally be classified as "relational contracts" which means that the courts will imply a duty of good faith on the franchisor and the franchisee. The problem is establishing what that duty involves. Is it simply to act honestly? Honesty is important, but the obligation is likely to also include an obligation not to do anything commercially unacceptable but probably nothing more.

Because of the uncertainty as to what precisely an implied term duty of good faith means, franchise agreements should include an express good faith clause that applies to both the franchisor and the franchisee. The English courts will not impose an implied term if there is an express good faith term. Very few franchisors do this.

Franchise agreements generally give to a franchisor a broad discretion in a number of areas, such as in relation to amending the Operations Manual and the terms of its renewal franchise agreements. That discretion is subject to implied limitations that a franchisor should not act arbitrarily, capriciously or irrationally!

Sweden

By Anders Fernlund, Ph.D., M.B.A

A Franchisee of a well-known Swedish steakhouse restaurant franchise continued with its restaurant business after the expiration of the franchise agreement. As the Franchisee held the lease to the premises the restaurant kept the address but with a new name. All signage and memorabilia in the restaurant were dismantled, but the menu was kept, at least its steakhouse-type orientation even though the names of the dishes were changed.

The expired franchise agreement between the Franchisee and the Franchisor contained a non-competition clause that prohibited the Franchisee from conducting business in competition with the Franchisor for a period of twelve months after the expiration date.

The Franchisor considered that the Franchisee violated the non-competition clause and sent a letter requesting a change in the menu orientation. As nothing happened the Franchisor sued the Franchisee for damages in the district court. The District Court concluded that the Franchisee served regular dishes that appear in most restaurants and that the similarities in the menus was not enough to establish a violation of the non-competition clause. The District Court dismissed the suit for damages.

The Franchisor appealed to the Court of Appeal, that stated in its verdict that it was clear from the non-competition clause that "Competing business means restaurant concept with a similar orientation as the Chain and Concept". The “Chain” was described as all restaurants working under the “Concept” regardless of if they were corporate owned or run by a franchisee. The "Concept" was described int the franchise agreement as "The model according to which the individual franchisees and their own restaurants conduct their business."

The Court of Appeal declared that the counsel of the Franchisor had focused on the menu as the grounds for its allegation of breach of the non-competition clause. Hence, they could not rule over a wider interpretation of the “Concept”. The Court of Appeal also declared that a restaurant's menu is a central part of its concept, but a concept also includes several other important aspects. Ruling on the menus only, the Court of Appeal stated that the menus also contained very common dishes that are not unique to the Franchisor's restaurant chain. The menus were not identical either, but differed, e.g. in terms of accessories. With this limited focus, the Court of Appeal concluded that the Franchisee had not breached the non-competition clause.

Since this verdict, the Franchisor has appealed the case to the Supreme Court – (to be continued?).

Switzerland

By Dr. Christoph Wildhaber

This article (slightly adapted for the purposes of this newsletter) first appeared in Marketing und Kommunikation m&k, January/February 2023.

SOCIAL FRANCHISING - ENTREPRENEURSHIP WITH IMPACT

Social franchising is a modern and sustainable way of pursuing social goals through franchising. It uses proven elements of business strategy franchising in typically socially oriented areas such as education or healthcare. It is worth looking at this still little used discipline of franchising.

What distinguishes social franchising from traditional franchising?

Social franchising is the use of a franchise system to offer products or services that have a positive social or environmental impact.

Unlike traditional franchising, social franchising is therefore not focused on maximizing profits and expanding a brand's market presence.

Social commitment needs a clear, credible and convincing message!

Social franchising can also go much further than simply promoting the sale of socially positively perceived goods or services.

The well-known principles of franchising can also be used to address social or environmental problems such as poverty, lack of access to education or healthcare, and environmental degradation. Traditional commercial franchises, on the other hand, typically target a general consumer market.

The difference from traditional franchising can also be seen in funding: Whereas traditional franchises rely on investments from business owners and outside capital providers for design and development, and finance ongoing operations through franchise fees and (often) trade in goods, social franchises also often use third-party grants and donations. Public-private partnerships with the public sector are also conceivable.

Opportunities of Social Franchising in Development Aid

In addition to the challenges that still exist in the societies of the Global North in the field of education or employment of disadvantaged people, the developing countries often face a number of major problems that can also be efficiently addressed through concepts such as social franchising.

Access to basic services such as health care, education and clean water hinders development. Developing countries are often disproportionately affected by environmental degradation, which affects their ability to sustainably develop and provide for their populations. Due to limited economic opportunities, there is often little access to know-how to overcome such challenges.

Social franchising has the potential to make an important contribution in addressing such challenges:

- **Promoting economic development**: social franchising creates opportunities by providing employment and entrepreneurial opportunities (such as the African Solar Sisters network in the field of energy supply).
- **Strengthening local communities**: social franchising, like franchising in general, builds on ownership and local management. This helps ensure that the solutions offered are tailored to specific local needs (for example, family planning services in Africa through social franchise networks).
- **Supporting environmental sustainability**: Social franchises that focus on environmental sustainability help to systematically address environmental issues (e.g. Oorja Development Solutions, an Indian provider in the agricultural sector).

Other reasons why social franchising can be a suitable business model

Social franchising is also based on the proven principles of the established franchising business model. Based on a proven business model ("proof of concept"), social franchising systems offer further advantages:

- **Multiplicability**: social franchising enables organizations to multiply their impact by systematically introducing their business model to new locations or markets (for example, Kidogo, a daycare provider in East Africa).
- **Leveraging expertise**: Social franchising enables the transfer of know-how to local markets. Tried-and-tested concepts can thus be duplicated and increase the efficiency of the social commitment.
- **Training and innovation**: Social franchising can promote the development of new ideas and approaches to tackle social problems. By promoting a system-wide mentality of innovation and constant training of all system participants, it is not always necessary to start "from scratch" in order to solve problems.

Legal aspects of social franchising

Social franchising cannot always be implemented according to the standard legal models of commercial franchising. Commercial franchising, as a two-sided profit-oriented entrepreneurial activity, is typically strongly characterized by adherence to system standards, uniformity of brand presence and stable financial relationships. This leads, for example, to commercial franchise agreements being highly regulated and rich in detail.

In contrast, due to the different strategic orientation of social franchising, the depth of regulation in a socially oriented partnership may be lower. This can be reflected in "softer" regulations, for example on the franchisee's market services, the financial arrangements or even the duration of the franchise cooperation. This is against the background that it may seem more important to a social franchisor from its social objective that local entrepreneurship can be created "at all" and that socially valuable activities are developed, than that a marketwide

system uniformity is achieved (even if this also remains desirable, of course).

In social franchising, it is therefore advisable to critically question the legal models and system documents typically used in commercial franchising and to develop them with regard to the specific purpose of use.

For whom is social franchising suitable?

If one is primarily looking for social benefit rather than economic profit, social franchising is an effective tool with the potential to drive social change.

Development aid agencies, philanthropists, impact investors and foundations are invited to consider the idea of social franchising as part of their activities.

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