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Franchising

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1.1. Franchising at international level

Franchising is a successful commercial vehicle for the distribution of products and services whereby, a **franchisor** ("affiliante", "concedente") having elaborated and tested a specific business procedure (the "business format"), use the latest for the distribution of goods or the supplying of services, by granting to several **franchisees** ("affiliato" o "aggregato alla catena") the right to use. In order to permit the franchisee to do so, the franchisor usually against compensation (normally, but not exclusively, in the form of an entry fee and/or continuing fees) will provide the franchisee with the *know-how* required and with the training needed to use this know-how. The franchisor will also in most cases provide a detailed manual containing the necessary instructions for the running of the business. Furthermore, for the duration of the agreement the franchisor will typically provide the franchisee with any assistance it might need in the operation of the franchise.

It is therefore a package which includes - but is not necessarily limited to - intellectual property rights (trademarks, trade names or, less frequently, patents), know-how, training and continued assistance on the part of the franchisor, franchisor control rights *vis-à-vis* the franchisee and obligations of the franchisee to follow the instructions of the franchisor and to comply with the financial terms of the agreement. It

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further permits, or may at times require, the franchise unit to be clearly identified as a member of a particular franchise network.

There are several type of franchising. Usually they are divided into:

- industrial franchises,
- distribution franchises; and
- service franchises.

Other descriptions of franchising divide franchises into product distribution franchises and business format franchises, the latest coming to symbolise franchising as a whole.

At international level, both the Unidroid and the ICC intervened on this subject matter with the so called soft tools of the international private law.

1.1.1. UNIDROIT Guide to International Master Franchise Arrangements

In particular the Institute for the Unification of Private Law (UNIDROIT) in 1998 (then reviewed in 2007) published a **Guide to International Master Franchise Arrangements** with the purpose "*to spread knowledge with a view to providing all those who deal with franchising, whether they be franchise operators, lawyers, judges, arbitrators or scholars, with a tool for the better understanding of the possibilities it offers*"[1].

The Study group set up for this purpose briefly considered as a possibility instrument, alternately to the one chosen (the guide) the model contract. The majority of the Group however did not feel that such an instrument would be suitable for master franchising. Furthermore, the *International Chamber of Commerce* in Paris was already preparing a model franchise contract for international franchises and the Study Group therefore decided to exclude the model contract from the options open for consideration.

Whereas a binding instrument such as an international convention was considered to be inappropriate, there emerged in the course of the meeting a general consensus on the fact that it would be opportune to

[1] Unidroit, "*Guide to International Master Franchise Arrangements*"- Introduction page xxxii

prepare a legal guide to international franchising, in particular to master franchise arrangements.

The Group felt that the guide approach would present several advantages for a subject such as franchising. In the first place it could illustrate the problems that might arise in connection with issues that had already been regulated in one way or another by national legislation, but which were of particular importance in the context of franchising (such as intellectual property). It could also illustrate the advantages and disadvantages of the different options open to operators and alert readers to the different hurdles that they might find on their path. This would clearly not be possible if an instrument such as an international convention were opted for.

Furthermore, a guide could be prepared in a relatively short period of time, could be launched on the market upon completion and could consequently be immediately available to operators, whereas an international convention would require adoption by a sufficient number of States for it to enter into force.

The Guide focuses on the master franchise agreement in which the franchisor grants another person, the sub-franchisor, the right, which in most cases will be exclusive, to grant franchises to sub-franchisees within a certain territory (such as a country) and/or to open franchise outlets itself. The sub-franchisor in other words acts as franchisor in the foreign country. The sub-franchisor pays the franchisor financial compensation for this right. This compensation often takes the form of an initial fee, which may take any one of a variety of different forms, and/or royalties constituting a percentage of the income the sub-franchisor receives from the sub-franchised outlets. The form of financial compensation, and the relative importance of the component parts of this compensation, will vary from country to country and from franchise to franchise. It should be noted that the use of master franchise agreements is not limited to international franchising and that they may also be used in the domestic franchising context.

In master franchise arrangements essentially two agreements are involved: an international agreement between the franchisor and the subfranchisor (the master franchise agreement), and a domestic franchise agreement between the sub-franchisor and each of the sub-franchisees (the sub-franchise agreement). There is in most cases no direct relationship between the franchisor and the sub-franchisees, although in some countries intellectual property legislation will make a direct link necessary for matters concerning those particular rights.

1.1.2. ICC Model International Franchising Contract

The ICC Model International Franchising Contract, first published in 2000 and updated in 2011[2], to reflect developments in the field, notwithstanding initial opinions, has demonstrated that a franchising agreement, like agency, distributorship and intermediary agreements can usefully be expressed in a model contract based on the most common clauses found in international franchise contracts.

The last version is the result of the works carried out by the ICC's drafting group, which chaired by Professor Fabio Bartolotti of the University of Torino (Italy) took on the task of revising the model in 2008. After multiple meetings, at least 10 drafts and after receiving comments from various international franchise lawyers, the ICC has completed and released its amended model, complete with comments and analysis.

The model is a relatively simple form of a single-unit franchise agreement intended for use in international franchising[3]. A significant improvement on its predecessor, the model follows a common law format, in that it attempts to clearly specify the parties' rights and duties, and does not rely upon references to a civil code to interpret the parties'

[2] ICC *Model International Franchising Contract, ICC Publication No. 557*
[3] DRAFTING AND NEGOTIATING INTERNATIONAL COMMERCIAL CONTRACTS, ICC Publications no. 671 (2008)

intentions. The model agreement is intended to be "fair" to both franchisors and franchisees.

The drafters exhort lawyers to become familiar with the "mandatory laws" of countries where their model will be used, including franchise disclosure and relationship laws, antitrust laws and laws restricting the repatriation of funds to the franchisor.

As general characteristic of ICC standard forms it should be mentioned that they are drafted with the intent of establishing a fair balance between the two parties involved (the so called "Neutral" approach). This, not only because the ICC represents all categories involved (hence franchisors and franchisees) but also because the ultimate intent of the ICC is to provide an international standard to which the parties may refer as an alternative to national laws.

According to the model contract introduction: "*This model franchise contract aims to provide those who are considering entering into a franchise contract with a set of clauses that can guide the parties in preparing their own franchise contract.The model follows the traditional ICC approach in seeking to strike a fair balance between the interests of the franchisor and those of the franchisee, taking into account the core obligations of an international franchising contract.*"

Hence the ICC model can be used (i) when the parties wish to come to an agreement quickly without discussing the various legal issues; (ii) by the weak party, which may propose the ICC model as alternative contractual solutions in the course of negotiation; and (iii) in general by representing the starting point for negotiation and adjustments by the parties will be added when necessary.

This aim is also pursued by the drafting techniques used in the ICC models.To reduce the risks of inappropriate manipulation of the contract texts by users (not using the advise of a lawyer) the ICC models try to separate, as far as possible, parts of the contract where the parties are asked to fill in certain details (such as prices, goods etc) and choose between different alternatives (which are normally presented in two

columns, according to current practice in standard contracts, in order to undeline the need of a choice).

In any case there is always a "default" solution corresponding to prevailing practice, which will automatically apply when the parties have made no choice. Normally, there will be a provision saying that in case no choice has been made, alternative "A" will apply.

These goals have been pursued through two different approaches:

1. use of detailed annexes (where the parties can insert further specifications)
2. division into special and general conditions.

The basic idea is to include in a first part called "special condition" all issues that imply a choice between alternative or that need to be filled in by the parties (names of the parties, contractual products, date of delivery etc…) and to put all the other clauses in a second part called "general conditions". In this way the parties are induced to discuss the main issues that require a specific choice in each individual contract.

The ICC model defines the franchising as "*an agreement whereby the franchisor grants the franchisee, in exchange for direct or indirect financial compensation, the right to exploit a package of industrial or intellectual property rights relating manly to know-how and commercial symbol, and to receive continuing commercial or technical assistance for the duration of the contract*[4]*"*

The ICC model is solely designated for International distribution franchise agreements; it does not apply to other types of franching agreements, like master franchise agreements (covered by the UNIDROIT guide).

The model set out the main clauses characterising the franchise relationship, including commentaries that explain the provisions and give advice to the users. In particular:

For the franchisor:

- the licensing of know-how embodied in operational manuals and permanently updated, with a training support system;

[4] Introduction to the ICC *Model International Franchising Contract.*

- the licensing of trademarks and symbols;
- the provision of assistance regarding distribution and managements
- supply of products (if applicable).

For the franchisee:

- the franchisor's exercise of reasonable quality controls over the franchisee to protect its intellectual property;
- the payment of initial and ongoing fees in exchange for the right to use the intangible assets;
- the participation in training courses organized by the franchisor;
- the use of the franchisor' trademarks and symbols;
- the strict compliance with the franchisors' commercial standard; and
- the information given to the franchisor concerning any difficulty which may appear or improvements which may seem suitable.

1.2. Franchising at European level

The European Union has to date limited its activities in relation to franchising to the field of competition law[5].

The examination of franchising within the Communities began with the decision of the European Court of Justice in the case of Pronuptia de Paris GmbH (Frankfurt am Main) and Pronuptia de Paris Irmgard Schillgalis (Hamburg)[6].

The case was referred to the Court of Justice under Article 177 of the EEC Treaty by the German Federal Court of Justice for a preliminary ruling on the interpretation of Article 85 of the EEC Treaty and Commission Regulation No 67/67/EEC of 22 March, 1967, on the application of Article 85(3) of the Treaty to certain categories of **exclusive dealing agreements**. It concerned the franchisee's obligation to pay the franchisor arrears of fees. The Court came to a series of conclusions of general applicability in its discussion of the Pronuptia

[5] PRINCIPLES OF EUROPEAN LAW ON Commercial Agency, Franchise And Distribution Contracts, HESSELINK, MARTIJN WILLEM, Oxford University Press (2005)
[6] Case 161/84 of 28 January 1986

case. *Inter alia*, the Court admitted that the franchisor must be in a position to protect certain interests vital to the business and to the identity of the network (for example the know-how), although the provisions must be essential for this purpose. However, certain categories of clauses that limit the franchisee's activities (for example price determination clauses) were not considered acceptable by the Court.

Following the landmark Pronuptia decision, the Commission of the European Communities rendered several decisions on franchising case[7]s and adopted a Block Exemption Regulation on franchise agreements.

This Block Exemption Regulation entered into force on 1 February and remained in force until 31 May 2000, when it was superseded by a Block Exemption Regulation on Vertical Restraints (Commission Regulation (EC) No 2790/1999 Commission Regulation (EC) No 330/2010 on the application of Article 81(3) (now 101 (3) of the Treaty to categories of vertical agreements and concerted practices).

1.3. Franchising in Italy

On 6 May 2004 Law no. 129 bringing "Provisions for the discipline of commercial affiliation" (i.e. franchising) was signed by the President of the Italian Republic. It is a brief law, comprising only 9 articles (the "**Franchise Act**")[8]. The law deals not only with disclosure, but also with aspects of the relationship of the parties.

The disclosure requirements are divided between what must be stated in the agreement itself, and what must be provided in the appendices to the agreement. Furthermore, each of the two parties is under an

[7] Decision 87/14/EEC, Yves Rocher, of 17 December 1986 (OJ EEC L 8/49, 10.1.1987);Decision 87/17/EEC, Pronuptia, of 17 December 1986 (OJ EEC L 13/39, 15.1.1987); Decision 87/407, Computerland, of 13 July 1987 (OJ EEC L 222/12, 10.8.1987); Decision 88/604, ServiceMaster, of 20 August 1988 (OJ EEC L 332/38, 3.12.1988) and Decision 89/94/EEC, Charles Jourdan, of 2 December 1988 (OJ EEC L 35/31, 7.1.1989).
[8] IL CONTRATTO DI FRANCHISING La Nuova legge sull'affiliazione commerciale Le norme Antitrust, FABIO BORTOLOTTI, CEDAM (2004)

obligation to provide the other with information that the other would consider necessary or useful with a view to concluding the contract. The difference is that the franchisor must give this information if the franchisee requests it, whereas the franchisee must give the franchisor the information even if he does not request it.

Two interesting requirements are, first, a general requirement that the franchisor's commercial formula has been tested, even if no indication is given of the required length of testing or number of units, and, second, a requirement that the term of a definite period contract must be sufficiently long for the franchisee to amortise its investment, but in any event no shorter than three years.

As required by Article 4(2) of the Law, the Ministry for productive activities adopted a decree, Decree No. 204 of 2005 (the "**Franchise Regulation**"), containing disclosure requirements for cases in which the franchisor, before the date of signature of the franchise agreement, has been active only abroad but Italian law applies to the contract according to private international law. The Decree was adopted on 2 September 2005 and entered into force on 19 October 2005.

The Franchise Act provides the most common mandatory rules applicable to franchise agreements, generally aimed at protecting the prospective franchisee. According to section 3 of the Franchising Act, the franchise agreement must be executed in written form to become legally valid. The franchisor must have experimented with its own business formula on the market. The minimum duration of the agreement must be that which is necessary to allow the amortisation of the investment, and in any event the duration cannot be less than three years. Furthermore, it requires that at least 30 days prior to the contemplated execution date of the agreement, the franchisor provides the prospective franchisee with complete information, including a copy of the agreement to be signed and any relevant information concerning the franchisor's activity, including the following:

- ✓ basic information relevant to the agreement, including:
  - the amount of investment and entry fees to be paid by the franchisee before starting its activities;

- the royalties and fees to be paid to the franchisor;
- the territorial exclusivity, if any;
- the know-how to be transferred to the franchisee;
- the criteria for the recognition of know-how added by the franchisee;
- the services and assistance rendered by the franchisor; and
- the renewal, termination and assignment rules of the agreement;

✓ the contractual relationships between franchisor and franchisee, including the transfer of trademarks and other intellectual property rights and the pre-contractual obligations that the parties must comply with. Among the latter, reference is made to the disclosure of information and data useful for the stipulation of the contract (sections 4 to 6 of the Franchising Act);

✓ the possibility to agree, apart from the ordinary jurisdiction clauses or arbitration rules, upon a conciliation (alternative dispute resolution) procedure before the chamber of commerce of the territory in which the franchisee is located; and

✓ circumstances under which the contract may be declared void (section 8 of the Franchising Act).

The Franchise Regulation applies exclusively to franchisors active outside Italy. It mainly sets forth the rules on the pre-disclosure obligations of a foreign franchisor towards the franchisee.

The Franchise Regulation states that, at least 30 days prior to the contemplated execution date of the agreement, the franchisor must deliver to the prospective franchisee a complete set of all contractual documents and the attachments thereto. Moreover, within the same 30-day period, the franchisor must deliver a list of franchisees operating in each single state and the number of sales points related thereto. Upon the request of the prospective franchisee, the franchisor must also deliver the contact details of at least 20 operating franchisees, as well as information on judicial proceedings.

Furthermore, upon the request of the prospective franchisee, the franchisor must deliver a copy of all the information concerning the agreement and the attachments thereto in Italian.

As per the interpretation of the majority of scholars, nor does the FranchiseAct introduce any exception to the general international legal principles on conflict of laws. Hence, the parties are free to choose the law under which the contract will be governed. However, 'opting out' of Italian law will not apply with respect to those provisions set forth in the interest of the weakest party of the contract (namely the franchisee), such as, for instance, those concerning disclosure obligations (section 4 of the Franchising Act) and minimum content of the contract (section 3.4 of the Franchising Act).

Pre-contractual disclosure

Pursuant to sections 4 and 6 of the Franchising Act, the franchisor must disclose to the franchisee a complete set of information, with the exception of that which is actually reserved or whose disclosure may violate third parties' rights, at least 30 days before the stipulation of the contract.

Section 4 of the Franchising Act also states that the franchisor must make this disclosure to the prospective franchisee within the time frame indicated above. The disclosure obligation is therefore limited only to the pre-contractual phase, while the performance of the contract must be carried out by the parties in compliance with the principle of good faith set forth by section 1.375 of the Italian Civil Code. In light of the above, the Franchising Act sets no duty on the franchisor to update the information disclosed in the pre-contractual phase. However, in conformity with the good faith principle, the franchisor may be required by the franchisee to update the information provided in the pre-contractual phase if the update may be considered to be in the interests of the franchisee.

The Franchise Act requires the franchisor to provide the franchisee, as part of its pre-contractual information duties, with a list of affiliated franchisees and changes to affiliated franchisees in the past three years,

or at least as of the date of the start of business. This pre-contractual obligation implies that there must be a minimum level of activity and franchisees for a franchisor to start a franchise business in Italy. The exact determination of the business must be examined on a case-by-case basis.

The Franchise Regulation, however, sets a more stringent requirement for the pre-contractual information duties of franchisors that have operated exclusively outside Italy. They need to provide the prospective franchisee with a list of franchisees divided per country of operation. Upon the request of the franchisee, the franchisor must provide a list of at least 20 affiliated franchisees or, if the number is below 20, the complete list of franchisees. Therefore, similar to the Franchise Act, for foreign franchisors the minimum business requirements must be evaluated on a case-by-case basis.

Termination

The franchisor may terminate the franchise relationship in the case of default or non-performance of the franchisee's obligations. In general, termination is granted if the breach of the agreement can be considered a serious breach, such as a default in payment of fees and royalties, violation of any exclusivity rights on the product or non-compliance with the franchisors' standards. Given that it is a matter of interpretation, the agreement should clearly state the cases in which the franchisor can terminate the franchise relationship.

Similarly to termination by the franchisor, the franchisee may terminate in the case of default or non-performance of the contract terms by the franchisor. The breach must be serious; for example, the franchisor unreasonably suspending the supply of goods to the franchisee.

Please note that if the franchisee terminates the agreement, it is also entitled to the reimbursement of initial fees and costs, damages, or both. In practice, due to the extreme difficulties of proving and quantifying damages, franchise agreements usually grant the right for the franchisee to be reimbursed of the entrance fee, if any, or an obligation for the

franchisor to repurchase the franchisee's stock. However, a typical franchise agreement may include a penalty fee in favour of the franchisor if the franchisee terminates the agreement without reasonable cause.

Renewal

Pursuant to section 3, paragraph 4(g) of the Franchising Act, renewal conditions must be set forth in the agreement. It is therefore crucial to state such conditions clearly in the agreement. In principle, however, there is no legal obligation for the franchisor to renew the franchise agreement.

Nature of the franchisee

A franchisee within a franchise structure is always qualified as an undertaking. Therefore it has a fiscal code, and in general it is required to request a VAT code and be registered with the local competent Register of Undertakings.

However, within an atypical franchise structure, the franchisees may be qualified as professionals or 'semi-professionals', which in principle should exclude the franchisee from being treated as a consumer (but this is not always the case), or as occasional professionals without any organisation or entrepreneurial risk (eg, in a franchise system that contemplates the door-to-door sale of the franchise products, where the franchisee is not obliged to purchase the goods from the franchisor or any of its qualified suppliers within the franchise system).

In such an atypical franchise system, the franchisee may well be treated as a consumer, with all the consequences linked to that, especially regarding the rights to withdrawal and other protection rights.

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Businessjus 51 (2014)